

GAAP 2012

HANDBOOK OF POLICIES AND PROCEDURES

Joel G. Siegel, Ph.D., CPA
Marc H. Levine, Ph.D., CPA
Anique A. Qureshi, Ph.D., CPA, CIA
Jae K. Shim, Ph.D.



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Portions of this work were published in previous editions.

In Chapter 1, "Reporting, Presentation, and Disclosures for the Income Statement," information and examples on the binomial option-pricing model are adapted from "Valuing Employee Stock Options Using a Lattice Model," by Les Barenbaum, Walt Schubert, and Bonnie O'Rourke, *The CPA Journal* (December 2004), pp. 16–20. Adapted with permission.

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GAAP 2012 Handbook of Policies and Procedures

by Joel G. Siegel, Marc H. Levine, Anique A. Qureshi, and Jae K. Shim

GAAP 2012 Handbook of Policies and Procedures is an essential reference in applying generally accepted accounting principles in practice. It contains all of the important authoritative pronouncements on GAAP, financial reporting presentation requirements, required and recommended disclosures, and specialized accounting topics needed to evaluate and solve the day-to-day problems of accounting and disclosure.

Guidelines, checklists, diagrams, illustrations, examples from annual reports, and step-by-step instructions simplify complex accounting issues and give public and private accountants quick answers to accounting application questions.

2012 Edition

Coverage has been updated throughout the 2012 Edition of the *GAAP Handbook* to include the following:

- Accounting Standards Update (ASU) No. 2011-04 (May 2011), *Fair Value Measurement* (Topic 820), *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*
- Accounting Standards Update (ASU) No. 2011-03 (April 2011), *Transfers and Servicing* (Topic 860), *Reconsideration of Effective Control for Repurchase Agreements*
- Accounting Standards Update (ASU) No. 2011-02 (April 2011), *Receivables* (Topic 310), *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*
- Accounting Standards Update (ASU) No. 2010-29 (December 2010), *Business Combinations* (Topic 805), *Disclosure of Supplementary Pro Forma Information for Business Combinations*
- Accounting Standards Update (ASU) No. 2010-28 (December 2010), *Intangibles—Goodwill and Other* (Topic 350), *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*
- Accounting Standards Update (ASU) No. 2010-25 (September 2010), *Plan Accounting—Defined Contribution Pension Plans* (Topic 962), *Reporting Loans to Participants*
- Accounting Standards Update (ASU) No. 2010-22 (August 2010), *Accounting for Various Topics*
- Accounting Standards Update (ASU) No. 2010-21 (August 2010), *Accounting for Technical Amendments to Various SEC Rules and Schedules*

iv Highlights

- Accounting Standards Update (ASU) No. 2010-20 (July 2010), *Receivables* (Topic 310), *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
- Full coverage of comprehensive income in light of the recent changes to ASC 220, *Comprehensive Income* (ASU 2011-05) (Chapters 1 and 18)
- Expanded discussion on derivative financial instruments (Chapter 17)
- Updated discussion on the FASB-IASB convergence and their joint conceptual framework project (Chapter 18)
- New 2010 annual report examples

(Note: The GAAP 2012 Handbook of Policies and Procedures will only include Accounting Standards Codification (ASC) citations. Traditional GAAP hierarchical (legacy) citations will no longer be included except in those cases where the historical development of a particular accounting principle is being described.)

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(Footnote Continued)

continuing professional education. Participating state boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding

QAS program sponsors may be addressed to NASBA, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Telephone: 615-880-4200.

WHAT THIS BOOK WILL DO FOR YOU

The *GAAP Handbook of Policies and Procedures* is a valuable reference in applying generally accepted accounting principles (GAAP) in practice. It can be used by either a certified public accountant (CPA) in the performance of his or her accounting and advisory functions to clients, or by accountants responsible for the accounting policies and procedures of a business entity. It also provides guidance in resolving any issues and problems that the accountant might be faced with day to day in applying GAAP. The book helps the professional accountant in determining what to look for, what to watch out for, what to do, and how to do it.

This volume will become an essential reference in assisting you in dealing with the complex, ever changing world of financial accounting. It provides many rules of thumb to guide you in evaluating and solving the problems of accounting and disclosure that a CPA encounters on the job. This is a practical, real-life, comprehensive, and useful working book. Its content includes informative rules, policies, and procedures applicable to public accountants at any level working for CPA firms and to private accountants working for large, medium, or small businesses. It may also be used as a training medium. The uses of this book are as varied as the topics presented.

This practical reference contains all of the important authoritative pronouncements on GAAP and is the most up-to-date source of such pronouncements. The GAAP pronouncements include Financial Accounting Standards Board (FASB) Accounting Standards Updates (ASUs) as well as statements, interpretations, technical bulletins, and concepts as well as the unsuperseded GAAP of the American Institute of CPAs (AICPA). This includes the Accounting Principles Board opinions, accounting research bulletins, and statements of position. Securities and Exchange Financial Reporting Releases are also covered when appropriate. Specialized industry accounting principles are included. Consideration is also given to Emerging Issues Task Force (EITF) Consensus Summaries. In general, the SEC follows EITF consensus opinions. In fact, the SEC Chief Accountant has stated that he would challenge any accounting principle that differs from the EITF consensus opinions. EITF issuances have the full effect of GAAP and are positioned in Category C of the GAAP hierarchy. Future developments in GAAP, such as FASB exposure drafts and proposed interpretations are considered.

This volume contains accounting principles, financial reporting presentation requirements, required and recommended disclosures, and specialized accounting topics to keep you on the forefront of GAAP. It avails you of instant answers to any accounting application question you may have in the course of your work and allows you to perform your duties correctly, productively, and successfully.

X What This Book Will Do For You

The book is comprehensive and detailed, so each topic is presented thoroughly. It includes examples, tables, exhibits, and practice aids to show how GAAP is practically applied. The material—clear, understandable, concise, current, and user friendly—is presented in a logical, sequential order to aid reader comprehension.

Guidelines, checklists, diagrams, illustrations, step-by-step instructions, and practical applications make this a valuable reference tool. Complex accounting issues are simplified. In some cases, flowcharts are presented to explain in clearer terms the practitioner's decision process in applying a pronouncement. For explanatory purposes, references including footnotes from annual reports are presented. Keep this book handy for easy reference and daily use.

In conclusion, the book explains and evaluates in easy-to-read terms promulgated GAAP. It analyzes how to apply GAAP to everyday business situations. The focus of this book is on the accounting practitioner working for a CPA firm rendering accounting and audit services to clients, the corporate accountant applying accounting rules and standards, and the CPA candidate whose future goals include a career in financial accounting.

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DEDICATION

Roberta M. Siegel,
loving wife, colleague, and partner

Carol Levine,
dedicated wife and friend

Reva, Daniel, and Sori Levine,
loving children

Tessie and Samuel Levine,
my dear departed parents

Shaheen Qureshi,
loving and devoted wife

Mohammad Rafique Qureshi and
Zakia Qureshi,
loving parents

Aamera N. Ahmed, Uzma Qureshi,
and Jawad Qureshi,
wonderful sisters and brother

Chung Shim,
dedicated wife

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Part I

FINANCIAL

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Chapter 1

Reporting, Presentation, and Disclosures for the Income Statement

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This chapter discusses the format of the income statement, major income statement categories, extraordinary and nonrecurring items, discontinued operations, research and development costs, deferred compensation arrangements, compensation expense arising under a stock option plan, insurance costs, and earnings per share calculation.

REVENUE, EXPENSES, GAINS, AND LOSSES

The four major components of an income statement, according to Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*, are revenues, expenses, gains, and losses:

1. **Revenues** Actual or expected inflows of cash or other assets or reductions in liabilities resulting from producing, delivering, or providing goods or services constituting an entity's major or central operations.
2. **Expenses** Actual or expected outflows of cash or other assets or incurrences of liabilities resulting from producing, delivering, or providing goods or services constituting an entity's major or central operations.
3. **Gains** Increases in equity or net assets from peripheral or incidental activities of an entity and from all other transactions except those resulting from revenues or investments by shareholders or owners.
4. **Losses** Decreases in equity or net assets from peripheral or incidental activities of an entity and from all other transactions except those resulting from expenses or distributions to shareholders or owners.

Revenues

Revenue is recognized when:

- ☐ It is *realized* or *realizable* (goods or services are converted or convertible to cash or claims to cash or receivables), *and*
- ☐ It is *earned* (the earning process is complete or virtually complete when the entity has substantially completed what it must do to receive the benefits represented by the revenues).

Revenue from selling products is usually recognized on the date of delivery of goods to customers. Revenue from services performed is usually recognized when the services have been rendered and are billable. Revenue is usually recognized at point of delivery; however, problems can sometimes occur when trying to implement it.

Sales with Buyback Agreements

No sale is recognized when a company sells a product in one accounting period and agrees to buy it back in the next accounting period at a set price that includes not only the cost of inventory but also related holding costs. Although the legal title may transfer in such a transaction, the economic substance of the transaction is to leave the risk with the seller, and hence no sale is recognized.

Sales When Right of Return Exists

When a company experiences a high rate of return, it may be necessary to delay reporting sales until the right of return has substantially expired. The right of return may be specified in a contract or it may be a customary business practice involving “guaranteed sales” or consignments. Three methods are generally used to record sales when the right of return exists. First, the company may decide not to record any sale until the right of return has substantially expired. Second, the company may record the sale and estimated future returns. Finally, the company may record the sale and accounting for returns as they occur. According to FASB Accounting Standards Codification™ (ASC) 605-15-25-1, *Revenue Recognition: Products*, the company may recognize revenue at the time of sale only if *all* of the following six conditions are satisfied:

1. The price is fixed or determinable at the date of sale.
2. The obligation of the buyer to pay the seller is not contingent on resale of the product, or the buyer has paid the seller.
3. Theft or other damage to the product would not affect the buyer’s obligation to the seller.
4. The product being acquired by the buyer for resale has economic substance apart from that provided by the seller.
5. Seller does not have significant future obligations to assist directly in the resale of the product by the buyer.
6. Future returns can be reasonably estimated.

Whereas revenue is generally recognized at the delivery date, under certain circumstances revenue may be recognized before the completion and delivery, such as in long-term construction contracts. Two methods have been used for

recognizing revenues from long-term contracts. Under the *percentage-of-completion method*, revenues are recognized based on the progress of construction. The *completed contract method* recognizes revenue only when the contract is complete.

Expenses

Expenses are generally recognized when incurred. Expenses are “matched” against revenues and should be recorded in the same accounting period. Expenses that benefit several periods, such as depreciation, should be allocated systematically over relevant periods.

Gains and Losses

Gains and losses do not involve an earnings process and are typically recognized at the time of sale of assets, at disposition of liabilities, or when the price of certain assets changes. Gains or losses may also result from environmental factors, such as damage by fire, flood, or earthquake.

INCOME STATEMENT FORMATS

There are two generally accepted formats for preparing the income statement: the single-step format and the multistep format. The single-step format contains just two sections: Revenues Minus Expenses Equals Net Income. The revenue section includes sales revenue, interest income, gains, and all other types of revenues. The expense section includes cost of goods sold, selling and administrative expenses, interest expense, losses, and taxes. The single-step format does not emphasize any one type of revenue or expense. Potential problems with classifying revenues and expenses are thus eliminated. An example of a single-step income statement is shown in Exhibit 1-1. Entities that choose the single-step format for income statement presentation break out income tax expense separately at the bottom of the statement placing it directly after the caption “income before taxes.” Although this is not strictly in accordance with the single-step concept, which requires income tax expense to be included in the expenses category, it is done to enhance the comparability of the entity’s income statement to other entities.

Exhibit 1-1: Example of Single-Step Income Statement

XYZ Company		
Income Statement		
For the Year Ended December 31, 20X5		
REVENUES		
Net sales	\$3,000,000	
Interest income	120,000	
Dividend income	45,000	
Rental income	36,000	
Gain on sale	150,500	
Total revenues		\$3,351,500

XYZ Company
Income Statement
For the Year Ended December 31, 20X5

EXPENSES

Cost of goods sold	\$2,000,000	
Selling expenses	700,000	
Administrative expenses	250,000	
Interest expense	65,000	
Loss on disposal	55,000	
Income tax expense	110,500	
	<hr/>	
Total expenses		3,180,500

NET INCOME

		<u>\$ 171,000</u>
Less: Net income attributable to the noncontrolling interest		(10,000)
Net income attributable to XYZ Company		<u>161,000</u>

EARNINGS PER SHARE (500,000 shares)

\$.34

A multistep income statement is used to emphasize certain sections and relationships. It contains separate sections for operating and nonoperating activities. Expenses are also classified by functions, such as merchandising or manufacturing (cost of goods sold), selling, and administration.

It is acceptable to combine the statement of income with the statement of retained earnings to produce a combined Statement of Income and Retained Earnings. The first part of the statement may be prepared using either the single-step or the multistep approach to derive net income. The beginning balance of retained earnings is added to net income. Dividends declared are deducted to arrive at ending retained earnings. An example of a combined Statement of Income and Retained Earnings using a multistep approach is shown in Exhibit 1-2.

Exhibit 1-2: Combined Statement of Income and Retained Earnings Using the Multistep Approach

XYZ Company
Combined Statement of Income and Retained Earnings
For the Year Ended December 31, 20X5

REVENUES

Sales		\$5,000,000
Less: Sales returns and allowances	\$ 670,000	
Sales discounts	95,000	765,000
	<hr/>	
Net sales		4,235,000

XYZ Company
Combined Statement of Income and Retained Earnings
For the Year Ended December 31, 20X5

COST OF GOODS SOLD

Beginning inventory	\$ 620,000	
Plus: Net purchases	1,300,000	
Merchandise available for sale	\$1,920,000	
Less: Ending inventory	435,000	
Cost of goods sold		1,485,000
Gross profit		\$2,750,000

OPERATING EXPENSES

Selling expenses		
Advertising	\$ 35,000	
Rent	150,000	
Travel	87,000	
Sales salaries	320,000	
Depreciation	120,000	
Utilities	77,000	
Commissions	150,000	
Total selling expenses		939,000

ADMINISTRATIVE EXPENSES

Legal expenses	\$ 215,000	
Professional expenses	125,000	
Insurance	83,000	
Supplies	62,000	
Officers' salaries	250,000	
Miscellaneous office expenses	35,000	
Total administrative expenses		770,000

INCOME FROM OPERATIONS \$1,041,000

OTHER REVENUES AND GAINS

Interest income	\$ 370,000	
Dividend income	425,000	
Rental income	325,000	
Gain on sale	175,000	
Total		1,295,000
		\$2,336,000

OTHER EXPENSES AND LOSSES

Interest expense	\$ 400,000	
Loss on disposal	395,000	
Total		\$ 795,000

INCOME BEFORE TAXES \$1,541,000

Income tax expense (30%)		462,300
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