



**AICPA
Adapted**

LO1 14. Acquiring net assets that constitute a business

Assume the net assets transferred from the investee qualify as a “business,” as that term is defined in FASB ASC Master Glossary. At what amount will Goodwill be reported in the financial statements of the acquiring company on January 1, 2016?

- a. \$100
- b. \$50
- c. \$0
- d. \$(50)

Use the following facts for Multiple Choice problems 15 and 16:

Assume that on January 1, 2016, the investor company issued 7,000 new shares of the investor company’s common stock in exchange for all of the individually identifiable assets and liabilities of the investee company. Fair value approximates book value for all of the investee’s identifiable net assets. The following financial statement information is for an investor company and an investee company on January 1, 2016, prepared immediately before this transaction.

	Book Values	
	Investor	Investee
Receivables & inventories	\$ 80,000	\$ 36,000
Land	160,000	80,000
Property & equipment	180,000	80,000
Total assets.	<u>\$420,000</u>	<u>\$196,000</u>
Liabilities.	\$126,000	\$ 63,000
Common stock (\$1 par)	16,000	8,000
Additional paid-in capital	224,000	120,000
Retained earnings	54,000	5,000
Total liabilities & equity	<u>\$420,000</u>	<u>\$196,000</u>
Net assets	<u>\$294,000</u>	<u>\$133,000</u>



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LO1 15. Asset acquisition (fair value equals book value)

If this transaction is to result in the investor recording no goodwill (or gain from “negative goodwill”), what is the per share fair value of the investor’s common stock?

- a. \$19/share
- b. \$28/share
- c. \$42/share
- d. \$60/share



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LO1 16. Asset acquisition (fair value equals book value)

Provide the investor company’s balance (i.e., on the investor’s books, before consolidation) for an “Investment in Investee” account immediately following the acquisition of the investee’s net assets:

- a. \$ 0
- b. \$ 7,000
- c. \$128,000
- d. \$133,000

Use the following facts for Multiple Choice problems 17 and 18 (each question is independent of the other):

The following financial statement information is for an investor company and an investee company on January 1, 2016. On January 1, 2016, the investor company’s common stock had a traded market value of \$22 per share, and the investee company’s common stock had a traded market value of \$18 per share.

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Multiple choice questions have been adapted from CPA exam questions to help students prepare for the exam.

computed for Goodwill is *negative*).²⁷ In that case, the investor recognizes the negative Goodwill as an ordinary **gain** in its income statement on the acquisition date.

To illustrate the computation and recognition of a bargain acquisition, assume that the parent company acquires a subsidiary, a private company, for \$200. Because the former owners of the subsidiary need to dispose of their investment by a specified date, they do not have sufficient time to market the company to multiple potential buyers. On the acquisition date, the fair value of the subsidiary's identifiable net assets is \$250, and the book value of the subsidiary's identifiable net assets is \$100. Our computation of Goodwill acquired in the purchase of the subsidiary is as follows:

	\$200	Purchase price of the subsidiary
–	250	Fair value of the subsidiary's identifiable net assets
=	\$ (50)	Unexplained negative residual (i.e., Bargain Purchase Gain)

The acquisition date journal entry recorded by the parent company will equal the fair value of ~~consid-~~ the subsidiary's identifiable net assets, as follows:

Equity investment.....	250	
Cash.....		200
Gain on bargain purchase.....		50
<i>(to record the purchase of the Equity Investment in the subsidiary)</i>		

Note that, immediately upon purchase, the parent company will recognize the Bargain Acquisition Gain. By immediately splitting the gain out of the investment account (and recognizing the gain in the parent's net income), the investment account represents the aggregate fair value of the acquired net assets. On the acquisition date, the parent will make the following consolidating entries to consolidate the controlling Equity Investment in the subsidiary.[†]

Equity investment	100
<i>(eliminates acquisition date stockholders' equity accounts against the investment account)</i>	

[A] Net assets (broken out into individual asset and liability accounts)	150	
Equity investment		150
<i>(eliminates the remaining Equity Investment account and reclassifies the AAP)</i>		

[†] Given that this represents an income statement account (i.e., immediate amortization of the AAP), a case could be made that this adjustment should be made via the **[D]** consolidating entry. However, the bargain acquisition gain "amortization" has no valid asset or liability account to include in the **[D]** entry. Therefore, we include the immediate recognition of the bargain purchase gain in the **[A]** entry.

The net result is that the gain on the bargain acquisition is recognized in the consolidated income statement immediately upon acquisition.

CHAPTER SUMMARY

The consolidation process combines the financial statements of the parent and its subsidiary by removing the Equity-Investment-related accounts from the parent's financial statements and replacing that information with the assets, liabilities, revenues and expenses of the subsidiary company. It is important to remember that the consolidation process does not result in any real adjustments to the parent or subsidiary accounting records. Instead, the consolidated financial statements are prepared after the financial statements have been prepared by the parent and subsidiary, and the consolidated financial statements are prepared to reflect the commonly controlled economic entity.

²⁷ A bargain acquisition might happen, for example, if a business combination is a forced sale (i.e., the seller is acting under compulsion). A bargain purchase might also happen if significant unrecognized contingencies exist at the acquisition date.

[†] This accounting treatment greatly simplifies the pre-consolidation equity method accounting and the resulting consolidation entries. If the net amount of the equity investment was recorded at \$200 on the acquisition date, the parent's pre-consolidation equity method accounting would need to record the gain on the parent's books (i.e., again, on the acquisition date), and a [C] consolidating entry would have been required to reverse that gain. In addition, the [A] entry would have required a \$50 credit to the income statement for the bargain purchase gain.

Cash	150	
Land		100
Gain on sale		50
<i>(to record the sale of Land to an unaffiliated company)</i>		

In addition, the parent company will record the following equity-method-related journal entries in its pre-consolidation accounting records:

Equity investment	50	
Income (loss) from subsidiary		50
<i>(to record the equity method adjustment for income recognized by the subsidiary)</i>		

Equity investment	20	
Income (loss) from subsidiary		20
<i>(to recognize the deferred intercompany profit when the land is sold to an unaffiliated entity)</i>		

Given that the 2016 transaction is with an unaffiliated party, the entire gain from both land transactions (i.e., the intercompany transaction and the independent transaction) will be recognized in the consolidated income statement. This means that the deferred profit of \$20 and the 2016 gain of \$50 recognized by the subsidiary will be combined for a \$70 gain recognized in the consolidated income statement. This is the same as taking the 2016 sales price (i.e., \$150) and subtracting the original cost of the Land (i.e., \$80); that is, it is like we are assuming the intercompany sale never took place. The effect of this transaction and the original sale (included in Retained Earnings by the parent) are reflected in the following excerpts from the consolidation worksheet in Exhibit 4.17:

EXHIBIT 4.17 Excerpts of Land-Transaction-Affected Accounts in Consolidation Spreadsheet in the Period in Which the Land Is Sold to an Unaffiliated Party (i.e., 2016)—Equity Method

	Consolidation Entries				
	Parent	Subsidiary	Debits	Credits	Consolidated
Income statement (excerpt):					
Gain on sale of land	\$ 0	\$50		[I _{gain}] 20	\$70
Income (loss) from subsidiary	70	0	[C] 70		0
Net effect on total profits	<u>\$70</u>	<u>\$50</u>	<u>70</u>	<u>20</u>	<u>\$70</u>
Balance sheet (excerpt):					
Land	\$ 0	\$ 0			\$ 0
Equity investment	\$50		[I _{gain}] 20	[C] 70	\$ 0
Accumulated in retained earnings	\$70	\$50	(NI) 70	(NI) 20	\$70

As we illustrate in Exhibit 4.17, the following consolidating entries are necessary to bring forward the Equity Investment account and to recognize the full \$70 of Gain on Sale of Land in 2016:

Consolidation entries to eliminate changes in the Equity Investment account during the year	[C]	Income (loss) from subsidiary	70	
		Equity investment		70
		<i>(consolidation entry to eliminate changes caused by equity method accounting)</i>		
Intercompany elimination entry in the year of sale to unaffiliated party	[I _{gain}]	Equity investment	20	
		Gain on sale of land		20
		<i>(to recognize deferred gain in year of sale to unaffiliated party)</i>		

recognizes its share of declared dividends under the cost method of pre-consolidation bookkeeping, there is no equity method income to eliminate. However, like the equity method case, the [C] entry still eliminates 100% of the subsidiary's declared dividends, introduces the income attributable to the noncontrolling interest for the consolidation year, and establishes the change in the noncontrolling interest balance sheet account for the year (i.e., the difference between the income attributable to the noncontrolling interest and the noncontrolling interest's share of declared dividends for the year). The computation of the income attributable to the noncontrolling interest for 2016 is as follows:

NCI share of the subsidiary's reported net income for 2016 ($20\% \times \$66,000$)	\$13,200
Less: 20% AAP amortization for 2016	(750)
Add: 20% of the BOY upstream intercompany inventory profits confirmed during 2016	N/A
Less: 20% of the EOY upstream intercompany inventory profits deferred from 2016	(1,575)
Add: 20% of the upstream confirmed intercompany depreciable asset profits ($20\% \times 1,500$)	300
Consolidated income attributable to the noncontrolling interest	<u>\$11,175</u>

Exhibit 5.16 presents the consolidation spreadsheet including the ADJ and C-E-A-D-I entries assuming a cost-method consolidation. Our consolidation entries are as follows:

[ADJ]	Investment in subsidiary.	91,950		Catch-up entry needed to place parent company on "as if equity method" basis at the beginning of the consolidation year. See computations above.
	Beg. retained earnings—Parent		91,950	
[C]	Income (loss) from subsidiary.	16,800		Removes dividend income from the income statement of the parent, and eliminates declared dividends from the equity section of the subsidiary. Establishes income attributable to the noncontrolling interest (see computation above) and the change in the noncontrolling interest on the balance sheet during the year (i.e., $\$6,975 = \$11,175 - [20\% \times \$21,000]$).
	Income attributable to NCI	11,175		
	Noncontrolling interest		6,975	
	Dividends—Subsidiary		21,000	
[E]	Common stock (S) @ BOY	195,000		Eliminates subsidiary Stockholders' Equity @ BOY. The credit to the Equity Investment eliminates the BOY balance recognized in the parent's Equity investment account. The credit to the Noncontrolling Interest Equity account establishes its balance @ BOY.
	Retained earnings (S) @ BOY	165,000		
	Investment in subsidiary @ BOY		288,000	
	Noncontrolling interest (@ BOY)		72,000	
[A]	Buildings & equipment, net @ BOY	7,500		Establishes the BOY 100% unamortized AAP for the identifiable net assets and goodwill. The credit to the Equity Investment eliminates the remaining BOY balance (i.e., not eliminated in [E]). The credit to noncontrolling interest equity account establishes its BOY AAP.
	Goodwill	48,000		
	Investment in subsidiary @ BOY		49,200	
	Noncontrolling interest @ BOY		6,300	
[D]	Depreciation & amortization expense.	3,750		Amortizes the 100% AAP for the year.
	Buildings and equipment, net		3,750	
[I _{cogs}]	Investment in subsidiary @ BOY	5,250		Recognizes the deferred downstream intercompany deferred inventory profit from the prior year.
	Cost of goods sold		5,250	
[I _{sales}]	Sales	33,000		Eliminates the intercompany inventory transactions for the year
	Cost of goods sold		33,000	
[I _{cogs}]	Cost of goods sold.	7,875		Defers the upstream intercompany deferred inventory profit from the current year .
	Inventories		7,875	
[I _{pay}]	Accounts payable.	7,500		Eliminates the intercompany payable and receivable at the end of the year
	Accounts receivable		7,500	
[I _{gain}]	Investment in subsidiary @ BOY	6,000		Adjusts for the BOY unconfirmed profit from the upstream intercompany depreciable asset transaction
	Noncontrolling interest @ BOY	1,500		
	Buildings & equipment, net @ BOY		7,500	
[I _{dep}]	Buildings & equipment, net	1,500		Confirms the current year of deferred profit from the upstream intercompany depreciable asset transaction
	Depreciation & amortization expense		1,500	

adjustments related to pre-consolidation investment accounting) is \$350,000. The subsidiary's recorded net income is \$70,000.

Based on this information, determine the balances for the accounts listed in questions 28-32:

L03

28. Equity investment accounting

Income from investment in subsidiary (on parent's pre-consolidations books preceding consolidation):

- a. \$21,000
- b. \$28,000
- c. \$56,000
- d. \$63,000

L03

29. Intercompany sale of depreciable assets

Consolidated building (net of accumulated depreciation):

- a. \$210,000
- b. \$245,000
- c. \$294,000
- d. \$336,000

L03

30. Intercompany sale of depreciable assets

Consolidated depreciation expense:

- a. \$25,200
- b. \$29,400
- c. \$42,000
- d. \$49,000

L02, 3

31. Intercompany sale of depreciable assets

Consolidated net income attributable to the controlling interest:

- a. \$371,000
- b. \$378,000
- c. \$406,000
- d. \$413,000

L02, 3

32. Noncontrolling interest and intercompany sale of depreciable assets

Consolidated income attributable to noncontrolling interest:

- a. \$15,400
- b. \$14,000
- c. \$7,000
- d. \$5,600

EXERCISES

L02

33. Preparing a consolidated income statement—With noncontrolling interest, but no AAP or intercompany profits

A parent company purchased a 70% interest in its subsidiary several years ago with no AAP (i.e., purchased at book value). Each reports the following income statement for the current year:

	Parent	Subsidiary
Income statement:		
Sales	\$6,000,000	\$900,000
Cost of goods sold	(4,200,000)	(540,000)
Gross profit	1,800,000	360,000
Income (loss) from subsidiary	88,200	0
Operating expenses	(1,140,000)	(234,000)
Net income	<u>\$ 748,200</u>	<u>\$126,000</u>

- a. Compute the Income (loss) from subsidiary of \$88,200 reported by the parent company.
- b. Prepare the consolidated income statement for the current year.

100% AAP:

		Year Ended December 31,				
100% AAP Amortization – Dr (Cr)		2012	2013	2014	2015	2016
Accounts receivable		\$ (8,000)	\$ —	\$ —	\$ —	\$ —
Property, plant & equipment, net		7,200	7,200	7,200	7,200	7,200
Patents		12,000	12,000	12,000	12,000	12,000
Notes payable		3,000	3,000	3,000	3,000	—
Net amortization		<u>\$14,200</u>	<u>\$22,200</u>	<u>\$22,200</u>	<u>\$22,200</u>	<u>\$19,200</u>

		December 31,				
100% Unamortized AAP – Dr (Cr)	Jan. 1, 2012	2012	2013	2014	2015	2016
Accounts receivable	\$ (8,000)	\$ —	\$ —	\$ —	\$ —	\$ —
PPE, net	36,000	28,800	21,600	14,400	7,200	—
Patents	84,000	72,000	60,000	48,000	36,000	24,000
Notes payable	12,000	9,000	6,000	3,000	—	—
Goodwill	36,000	36,000	36,000	36,000	36,000	36,000
Unamortized balance	<u>\$160,000</u>	<u>\$145,800</u>	<u>\$123,600</u>	<u>\$101,400</u>	<u>\$79,200</u>	<u>\$60,000</u>

80% AAP:

		Year Ended December 31,				
80% AAP Amortization – Dr (Cr)		2012	2013	2014	2015	2016
Accounts receivable		\$(6,400)	\$ —	\$ —	\$ —	\$ —
Property, plant & equipment, net		5,760	5,760	5,760	5,760	5,760
Patents		9,600	9,600	9,600	9,600	9,600
Notes payable		2,400	2,400	2,400	2,400	—
Net amortization		<u>\$11,360</u>	<u>\$17,760</u>	<u>\$17,760</u>	<u>\$17,760</u>	<u>\$15,360</u>

		December 31,				
80% Unamortized AAP – Dr (Cr)	Jan. 1, 2012	2012	2013	2014	2015	2016
Accounts receivable	\$ (6,400)	\$ —	\$ —	\$ —	\$ —	\$ —
PPE, net	28,800	23,040	17,280	11,520	5,760	—
Patents	67,200	57,600	48,000	38,400	28,800	19,200
Notes payable	9,600	7,200	4,800	2,400	—	—
Goodwill*	30,400	30,400	30,400	30,400	30,400	30,400
Unamortized balance	<u>\$129,600</u>	<u>\$118,240</u>	<u>\$100,480</u>	<u>\$82,720</u>	<u>\$64,960</u>	<u>\$49,600</u>

*\$360,000 – (80% × [\$288,000 – \$8,000 + \$36,000 + \$84,000 + \$12,000]) = \$30,400

20% AAP:						
		Year Ended December 31,				
20% AAP Amortization – Dr (Cr)		2012	2013	2014	2015	2016
Accounts receivable.....		\$(1,600)	\$ —	\$ —	\$ —	\$ —
Property, plant & equipment, net		1,440	1,440	1,440	1,440	1,440
Patents		2,400	2,400	2,400	2,400	2,400
Notes payable		600	600	600	600	—
Net amortization		<u>\$ 2,840</u>	<u>\$4,440</u>	<u>\$4,440</u>	<u>\$4,440</u>	<u>\$3,840</u>

December 31,						
20% Unamortized AAP – Dr (Cr)	Jan. 1, 2012	2012	2013	2014	2015	2016
Accounts receivable.....	\$ (1,600)	\$ —	\$ —	\$ —	\$ —	\$ —
PPE, net	7,200	5,760	4,320	2,880	1,440	—
Patents	16,800	14,400	12,000	9,600	7,200	4,800
Notes payable	2,400	1,800	1,200	600	—	—
Goodwill*	5,600	5,600	5,600	5,600	5,600	5,600
Unamortized balance	<u>\$30,400</u>	<u>\$27,560</u>	<u>\$23,120</u>	<u>\$18,680</u>	<u>\$14,240</u>	<u>\$10,400</u>

* \$88,000 – (20% × [\$288,000 – \$8,000 + \$36,000 + \$84,000 + \$12,000]) = \$5,600

c. **Intercompany depreciable asset sale:**

One downstream asset sale.

Intercompany profit recognized on December 31, 2014: \$130,000 – \$100,000 = \$30,000, 5-year remaining life

Profit confirmed each year: \$30,000/5 = \$6,000

	Downstream	Upstream
Net intercompany profit deferred at January 1, 2016	\$24,000	
Less: Deferred intercompany profit recognized during 2016	<u>6,000</u>	
Net intercompany profit deferred at December 31, 2016	<u>\$18,000</u>	

Intercompany inventory transactions:

Intercompany inventory sales during 2016: \$48,000

	Downstream (in Subsidiary's Inventory)	Upstream (in Parent's Inventory)
Intercompany profit in inventory on January 1, 2016	\$ 0	\$6,600
Intercompany profit in inventory on December 31, 2016	<u>\$8,400</u>	<u>\$ 0</u>

Intercompany accounts receivables and payables at December 31, 2016: \$16,000

- d. The following is the general formula for computing the Equity Investment account (under the equity method) at any point in time:

	(1) p% × book value of the net assets of the subsidiary
Plus:	(2) Unamortized p% AAP
Less:	(3) 100% × downstream deferred intercompany profits
Less:	(4) p% × upstream deferred intercompany profits
	<u>Equity method Equity Investment account</u>

29. Attributes of Special Purpose Entities

Which of the following characteristics does not usually exist for a special purpose entity (SPE) that is used in a securitization transaction?

- a. The SPE is usually legally distinct from the sponsoring company that forms the SPE and is bankruptcy remote
- b. If the SPE is formed to securitize accounts receivable, then the SPE's security holders are only repaid if the securitized accounts receivable are collected
- c. The SPE is expected to seek strategic business opportunities that maximize returns to the SPE's equity investors
- d. All of the above

L01AICPA
Adapted**30. Examples of variable interests**

Which of the following is not a variable interest?

- a. Common stock
- b. Guarantee of indebtedness
- c. Corporate bond rated BBB- by Standard & Poors
- d. U.S. treasury bond

L02AICPA
Adapted**31. Scope of FASB ASC 810 ("Consolidations")**

Which of the following is not automatically exempt from the consolidation guidance included in FASB ASC 810 ("Consolidations")?

- a. Legal entities that meet the definition of "businesses" as defined by FASB ASC 805 ("Business Combinations")
- b. Legal entities that are not-for profit
- c. Legal entities that administer employee benefit plans subject to FASB ASC 712 ("Compensation—Nonretirement Postemployment Benefits")
- d. Legal entities that qualify as investments accounted for at fair value in accordance with the specialized guidance in FASB ASC 946 ("Financial Services—Investment Companies")

L02AICPA
Adapted**32. Shortcut to voting interest entity consolidation evaluation**

If a legal entity is within the scope of FASB ASC 810 ("Consolidations"), when can a reporting company completely skip an evaluation of whether the legal entity is a variable interest entity (i.e., the "variable interest entity model") and solely determine consolidation based on whether the reporting company owns a majority of the voting common stock of the legal entity (i.e., the "voting interest entity model")?

- a. The legal entity is only capitalized with a bank loan and voting common stock
- b. The legal entity satisfies **none of the** four conditions for the business-related scope exception
- c. The reporting company does not have the power to direct the activities that most significantly impact the legal entity's business activities
- d. The reporting company does not have the obligation to absorb the losses of the legal entity that could potentially be significant to the legal entity

L02AICPA
Adapted**33. Determination of primary beneficiary**

FASB ASC 810 ("Consolidations") states that a Primary Beneficiary is the company that consolidates a variable interest entity (VIE). What is the triggering condition for a reporting entity to be deemed the Primary Beneficiary of a VIE in which the reporting entity has a variable interest?

- a. The reporting entity owns a majority of the voting common stock of the VIE
- b. The reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance
- c. The reporting entity has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.
- d. The reporting entity has both b and c, above

L02AICPA
Adapted**34. Initial recognition of consolidated legal entity by primary beneficiary**

When a Primary Beneficiary initially consolidates a variable interest entity (VIE), the primary beneficiary must determine whether the VIE is a "business" as defined by FASB ASC 805 ("Business Combinations") because

- a. FASB ASC 805 only applies to acquisitions of "businesses," so the Primary Beneficiary can avoid consolidation if the VIE is not a business
- b. Goodwill is only recognized by the Primary Beneficiary when a consolidated VIE is a "business"

L02AICPA
Adapted

lower of cost or market on the balance sheet when it is not hedged, will be reported at fair value under hedge accounting, with changes in fair value reflected in current earnings. Accounting for changes in the fair value of hedged assets and liabilities in current earnings does not result in increased earnings volatility to the extent that the hedge is effective, however, as the inventory gains (losses) are offset by losses (gains) in the derivative security.

Foreign Currency Fair Value Hedge Example Hedge accounting can be used to reduce the effects of changes in fair values of recognized assets and liabilities. In this example, we illustrate the accounting for a foreign currency fair value hedge of an available-for-sale security with a purchase price of €100,000 that a company purchases on September 30 and intends to sell in 3 months. Assume that current exchange rate (“spot rate”) on the date the security is purchased is \$1.50:€1 and the company is concerned about the prospect of a weakening \$US that will reduce the \$US fair value of the security. To hedge this risk, the company purchases a forward contract to sell €100,000 for \$1.49:€1 (the current forward rate) on December 31. On December 31, the spot rate for the Euro is \$1.30 as summarized in the following table:

Date	Spot Rate	Forward Exchange Rate to 12/31/01	Fair Value of Forward Contract
September 30.....	\$1.50:€1	\$1.49:€1	\$ —
December 31	\$1.30:€1	\$1.30:€1	19,000
$(\$1.49:€1 - \$1.30:€1) \times €100,000 = \$19,000$			

We summarize the accounting for the available-for-sale security and the derivative security (the forward contract) as follows:¹⁷

Transaction	AFS Security	Forward Contract
At inception	Investment in AFS security..... 150,000 Cash 150,000 (to record the purchase of the AFS security for €100,000 when the exchange rate is \$1.50:€1)	No entry
At maturity	Loss on hedge activity..... 20,000 Investment in AFS security... 20,000 (to record the decrease in the value of the AFS security $[\$1.30:€1 - \$1.50:€1] \times €100,000 = \$20,000$) Cash..... 130,000 Investment in AFS security.. 130,000 (to record the sale of the security at the spot rate of \$1.30:€1)	Forward contract receivable... 19,000 Gain on hedge activity..... 19,000 (to record the increase in fair value of the forward contract $[\$1.49:€1 - \$1.30:€1] \times €100,000 = \$19,000$) Cash..... 19,000 Forward contract receivable... 19,000 (to record the settlement of the forward contract)

Notice that, under a fair value hedge, both the hedge (the forward contract) and the asset to which it relates (the AFS security) are reported at fair value on the balance sheet and that changes to their respective fair values are recognized in current earnings. In this case, the increase in the \$US value of the forward contract offsets the decrease in the \$US value of the AFS security and the net cost to the company (recognized in earnings) is the \$1,000 difference between the spot and forward rates at the inception of the forward contract. This is the “cost” of the hedge that the company locked in at inception in order to avoid the prospect of a greater loss in the future.

The net effect is that the fluctuation in Stockholders’ equity has also been minimized as the decline in the \$US value of one asset (AFS security) is offset by the increase in the \$US value of the other (forward contract). In addition, the fluctuation in net income arising from changes in foreign exchange rates is minimized as the changes in fair values of the two assets are both reflected in current earnings, leaving only the \$1,000 cost of the hedge as an expense in the company’s income statement. And, finally, the effect on cash flow is minimized as the cash inflow from the forward contract nearly offsets the reduced cash flow from the sale of the AFS security when the €100,000 is converted into \$US.

¹⁷ In order to focus on the accounting for derivative securities in this example, we are only hedging the exposure to changes in fair value of the AFS security arising from fluctuations in foreign exchange rates. AFS securities can also fluctuate in value because of fluctuations in stock prices, and we are holding the stock price constant in this case.

continued

- a. Interest rate risk must be the only risk identified as the hedged risk.
- b. The hedging instrument involves an interest rate swap.
- c. The hedge must involve a recognized interest-bearing financial asset or liability.

The critical terms match approach. If the critical terms of the hedging instrument and of the entire hedged asset or liability or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. Critical terms can be assumed to match if

- 1) The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
- 2) The fair value of the forward contract at inception is zero.
- 3) Either of the following criteria is met:
 - a) The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in earnings
 - b) The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity. (FASB ASC 815-20-25-84)

In this abbreviated method, the entity may forego performing a detailed effectiveness assessment in each period.

The FASB provides a number of examples of the determination of hedge effectiveness in ASC 815-25-55 and 815-30-55.

PRACTICE INSIGHT

Counter-Party Risk The purpose of derivative financial instruments is to transfer risk from one company to another. For example, a company might be concerned about the possible decline in the \$US value of a foreign-currency-denominated account receivable. In order to hedge that risk, the company might execute a forward contract to sell the foreign currency and receive \$US. That forward contract only has value, however, if the party on the other side of the transaction (the counter-party) ultimately purchases the foreign currency for \$US when the contract matures. If the counter-party fails to honor its part of the agreement, the forward contract is of no value.

The risk that the other party might not live up to its part of the bargain is known as *counter-party risk*. The only justification for recognizing a gain in a forward contract to offset the loss in a foreign-currency-denominated receivable is the expectation that the counter-party has the intention and ability to purchase the foreign currency in exchange for \$US when the contract matures.

Counter-party risk is very real. Many companies require counter-parties to back up their agreement with cash collateral or other acceptable forms of guarantees (like a bank letter of credit, for example). Disclosures relating to counter-parties are, generally, not adequate to assess the risk of non-performance. As a result, there is a hidden risk in companies' use of derivatives that is difficult to quantify.

Foreign Currency Hedge: Use of a Forward Contract to Hedge a Firm Commitment to Pay Foreign Currency²⁰

On September 30, 2014, a U.S. company enters into a firm commitment to purchase equipment from a foreign supplier for €1,000,000.²¹ The equipment is deliverable on March 31, 2015, and the €1,000,000 payment is due on June 30, 2015. The company expects the \$US to weaken during this period of time. To hedge the commitment to pay €1,000,000, the company enters into a forward exchange contract on September 30, 2014, to receive €1,000,000 on June 30, 2015, at an exchange rate of €1:US\$1.32. The

²⁰ Effective hedges of *forecasted* foreign-currency-denominated transactions (i.e., that are not firm commitments) can only be accounted for as cash flow hedges (FASB ASC 815-20-25-38). In contrast, recognized foreign-currency-denominated assets and liabilities and unrecognized foreign-currency-denominated firm commitments are afforded the choice of applying cash-flow hedge accounting or fair value hedge accounting (FASB ASC 815-20-25-12 and -38). This example illustrates fair value hedge treatment.

²¹ Recall that an unrecognized firm commitment is an agreement for future performance that (1) specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction and (2) includes a disincentive for nonperformance that is sufficiently large to make performance virtually assured.

EXHIBIT 7.2 (cont.) Summary of Hedge Accounting for Derivatives

Journal Entries for Hedges Assets and Losses
(Journal entries for liabilities and gains are reversed)

Fair Value**Cash Flow****At each balance sheet date****Forward contract:**

Asset loss	same
Asset	xxx
Fwd. Contr.	xxx
Fwd. Contr. gain	same
<i>(to record changes in fair value)</i>	

Forward contract:

Fwd. Contr.	xxx
AOCI	xxx
<i>(to record changes in fair value)</i>	

Option contract:

Asset loss	same
Asset	xxx
Option Contr.	xxx
Option Contr. gain	same
<i>(to record changes in fair value)</i>	

Option contract:

Option Contr.	xxx
AOCI	xxx
Option exp. (NI) ¹	xxx
Option Contr.	xxx
<i>(to record changes in fair value)</i>	

¹Option expense is the change in the time value of the option.**Forward or Option for Firm commitment:**

Loss on firm commitment	same
Firm commitment	xxx
Option/Forward Contract	xxx
Option/Forward contract gain	same
<i>(to record changes in fair value)</i>	

Expiration date

Accrue gains (losses) on asset and derivative as above

Accrue gains (losses) on asset and derivative as above

Forward contract:

Cash	xxx
Fwd. Contr.	xxx
<i>(to record receipt of cash and close-out of forward contract)</i>	

Option contract:

Cash	xxx
Option	xxx
<i>(to record receipt of cash and close-out of option)</i>	

Forward or Option for Firm Commitment:

Cash	xxx
Fwd. Contr./Option	xxx
Firm commitment	xxx
Adj. to income	xxx
<i>(to record receipt of cash and close-out of forward contract or option)</i>	

Forward contract:

Cash	xxx
Fwd. Contr.	xxx
AOCI	xxx
Adj. to sales†	xxx
<i>(to record receipt of cash, close-out the forward contract, and reverse the previously recorded AOCI)</i>	

Option contract:

Cash	xxx
Option	xxx
AOCI	xxx
Adj. to sales†	xxx
<i>(to record receipt of cash, close-out the option contract, and reverse the previously recorded AOCI)</i>	

Forecasted cash flow:

Cash	xxx
Sales†	xxx

† A common forecasted cash inflow is sales, which is why we are designating it as such. If the cash inflow is from another source, then that account would be credited for the transaction itself and for the reversal for AOCI.

Hedge of an Available-for-Sale Security with a Put Option

Our company owns 500,000 shares of XYZ's publicly traded stock. As of January 1 these shares are trading at \$50 per share and we have an unrealized gain relating to this investment of \$1,000,000 in Accumulated Other Comprehensive Income (AOCI). We are concerned that the market price of the shares may decline and lock in our unrealized gain with the purchase of a put option on XYZ's stock from a bank for \$100,000. This put option allows our company to sell our 500,000 shares of XYZ stock to the bank at \$50 per share at December 31 of the current year.

The share price and fair value of our investment in XYZ were as follows:

Date	Share Price	Fair Value
January 1	\$50	\$25,000,000
March 31	60	30,000,000
June 30	45	22,500,000
September 30	40	20,000,000
December 31	30	15,000,000

The fair value (assumed and provided to us by our bank), intrinsic value, and time value of the put option are as follows:

Date	(A) Fair Value	(B) Intrinsic Value	(A) – (B) Time Value
January 1	\$ 100,000	\$ —	\$100,000
March 31	90,000	—	90,000
June 30	2,575,000	2,500,000	75,000
September 30	5,025,000	5,000,000	25,000
December 31	10,000,000	10,000,000	—

The following journal entries will be made January 1, March 31, June 30, September 30, and December 31:

Date	Journal Entries		
January 1	Purchased put option (B/S)	100,000	
	Cash (B/S)		100,000
	<i>(to record the purchased put option in the statement of financial position at fair value)</i>		
March 31	Option expenses - change in the time value of the put option (I/S)	10,000	
	Purchased put option (B/S)		10,000
	<i>(to record the change in the time value portion of the put option (\$90,000 – \$100,000) = (\$10,000))</i>		
	Investment in XYZ (B/S)	5,000,000	
	OCI		5,000,000
	<i>(to record the increase in fair value of the investment in XYZ in OCI; note that there was no change in the intrinsic value of the put option \$30,000,000 – \$25,000,000 = \$5,000,000)</i>		
June 30	Option expenses - change in the time value of the put option (I/S)	15,000	
	Purchased put option (B/S)		15,000
	<i>(to record the change in the time value portion of the put option \$75,000 – \$90,000 = (\$15,000))</i>		
	Purchased put option (B/S)	2,500,000	
	Unrealized gain on put option (I/S)		2,500,000
	<i>(to record the change in the intrinsic value of the purchased put option)</i>		
	OCI	5,000,000	
	Unrealized loss on investment in XYZ (I/S)	2,500,000	
	Investment in XYZ (B/S)		7,500,000
	<i>(to record the change in fair value of the investment in XYZ. Note that the loss on this investment that is recognized in earnings is limited to the change in the put option's intrinsic value (i.e., the hedged risk). The remainder of the change in fair value is recorded in OCI. \$22,500,000 – \$30,000,000 = (\$7,500,000))</i>		

Date	Journal Entries		
September 30	Option expenses - change in the time value of the put option (I/S)	50,000	
	Purchased put option (B/S)		50,000
	<i>(to record the change in the time value of the put option</i> $\$25,000 - \$75,000 = (\$50,000)$)		
	Purchased put option (B/S)	2,500,000	
	Unrealized gain on put option (I/S)		2,500,000
	<i>(to record the change in the intrinsic value portion of the purchased put option $\\$5,000,000 -$</i> $\$2,500,000 = \$2,500,000$)		
	Unrealized loss on investment in XYZ (I/S).	2,500,000	
	Investment in XYZ (B/S).		2,500,000
	<i>(to record the change in fair value of the investment in XYZ</i> $\$20,000,000 - \$22,500,000 = (\$2,500,000)$)		
December 31	Option expenses - change in the time value of the put option (I/S)	25,000	
	Purchased put option (B/S)		25,000
	<i>(to record the change in the time value portion of the put option</i> $\$0 - \$25,000 = (\$25,000)$)		
	Purchased put option (B/S)	5,000,000	
	Unrealized gain on put option (I/S)		5,000,000
	<i>(to record the change in the intrinsic value of the purchased put option, this entry would be made</i> <i>prior to the settlement of the put option $\\$10,000,000 - \\$5,000,000 = \\$5,000,000$)</i>		
	Unrealized loss on investment in XYZ (I/S).	5,000,000	
	Investment in XYZ (B/S).		5,000,000
	<i>(to record the change in fair value of the investment in XYZ</i> $\$15,000,000 - \$20,000,000 = (\$5,000,000)$)		
	Cash (B/S)	25,000,000	
	Investment in XYZ (B/S).		15,000,000
	Purchased put option (B/S)		10,000,000
	<i>(to record the settlement of the purchased put option through delivery of the shares of XYZ's stock</i> <i>at a price of \$50 per share to the bank)</i>		
	AOCI (B/S)	1,000,000	
	Realized gain on investment in XYZ (I/S).		1,000,000
	<i>(to reclassify the unrealized gain on XYZ's shares from AOCI to earnings on the sale of the shares</i> <i>to the bank)</i>		

Even though XYZ's share price fell to \$30 per share, we were able to lock in a \$50 share price as a result of entering into the put option. Thus, we were able to realize the gain of \$1,000,000 that we originally wanted to protect (less the \$100,000 premium paid for the option).

Superscript ^{A, (B)} denotes assignments based on Appendix 7A (B).

QUESTIONS

- What is the definition of an "exchange rate" as the term is used in FASB ASC 830?
(Hint: See the Glossary to FASB ASC 830.)
- Briefly explain why the value of the \$US fluctuates vis-à-vis other world currencies.
- Explain why a weakening \$US can result in a higher level of reported sales, expense and profit even if unit volumes remain constant.
- Why is it necessary to translate foreign-currency-denominated income statement and balance sheet items into \$US?
(Hint: See FASB ASC 830-10-10.)
- FASB ASC 830 requires the recognition in income of transaction gains and losses that result from fluctuations in the fair value of the \$US vis-à-vis other world currencies. What is the rationale for the recognition of these gains and losses in income?
(Hint: See FASB ASC 830-20-35-1.)

**FASB ASC
Research**

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Research**

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Research**

Prepare the journal entries to record the purchase (assume perpetual inventory accounting), the required adjusting entry at December 31, and the payment on March 15.

23. Journal entries for an account payable denominated in Canadian Dollars (\$US strengthens)

LO1

Assume that your company purchases inventories from a Canadian supplier on November 3. The invoice specifies that payment is to be made on February 1 in Canadian dollars (\$CAD) in the amount of \$75,000 (CAD). Your company operates on a calendar year basis.

Assume the following exchange rates:

November 3	\$0.90:CA \$1
December 31	\$0.80:CA \$1
February 1	\$0.75:CA \$1

Prepare the journal entries to record the purchase (assume perpetual inventory accounting), the required adjusting entry at December 31, and the payment on Feb. 1.

24. Journal entries for an account receivable denominated in Euros (\$US weakens)

LO1

Assume that your company sells products to a customer located in France on October 15. The invoice specifies that payment is to be made on January 15 in Euros (€) in the amount of €350,000. Your company operates on a calendar year basis.

Assume the following exchange rates:

October 15	\$0.90:€1
December 31	\$1.05:€1
January 15	\$1.10:€1

Prepare the journal entries to record the sale (ignore cost of goods sold), the required adjusting entry at December 31, and the receipt of payment January 15.

25. Journal entries for an account receivable denominated in Swiss Francs (\$US strengthens)

LO1

Assume that your company sells products to a customer located in Switzerland on November 20. The invoice specifies that payment is to be made on February 20 in Swiss Francs (CHF) in the amount of CHF 275,000. Your company operates on a calendar year basis.

Assume the following exchange rates:

November 20	\$1.15:1CHF
December 31	\$1.10:1CHF
February 20	\$1.05:1CHF

Prepare the journal entries to record the sale (ignore cost of goods sold), the required adjusting entry at December 31, and the receipt of payment February 20.

26. Economics of a fair value hedge

LO2

On September 30, our company executed a purchase order to buy 100,000 lbs. of copper on December 31 at a purchase price of \$2.28/lb., the spot rate on the date the purchase order is signed. Also on September 30, we execute a forward contract to sell 100,000 lbs. of copper for ~~\$0.92/lb.~~ the forward price in effect on that date. Since this is a firm commitment, we classify this transaction as a fair value hedge and we can apply hedge accounting because we believe the hedge to be highly effective.

\$2.25/lb.,

The price of copper and the fair value of the forward contract on September 30 and December 31 are as follows:

	Copper	Forward Contract
September 30	\$2.28	\$2.25
December 31	\$2.21	\$2.21

**L02 34. Calculating the purchase cost of inventory in a fair value hedge of a firm commitment.**

Assume that our company enters into a firm commitment on July 15 to purchase 1,000 troy ounces of gold in December that will be used in our manufacturing process. The firm price commitment is required by our supplier. We expect the price of gold to decline over this period, however, and would, therefore, prefer to purchase it at the prevailing market price. Therefore, on July 15, we enter into a six-month forward contract to sell 1,000 troy ounces of gold on December 15 at the current forward rate of \$310/troy ounce. Thus, the forward contract essentially “unlocks” the firm commitment. The forward contract requires net cash settlement on December 31, 20X1 and has a fair value of zero at inception. Assume that the spot price for gold declines to \$285 on December 15. At what amount will the gold inventory be recorded when purchased?

L02 35. Interpreting footnote disclosure—Tiffany & Co.

Tiffany & Co. reports the following table in the footnotes to its 2015 10-K:

(in thousands)	Years Ended January 31,			
	2015		2014	
	Pre-Tax Gain (Loss) Recognized in OCI (Effective Portion)	Pre-Tax Gain (Loss) Reclassified from Accumulated OCI into Earnings (Effective Portion)	Pre-Tax Gain (Loss) Recognized in OCI (Effective Portion)	Pre-Tax Gain (Loss) Reclassified from Accumulated OCI into Earnings (Effective Portion)
Derivatives in Cash Flow Hedging Relationships:				
Foreign exchange forward contracts ^a	\$23,225	\$18,717	\$16,184	\$17,660
Put option contracts ^a	—	—	1,241	2,201
Precious metal forward contracts ^a	(4,428)	(4,173)	(8,709)	(4,376)
Forward-starting interest rate swaps ^b	(4,177)	(1,517)	—	(1,535)
	<u>\$14,620</u>	<u>\$13,027</u>	<u>\$ 8,716</u>	<u>\$13,950</u>

^a The gain or loss recognized in earnings is included within cost of sales.

^b The gain or loss recognized in earnings is included within interest expense and financing costs.

Describe the difference in the impact on Tiffany’s financial statements of the “Pre-Tax Gain (Loss) Recognized in OCI (Effective Portion)” and “Pre-Tax Gain (Loss) Reclassified from Accumulated OCI into Earnings (Effective Portion).”

PROBLEMS

**L02 36.^B Use of futures contracts to hedge cotton inventory—fair value hedge**

On December 1, 2014, a cotton wholesaler purchases 7 million pounds of cotton inventory at an average cost of 75 cents per pound. To protect the inventory from a possible decline in cotton prices, the company sells cotton futures contracts for 7 million pounds at 66 cents a pound for delivery on June 1, 2015, to coincide with its expected physical sale of its cotton inventory. The company designates the hedge as a fair value hedge (i.e., the company is hedging changes in the inventory’s fair value, not changes in cash flows from anticipated sales). The cotton spot price on December 1 is 74 cents per pound.

On December 31, 2014, the company’s fiscal year-end, the June cotton futures price has fallen to 56 cents a pound, and the spot price has fallen to 65 cents a pound. On June 1, 2015, the company closes out its futures contracts by entering into an offsetting contract in which it agrees to buy June 2015 cotton futures contracts at 47 cents a pound, the spot rate on that date. Finally, the company sells its cotton for \$0.47 per pound on June 1, 2015.

Following are futures and spot prices for the relevant dates:

Date	Spot	Futures
December 1, 2014	74¢	66¢
December 31, 2014	65¢	56¢
June 1, 2015	47¢	n/a

Prepare the journal entries to record the following:

- Purchase of cotton
- Sale of cotton futures contract
- Adjusting entry at December 31
- Sale of cotton on June 1

37.^B Use of futures contracts to hedge a forecasted transaction—cash flow hedge

LO2

As of January, our company plans to purchase 200,000 lbs. of copper on May 31 at the prevailing spot rate. To hedge this forecasted transaction, we purchase May futures contracts in January for 200,000 lbs. of copper at the futures price of \$1.58/lb. On May 31, we close out our futures contracts by entering into an offsetting contract in which we agree to buy 200,000 lbs. of May copper futures contracts at \$1.84/lb., the spot rate on that date. We also purchase 200,000 lbs. of copper at \$1.84/lb. on that date. Finally, we sell the inventory in June for \$2.06/lb. Our company operates on a calendar year and issues financial statements quarterly.

Following are futures and spot prices for the relevant dates:

Date	Spot	Futures
January	\$1.44	\$1.58
March 31	\$1.52	\$1.67
May 31	\$1.84	n/a

Prepare the journal entries to record the following:

- Purchase of copper futures contract in January
- Adjusting entry at March 31
- Purchase of copper on May 31
- Sale of copper on June 1

38. Use of variable-for-fixed swap agreement—fair value hedge

LO2

On June 30, our company borrows \$25 million of 5-year 7.5% fixed-rate interest-only nonprepayable debt. We prefer variable-rate debt since our cash flows are positively correlated to the level of interest rates, and decide to enter into a fixed-for-variable interest rate swap. Under the terms of the swap, we receive interest at a fixed rate of 7.5% and pay interest at a variable rate equal to the six-month U.S. LIBOR, based on a notional amount of \$25 million. Both the debt and the swap require that payments be made or received on December 31 and June 30. The six-month U.S. LIBOR rate on each reset date determines the variable portion of the interest-rate swap for the following six-month period. Our company designates the swap as a fair value hedge of the fixed-rate debt, with changes in the fair value that are due to changes in benchmark interest rates being the specific risk that is hedged.

The six-month U.S. LIBOR rates and the swap and debt fair values are assumed to be as follows for the first year of the swap and debt agreements:

Date	Six-Month U.S. LIBOR Rate	SWAP Fair Value	Debt Carrying Value
June 30 (date of borrowing)	6.00%	\$ 0	\$25,000,000
December 31	5.75%	68,750	25,068,750
June 30 (following year)	5.50%	137,500	25,137,500

Prepare the journal entries to record the following:

- Borrowing on June 30 (year of borrowing)
- Interest payment at December 31
- Interest payment at June 30 (following year)

39.^B Use of futures contracts to hedge available-for-sale securities --fair value hedge

LO2

On June 1, our company purchases \$10 million book value of corporate bonds that we classify as available-for-sale (AFS). We intend to sell these securities on September 30 to meet planned funding needs. Since an increase in interest rates will cause the fair value of the securities to decrease, we decide

to hedge against the risk of loss in the fair value of the debt securities that would result if the interest rates were to rise. As a result, we sell September Treasury-note futures contracts on June 1 in the amount of the debt securities.

We have determined that the hedging relationship between the futures contracts and the debt securities is highly effective (both at the inception of the relationship and on an ongoing basis) in achieving offsetting changes in the fair value that are due to changes in the benchmark interest rate. Accordingly, this transaction is designated as a fair value hedge.

Interest rates rise as we had predicted, and the prices of the corporate bonds (the hedged item) and the futures contracts (the hedging instrument), and the resulting gains and losses, are as follows:

Date	Securities Loss	Futures Gain	Net
August	\$(100,000)	\$75,000	\$(25,000)
September	(50,000)	50,000	0
			<u>\$(25,000)</u>

We sell the debt securities on September 30 at their fair value of \$9,850,000.

Prepare the journal entries to record the following:

- Purchase of the debt securities and futures contracts on June 1
- Accrue changes in fair value of AFS debt securities and futures contract in August
- Accrue changes in fair value of AFS debt securities and futures contract in September
- Record sale of securities in September

LO2 40.^B Use of option contracts to hedge available-for-sale securities --fair value hedge

Assume that our company purchased 100,000 shares of GE common stock at a cost of \$50 per share on June 1. Since we did not plan to sell these securities in the near term, we classified the shares as “available for sale.” The current market price is \$65 per share, and we are concerned that the shares may be overvalued. In order to protect us from a decrease in the price of GE shares, on December 31, 2013, we purchase for a premium of \$600,000 a put option, which gives us the right, but not the obligation, to sell 100,000 shares of GE at \$65 per share, the current market price. The option expires on December 31, 2015, and qualifies as a fair value hedge.

The fair value of the GE shares and the option are as follows:

	12/31/2013	12/31/2014	12/31/2015
GE Price/Share	\$ 65	\$ 60	\$ 57
Total	6,500,000	6,000,000	5,700,000
Put option:			
Time Value	600,000	350,000	0
Intrinsic value	0	500,000	800,000
Total	\$ 600,000	\$ 850,000	\$ 800,000

Just prior to the option’s expiration on December 31, 2015, we exercise the option (and deliver the GE shares to the option writer), since it is “in the money.”

Prepare the journal entries to record the following:

- Purchase of the GE securities on June 1
- The change in the fair value of the shares as of December 31, 2013, and the purchase of the option (note: since the hedge is not purchased until December, the accrual of the increase in the share price must be to AOCI since the shares are classified as available-for-sale).
- The change in the fair value of the GE shares and the put option as of December 31, 2014 (note: this is now accounted for as a derivative)
- Record sale of securities on December 31, 2015

The relevant exchange rates for the \$US value of the British pound (GBP) are as follows:

BOY rate	\$1.50
EOY rate	\$1.57
Avg. rate	\$1.53
Dividend rate	\$1.54
Historical rates:	
Beginning inventory	\$1.50
Land	\$1.54
Building	\$1.54
Equipment	\$1.54
Historical rate (common stock and APIC)	\$0.60

- a. Remeasure the subsidiary's income statement, statement of retained earnings, and balance sheet into \$US for the current year (assume that the BOY Retained Earnings is \$2,555,320).
- b.^A Compute the remeasurement gain or loss directly assuming BOY net monetary assets of GBP(462,240), a net monetary liability.

30. Remeasurement of financial statements

Assume that your company owns a subsidiary operating in Canada. The subsidiary has adopted the Canadian Dollar (CAD) as its functional currency. Your parent company operates this subsidiary like a division or a branch office, making all of its operating decisions, including pricing of its products. You conclude, therefore, that the functional currency of this subsidiary is the \$US and that its financial statements must be remeasured prior to consolidation. Following are the subsidiary's financial statements (in CAD) for the most recent year:

LO2



	(in CAD)
Beginning inventory	2,346,750
Purchases	6,139,350
Ending inventory	(2,816,100)
Cost of goods sold	5,670,000
Land	2,058,840
Building	3,780,000
Accum. deprec.—building	(1,890,000)
Equipment	2,520,000
Accum. deprec.—equipment	(1,260,000)
Property, plant, and equipment (PPE), net	5,208,840
Depreciation expense—building	189,000
Depreciation expense—equipment	252,000
Depreciation expense	441,000

	(in CAD)
Income statement:	
Sales	9,450,000
Cost of goods sold	(5,670,000)
Gross profit	3,780,000
Operating expenses	(2,016,000)
Depreciation	(441,000)
Net income	1,323,000
Statement of retained earnings:	
BOY retained earnings	4,961,250
Net income	1,323,000
Dividends	(132,300)
Ending retained earnings	6,151,950

The relevant exchange rates for the \$US value of the Brazilian real (BRL) are as follows:

BOY rate.....	\$0.22
EOY rate.....	\$0.29
Avg. rate.....	\$0.25
PPE purchase date rate.....	\$0.26
LTD borrowing date rate.....	\$0.26
Dividend rate.....	\$0.27
Historical rate (Common stock and APIC).....	\$0.10

- Translate the subsidiary's income statement, statement of retained earnings, balance sheet, and statement of cash flows into \$US (assume that the BOY Retained Earnings is \$649,373).
- ^A Compute the ending Cumulative Translation Adjustment directly, assuming a BOY balance of \$219,711. What journal entry did the parent company make as a result of this computation?
- Following are selected balance sheet accounts for the parent:

Income statement:		Balance sheet:	
Sales.....	\$26,846,000	Assets	
Cost of goods sold.....	(18,792,200)	Cash.....	\$ 6,320,609
Gross profit.....	8,053,800	Accounts receivable.....	3,436,288
Equity income.....	220,350	Inventory.....	5,208,124
Operating expenses.....	(5,100,740)	Equity investment.....	1,581,807
Net income.....	<u>\$ 3,173,410</u>	Property, plant, and equipment (PPE), net.....	<u>27,737,287</u>
			<u>\$44,284,115</u>
Statement of retained earnings:		Liabilities and stockholders' equity	
BOY retained earnings.....	\$21,204,636	Current liabilities.....	\$ 2,150,365
Net income.....	3,173,410	Long-term liabilities.....	7,750,000
Dividends.....	(848,185)	Common stock.....	1,818,885
Ending retained earnings.....	<u>\$23,529,861</u>	APIC.....	8,455,362
		Retained earnings.....	23,529,861
Statement of accum. comp. income:		Cumulative translation adjustment.....	<u>579,642</u>
BOY cumulative translation adjustment.....	\$ 219,711		
Current-year translation gain (loss).....	359,931		<u>\$44,284,115</u>
EOY cumulative translation adjustment.....	<u>\$ 579,642</u>		

Assume the following information: The purchase price for the subsidiary included an AAP asset relating to a Patent that the parent estimated was worth BRL300,000 more than its book value on the subsidiary's balance sheet. The Patent is being amortized at the rate of BRL30,000 per year and the BOY book value of the Patent is BRL270,000.

- Compute the balance of the Equity Investment account of \$1,581,807 on the parent's balance sheet.
 - Compute the equity income of \$220,350 reported by the parent in its income statement.
- Using your translated subsidiary financial statements from *Part a* and the parent's financial data provided in *Part c*, prepare the consolidation spreadsheet for the year.

49. Preparation of journal entries for a number of transactions**LO4**

Prepare journal entries for the following transactions for the City of Sparks, NV:

- The City Council approved its budget for the year for estimated revenues of \$3,500,000 and appropriations of \$3,400,000.
- Revenues received in cash amounted to \$3,400,000 for the year.
- The City issues \$500,000 of purchase orders.
- The City purchased goods and services under \$450,000 of the purchase orders in *Part b* amounting to a cash payment of \$445,000. The remaining \$50,000 of purchase orders are still outstanding and unpaid at year-end.
- The City paid \$2,000,000 of wages to City employees during the year. These wages were not evidenced by a formal encumbrance since they are recurring in nature.

**50. Preparation of journal entries for a number of transactions****LO4**

The Town of Bolton reports the following transaction during the month:

- Received a \$200,000 grant from the State of Massachusetts that is unassigned
 - Purchased a truck for \$50,000 in cash
 - Paid wages of \$25,000 in cash
 - Borrowed \$50,000 from a bank to replenish funds used for the purchase of the truck
 - Made an interest payment on the bank loan of \$500 in cash
- Prepare journal entries in the general fund for these transactions.
 - Prepare a Balance Sheet and a Statement of Revenues, Expenditures and Changes in Fund Balances for the general fund. Assume that the Town began the period with cash and an unassigned fund balance of \$100,000.

PROBLEMS

51. Journal entries for a series of transactions**LO4**

Prepare journal entries in the General Fund for each of the following events relating to the City of Bar Harbor (all amounts in \$1,000s).

- The citizens approve the following budget for the year:

ESTIMATED REVENUES	\$94,709
ESTIMATED OTHER FINANCING SOURCES	2,000
APPROPRIATIONS	(92,728)
BUDGETARY FUND BALANCE	\$ 3,981

- The City records the following revenues (on account) and other financing sources (paid in cash) during the year:

Revenues—real estate and personal property taxes	\$81,900
Revenues—intergovernmental	14,742
Other financing sources—bond proceeds	2,000

- The City issues purchase invoices totaling \$91,810 (record the issuance of invoices as a lump sum).
- The City recognizes the following expenditures, all on account (these expenditures were previously reserved as budgetary encumbrances):

Expenditures—general government	\$13,772
Expenditures—public safety	9,181
Expenditures—education	55,086
Expenditures—public works	4,590
Expenditures—human services	9,181



What amount should the shelter record as contribution revenue?

- a. \$8,000
- b. \$11,000
- c. \$12,500
- d. \$14,500

L02 22. Release from restrictions

Terrier Town, a not-for-profit organization, received a grant in the amount of \$200,000 that was restricted to fund dog protection activities during the upcoming year. Later in the year, Terrier Town recognized revenues of \$500,000 and expenses of \$450,000, including expenses relating to dog protection activities amounting to \$150,000. What amount, if any, should Terrier Town report as net assets released from restriction during the year?

- a. \$0
- b. \$200,000
- c. \$150,000
- d. \$250,000

L02 23. Recording contribution

Whitestone, a nongovernmental not-for-profit organization, received a contribution in December Year 1. The donor restricted use of the contribution until March Year 2. How should Whitestone record the contribution?

- a. Footnote the contribution in Year 1 and record as income when it becomes available in Year 2
- b. No entry required in Year 1 and record as income in Year 2 when it becomes available
- c. Report as income in Year 1
- d. Report as deferred income in Year 1

L02 24. Recording contribution

Stapleton College received \$200,000 from a donor that was restricted for student scholarships. During the year, the College awarded all of the scholarships to deserving students. How should the donation be recognized in the year-end statement of activities?

- a. As both an increase and a decrease in ~~in~~ unrestricted net assets
- b. As a decrease in unrestricted net assets
- c. With only a footnote reference
- d. The transaction is not reported

EXERCISES

L01, 2

25. Preparation of financial statements for not-for-profit

Following is financial data for the Center for Cardio Research, a not-for profit organization investigating the benefits of exercise for heart disease. Given this information, prepare the Statement of Activities and the Statement of Financial Position.

	Unrestricted	Temporarily Restricted	Permanently Restricted
Revenues—contributions	\$4,238,993	\$ 427,332	\$ 80,553
Revenues—investment	183,224	83,772	103,758
Net assets, beginning of year	3,732,853	2,851,667	783,228

Long-term liabilities	\$1,383,859
Contributions receivable	1,238,657
Expenses—support	882,937
Net assets released from restriction	337,833
Cash	438,654
Payables	827,938
Expenses—program	3,658,933
Investments	984,688
Depreciation expense	153,852
PPE, net	7,339,456

Segment Disclosures and Interim Financial Reporting

12

3M is a diversified technology company with a global presence in the following businesses: Industrial; Safety and Graphics; Electronics and Energy; Health Care; and Consumer. 3M is among the leading manufacturers of products for many of the markets it serves. Most 3M products involve expertise in product development, manufacturing and marketing, and are subject to competition from products manufactured and sold by other technologically oriented companies.

3M COMPANY

In a recent year 3M reported sales of over \$31 billion, net income of nearly \$5 billion, and total assets of over \$31 billion. In our analysis of the company's operating results, it might be helpful to know which of these operating segments mentioned above are performing particularly well and

which aren't. And, ultimately, an investor might have particular interest in knowing if the company's profitability is due to one operating segment. If so, future results might be significantly impacted by competition entering that space.

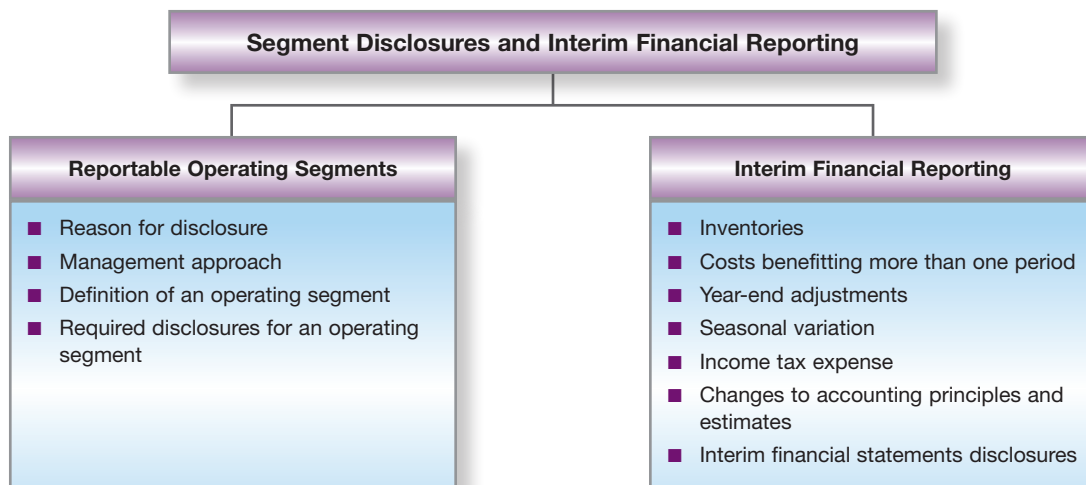
The operating performance of these business lines had traditionally been a closely guarded secret. ~~Although analysts~~

Until the late 1960s, US-based companies were only required to provide limited disclosures about their international operations, and sometimes voluntarily provided disaggregated information about individual product lines and industries within the consolidated entity. The Securities and Exchange Commission (SEC) began requiring companies to provide "line-of-business" information in registration statements (1969), annual reports filed with the SEC (1970) and annual reports provided to stockholders and bondholders of companies filing with the SEC (1974).

In 1976, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 14: *Financial Reporting for Segments of a Business Enterprise*, requiring business enterprises to report segment information by industry and by geographic area. Although this standard was a step in the right direction, the basis for conclusions in SFAS No. 131: *Disclosures about Segments of an Enterprise and Related Information* (now codified in FASB ASC 280) states that "[m]any analysts said that they found [existing segment disclosures] helpful but inadequate." Analysts' complaints often focused on the fact that companies could define industry and geographic segments in highly aggregated and non-comparable ways. Current GAAP (i.e., SFAS No. 131, as codified in FASB ASC 280), takes the view that the reportable segments should be based on the same level of aggregation reviewed by top management in the organization.

In addition, to the reporting of financial information on business segments, the SEC requires companies to report consolidated financial statements on a quarterly basis. This quarterly reporting presents some estimation and disclosure issues for accountants since all of the information that would normally be required for the preparation of year-end financial statements may not be available during each quarter. We discuss the issues involved in the preparation of interim financial statements in this chapter as well.

Source: 3M Company 2014 10-K



Users of financial statements have long argued for increased disclosure about the investment that companies make in their various businesses and the resulting profitability of those businesses. Companies, on the other hand, are reluctant to provide much transparency, citing the risks of increased competition and the resulting decline in profitability that such information might cause. ~~In the late 1990s, the pen-~~

In the late 1990s, US accounting standard setters decided that more useful information would be provided to investors and creditors if--as compared to poorly defined "industry segments" included in existing generally accepted accounting principles (GAAP)--segment reporting is based on the same business segments that are reviewed by the top decision makers of the reporting company.

Even after the passage of new disclosure requirements, the degree of transparency differs markedly across companies. **Apple Inc.**, for example, provides the following information about its various product lines in its 2014 10-K:

	2014	Change	2013	Change	2012
Net sales by product					
iPhone.....	\$101,991	12%	\$ 91,279	16%	\$ 78,692
iPad.....	30,283	(5)%	31,980	3%	30,945
Mac.....	24,079	12%	21,483	(7)%	23,221
iPod.....	2,286	(48)%	4,411	(21)%	5,615
iTunes, software and services.....	18,063	13%	16,051	25%	12,890
Accessories.....	6,093	7%	5,706	11%	5,145
Total net sales.....	<u>\$182,795</u>	7%	<u>\$170,910</u>	9%	<u>\$156,508</u>
Unit sales by product					
iPhone.....	169,219	13%	150,257	20%	125,046
iPad.....	67,977	(4)%	71,033	22%	58,310
Mac.....	18,906	16%	16,341	(10)%	18,158
iPod.....	14,377	(45)%	26,379	(25)%	35,165

From this table, we are able to derive information about the importance of Apple's iPhone and iPad products as well as its Macintosh computers. Contrast this level of disclosure with that for **Coca-Cola** in the same year:

As of December 31, 2014, our organizational structure consisted of the following operating segments: Eurasia and Africa; Europe; Latin America; North America; Asia Pacific; Bottling Investments; and Corporate . . . The business of our Company is nonalcoholic beverages . . . Management evaluates the performance of our operating segments separately to individually monitor the different factors affecting financial performance...Information about our Company's operations by operating segment for the year ended December 31, 2014 is as follows (in millions):

Quantitative Thresholds SFAS 131 requires disclosure for all segments that exceed *any* of the quantitative thresholds for revenues (sales), profit, and assets.

Revenues All operating segments exceeding 10% of combined revenue, internal and external, of all operating segments must be separately disclosed. We do not have data on the internal revenues as these have been eliminated in the consolidation process. For external revenues, the threshold is 10% of \$32,421 million (\$31,821 million + \$604 million – \$4 million), or \$3,242.1 million. All of the reported segments exceed that threshold as we would expect.

Profit All operating segments for which the absolute value of segment profit or absolute value of segment loss exceeds 10 percent of the greater of the absolute value of aggregate segment profit (for profitable operating segments) or absolute value of aggregate segment losses (for unprofitable segments). All of 3M's segments are profitable, and the threshold is 10% of \$7,519 million (\$7,135 million + \$133 million + \$251 million), or \$751.9 million. All of the reported segments exceed the profit threshold.

Assets All operating segments with assets exceeding 10% of combined assets for all operating segments must be separately disclosed. All of 3M's segments, except Consumer, exceed the asset threshold of 10% of \$25,341 million (\$31,269 million – \$5,928 million), or \$2,534.1 million.

Other Disclosures In addition to the financial data presented above, 3M also provides, by geographical area, the following required disclosure relating to its sales and long-lived assets, and voluntary disclosure related to its operating income:

(Millions)	Net Sales			Operating Income			Property, Plant and Equipment, Net	
	2014	2013	2012	2014	2013	2012	2014	2013
United States	\$11,714	\$11,151	\$10,571	\$2,540	\$2,210	\$1,938	\$4,619	\$4,478
Asia Pacific.....	9,418	9,047	9,092	2,487	2,386	2,450	1,798	1,943
Europe, Middle East and Africa ...	7,198	7,085	6,730	1,234	1,168	1,163	1,502	1,636
Latin America and Canada.....	3,504	3,611	3,529	867	908	936	570	595
Other Unallocated	(13)	(23)	(18)	7	(6)	(4)	—	—
Total Company	<u>\$31,821</u>	<u>\$30,871</u>	<u>\$29,904</u>	<u>\$7,135</u>	<u>\$6,666</u>	<u>\$6,483</u>	<u>\$8,489</u>	<u>\$8,652</u>

Corporate and unallocated operating income includes a variety of miscellaneous items, such as corporate investment gains and losses, certain derivative gains and losses, certain insurance-related gains and losses, certain litigation and environmental expenses, corporate restructuring charges, and certain under- or over-absorbed costs (e.g., pension, stock based compensation) that the company may choose not to allocate directly to its business segments. Because this category includes a variety of miscellaneous items, it is subject to fluctuation on a quarterly and annual basis.

FASB ASC 280-10-50-41 requires two disclosure categories: U.S. and outside of the U.S. (for public companies domiciled in the U.S.). 3M's disclosure of the U.S. and several geographic areas outside of the U.S. is typical.

Finally, companies are required to disclose significant concentrations of sales. 3M does not disclose that it has significant reliance on any one customer.

Analysis of Segment Disclosures Prior to the issuance of SFAS 131, analysts complained that segment reporting was not as useful as it could be because segments were too highly aggregated and did not conform to the internal structure of companies. Analysts and other user groups lobbied the FASB to increase the amount of information contained in segment disclosures, and the current standard provides information that is similar to that which executives use to manage the business. This data can be helpful in understanding the factors that drive profits and cash flows.

From the segment disclosures presented above, we are able to break down 3M's sales and profit by operating segment:

10. Partnership agreement

The partnership agreement does not include one of the following:

- Language relating to the formation, ongoing operation, and ultimate dissolution of the partnership.
- A requirement that all financial statements will be prepared in accordance with GAAP.
- Language relating to the way in which profit and loss is to be allocated to the partners' Capital Accounts.
- Language relating to whether the partners wish to recognize the intangible asset on the books of the partnership upon formation of the partnership.

LO1

**AICPA
Adapted**

**11. Revaluation of net assets**

Which of the following is true with respect to the revaluation of net assets prior to partnership realignment?

- When partnership net assets are revalued in anticipation of a realignment transaction, the resulting gains and losses accrue only to the partners who have an ownership interest in the entity during the period in which the net assets changed in value.
- When partnership net assets are revalued in anticipation of a realignment transaction, only the resulting gains accrue to the partners who have an ownership interest in the entity during the period in which the net assets changed in value. Losses are allocated in proportion to the relative balances of the Capital Accounts.
- Partnership net assets cannot be revalued as a result of partnership realignment.
- Partnership net assets can only be written down to net realizable value and cannot be increased if market value exceeds their book value.

LO3

**AICPA
Adapted**

**12. Recording profit and loss**

Which of the following is true with respect to the recognition of partnership profit or loss?

- Capital contributions are treated as income to the partnership.
- Withdrawals of capital from the partnership are treated as expenses.
- Salary paid to a partner is not treated as an expense.
- The net of revenues less expenses is always allocated to the partners in proportion to their relative Partner Capital accounts.

LO4

**AICPA
Adapted**

**13. Partnership dissolution**

Which of the following is not true with respect to the dissolution of a partnership?

- The assets of the partnership must be converted to cash used to pay the obligations to creditors, including partners who are creditors, and any remaining cash must be distributed to the partners in accordance with the profit-sharing ratio.
- Profits (losses) that result from the liquidation of the partnership assets must be credited (charged) to the partners' Capital Accounts.
- If a partner's Capital Account becomes negative as a result of the sales of assets, the partner is relieved of all liability with respect to the partnership.
- If a partner's Capital Account becomes negative as a result of the sales of assets, the partner must make a cash contribution to the partnership in an amount sufficient to bring the Capital Account to a zero balance.

LO5

**AICPA
Adapted**

**14. Partnership liquidation**

Which of the following is not true with respect to the liquidation of a partnership?

- It may be difficult to estimate the liquidation expenses, thereby limiting the amount of cash that can be safely distributed.
- There may be unreported liabilities that were not properly accrued as of the balance sheet date. The liquidation administrator must, therefore, be conservative in estimating the amount of cash that can be safely disbursed.
- It is not uncommon to assume that no cash will be realized from the sale of assets.
- All of the above are true.

LO5

**AICPA
Adapted**

**15. Partner capital accounts upon formation of partnership—Bonus Method**

Assume that two individuals agree to form a partnership. Partner A is contributing an operating business that reports net assets of \$25,000. Partner B is contributing cash of \$35,000. The partners agree that the initial capital of the partnership should be shared equally. What will be the initial balance of the Capital Accounts of the partners assuming that the partners wish to employ the Bonus Method?

LO2

**AICPA
Adapted**

