前言

USCPA—美国注册会计师，是由 AICPA 美国注册会计师协会颁发，是全球财会证书中含金量最高的证书之一，因其具备全球签字权，可换全球八个国家的会计资格证，成为全球使用范围最广的财会证书之一。目前 USCPA 在国内外的认可度极高，但报考流程复杂，考试范围广，全英文的内容这些因素困扰着备考学员。

因此，高顿财经 USCPA 教研团队基于多年的教学经验和研发积累，将"英文考核内容"和"中式学习方法"有机结合，多位讲师和学术研究员全身心投入，历时 2 年，完成了这套直接对标中国考生的 USCPA 学习资料. 这套学习资料并非考纲知识点的简单罗列和展示，而是充分考虑中国考生的背景知识和思维惯性后，重新梳理整个考核体系和知识内容. 在考点全覆盖的前提下，着重强调背景知识的介绍，语言表述的简化，相关考点的分析比较. 考试趋势的总结预测，力争让"零基础"的中国学员也能顺畅阅读和理解，打破英文考试的壁垒。

作为一本更适合中国考生学习的 USCPA 学习资料 ，本套资料的学习方法总结如下:

1. 每本讲义的 task1 均为当年最新的官方考纲 blueprints，建议作为初期学习的一个知识指引和最后冲刺的一个自检清单；
2. 每本讲义均划分为独立的章节(Chapter/Section)，章节下设具体目标学习任务. 学习时既要具体掌握细节考点，又要有"整体思想"，宏观把控各章节间的联系和不同章节的难易考核程度；
3. 正文 task 均强调添加"Background" "Note" "Summary" "Pass Key" "Example"等特色模块. 佐以表格和图例，建议初次学习和复习阶段，重点把握本部分内容；
4. 正文内容和框架均为中国考生"量身打造"，从"为什么考?""考什么?""怎么考?"多维度对知识点进行重构，也建议学员按照这种思维进行备考学习；
5. 正文结束最后配备 Appendix，作为课外学习的补充资料，建议了解这部分内容。

最后，本套学习资料凝结了高顿财经多年的教学研究成果，我们衷心希望能帮助广大考生高分通过考试!

高顿 USCPA 教研团队

Preface

USCPA—Certified Public Accountant of the United States, issued by the AICPA American Institute of Certified Public Accountants, is one of the most valuable certificates in the Global Accounting Certificate. Because of its global signature rights, it can be exchanged for accounting qualifications in eight countries around the world. At present, USCPA is highly recognized at home and abroad, but the application process is complex, the examination range is wide, and the English content plagues the test taker most.

Therefore, based on years of teaching research experience, Gordon USCPA Research Institute combines “English assessment content” with “Chinese learning method”. Together with many lecturers and researchers devoted themselves to it, after 2 years, this set of USCPA textbooks came out aimed specially for Chinese candidates. This set of textbooks is not a simple listing and display of the knowledge points of the exams. Instead, it fully considers the background knowledge and thinking inertia of Chinese candidates, and reorganizes the entire assessment system and knowledge content. To be more specific, it emphasizes the introduction of background information, the simplification of language expression, the analysis and comparison of relevant test sites. Which can help the "zero-based" students read and understand smoothly, break the barriers of English test.

As a set of USCPA textbooks that is more suitable for Chinese candidates, the learning methods of this set of books are summarized as follows:

1. The task1 of each book is the latest official blueprints of the year, recommended as a knowledge guide for the initial learning and a self-check list for the final sprint;
2. Each book is divided into independent chapters/sections and specific tasks. When learning, it is necessary to have specific details of the test sites, but also need have overall reflection and macro control of the links between the chapters.
3. The text task specially adds “Background” “Note” “Summary” “Pass Key” “Example” and other special modules. With the table and legend, it is recommended to focus on these parts during study.
4. The content and framework of the text are “tailor-made” for Chinese candidates. On the strength of multi-dimensional reconstruction (“Why test this point?” “What this point mean?” “How to test?”) of test points, students can better prepare for exam.
5. At the end of the book, Appendix is finally installed. As a supplement to extracurricular learning, it is recommended to simply understand this part.

Finally, this set of textbooks has condensed the effort of teaching and research of Gaodun Finance for several years. We sincerely hope that this set of books can help the majority of candidates pass the exam!

USCPA Research Institute

此套资料参与教研老师如下

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Chapter 1: Standard-setting and general purpose financial reporting

Task 1: SEC, FASB and General Purpose Financial Reporting

Task 1 SEC, FASB and General Purpose Financial Reporting

I. Bodies Involved in U.S. Accounting Standard-Setting

A. The Securities and Exchange Commission (SEC)

The SEC is an independent agency of the United Stated federal government. The commission was established by Securities Exchange Act of 1934 and enforced the Securities Act of 1933,the Sarbanes–Oxley Act of 2002, and other statutes. In the United States, the Securities and Exchange Commission (SEC) holds primary responsibilities for establishing and enforcing U.S. generally accepted accounting principles (GAAP).

B. Financial Accounting Standards Board (FASB) 1973 - present

In most instances, other accounting professions have authorities from SEC to establish GAAP. Since 1973, the FASB has established and improved GAAP within the United States in the public interest. The purpose of FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

II. General Purpose Financial Reporting

U.S. GAAP defines general purpose financial reporting as 1) a full set of financial statements and 2) notes to the financial statements.

A. A full Set of Financial Statement typically includes:

1. Statement of financial position, also known as balance sheet
2. Statement of earnings, also known as income statement
3. Statement of comprehensive income
4. Statement of cash flows
5. Statement of owners' equity

B. Balance sheet

The main purpose of a balance sheet is to report an entity's assets, liabilities, and shareholder equity at a specific point in time.

1. Classified balance sheet

Some entities may use a classified balance sheet. A classified balance sheet presents both assets and liabilities by current and non-current portions. When appropriate, a balance sheet presentation based on liquidity is also permissible.

Below is an example of a classified balance sheet.

Golden Products Co. Balance Sheet As of December 31, Year 1	
Assets	**Liabilities and Stockholders' Equity**
Current assets Cash and cash equivalents Trading securities, at fair value Accounts receivable, net of allowance Notes receivable Inventory Prepaid expenses	**Current liabilities** Current portion of long-term debt Accounts payable Notes payable Interest payable Salaries payable Unearned revenue
Investments Available-for-sale securities, at fair value Held-to-maturity securities Investments in affiliates	**Long-term Liabilities** Bonds payable Deferred income tax liability Pension and other postretirement benefit liabilities
Property, plant, and equipment Land Building Equipment Less: accumulated depreciation	**Total liabilities**
Intangible assets Goodwill Patents, net of amortization	**Stockholders' equity** Capital stock Common stock Preferred stock Paid-in capital in excess of par Retained earnings Accumulated other comprehensive income (Treasury stock at cost)
Other assets Pension and other postretirement benefit assets Deferred income tax asset	**Total stockholders' equity**
Total assets	**Total liabilities and stockholders' equity**

C. Income Statement (Details will be covered later)

The primary purpose of an income statement is to report an entity's earnings over a specific period of time. It is used in a variety of ways (both internally and externally) to aid the decision-making process. For example:

1. To show how well management is investing the money under its control.
2. To enable comparisons with an entity's competitors.
3. To assess an entity's operating performance over a defined period.
4. To determine the type of investment opportunity the entity represents.

Chapter 2: Fundamental concepts

Task 1: Revenue and Expense Recognition

Task 2: Revenue and Expense Recognition Types

Task 3: Installment Sales and Cost Recovery Method

Task 4: Fair Value Measurements and Fair Value Option

Task 1 Revenue and Expense Recognition

I. Revenue Recognition

In order to comply with the revenue recognition standard, an entity should apply the five-step approach to recognize revenue:

Step 1: Identify the contract with the customer

Step 2: Identify the separate performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the separate performance obligations

Step 5: Recognize revenue when each performance obligation is satisfied

A. Step 1: Identify the Contract(s) With the Customer

1. Definitions

A contract is an agreement between two or more parties that creates enforceable rights or obligations. Contracts can be written, oral, or implied from customary business practice.

2. Criteria for A Valid Contract

Revenue is recognized only when a valid contract exists. Here are the components of a valid contract:

a. the contract has commercial substance

b. the parties have approved the contract

c. identification of the rights of the parties is established

d. payment terms are identified

e. it is probable that the consideration will be collected

The entity should perform the criteria assessment at contract inception. If all criteria are met, the entity does not need reassessments until significant changes occur. If all of the criteria are not met at inception, the entity should perform regular reassessments.

If the criteria are not met but a nonrefundable consideration has been received by the entity, the entity can recognize revenue if there are no remaining obligations or the contract is terminated. If the consideration received is not recognized as revenue, the consideration received in advance is recorded as a liability.

Example

Facts: On February 1, Year 1, Golden Inc. entered a contract to sell a product to Puppy Inc. on October 1, Year 1. Puppy will pay the full contract price of $30,000 to Golden by September1, Year 1. The cost of the product totaled $15,000. Golden delivered the product to Puppy on October 1, Year 1.

Required: Record the Year 1 journal entry for Golden Inc.

Solution: February1, Year 1: no entry is required because neither party has performed.

September 1, Year 1: a contract liability (e.g., unearned revenue) is recognized when the cash is received in advance.

Cash	30,000	
Unearned revenue		30,000

October 1, Year 1: revenue is recorded when the product is delivered from the seller to the buyer.

Unearned revenue	30,000	
Sales revenue		30,000
Cost of goods sold	15,000	

Inventory	15,000

3. **Combination of Contracts**

When two or more contracts are entered into with the same customer or with related parties of the customer at or near the same time, the contracts should be combined and accounted for as a single contract if either the contracts are negotiated as a package with a single commercial objective, consideration for one contract is tied to the performance or price of another contract, or the goods/services promised represent a single performance obligation.

4. **Contract Modifications**

A customer and seller might agree to modify a contact in some way. For instance, they might change the transaction price, change the performance obligations, or add another performance obligation. When a contract modification occurs, companies determine whether a new contract (and performance obligations) results or whether it is a modification of the existing contract.

a. A contract modification counts as a new contract if both of the following conditions are satisfied:

(1) The promised goods or services are distinct, and

(2) The company has the right to receive an amount of consideration that reflects the standalone selling price of the promised goods or services.

b. A contract modification counts as a modification of the existing contract:

If a contract modification is not counted as a new contract, the modification is treated as modification of the existing contract with an adjustment to revenue to reflect the change in the transaction price.

B. Step 2: Identify the Separate Performance Obligations in the Contract

Performance obligations are promises to transfer goods or services to a customer. Sellers account for a promise to provide a good or service as a performance obligation if the good or service is distinct from other goods or services in the contract. Goods or services that are not distinct are combined and treated as a single performance obligation.

1. **A Distinct Good or Service**

A good or service is distinct if it is both:

a. Capable of being distinct; the good or service can be sold separately and

b. Separately identifiable from other goods or services in the contract.

2. **Separately Identifiable**

Following factors that indicate two or more performance obligations are not separately identifiable include:

a. Goods or services aren't considered separately identifiable if they are highly interdependent, or if one significantly modifies or customizes another.

b. The entity's contract includes a single performance obligation because the entity provides the service of combining goods/services into a combined output. Those goods/services aren't separately identifiable in the context of the contract.

Example
Facts: Home Depot is a store to sell lumber, paint, and other building supplies for home project. Mike goes into the store and purchases a lumber.
Required: Identify the performance obligation(s) in this contract.
Solution: Each of those products provided by Home Depot is capable of being distinct, because Mike can buy it individually and use it whenever he desires. Each also is separately identifiable from other goods and services, because Home Depot's only performance obligation is to deliver the individual items. So, Home Depot can view its promise to deliver each of these items as a separate

performance obligation.

Example
Facts: Tom signed an agreement with a construction contractor to build a house. The contractor is selling Tom lumber, paint, and other building supplies.
Required: Identify the performance obligation(s) in this contract.
Solution: While those items are capable of being distinct, they aren't separately identifiable in the context of the contract, because the contractor's performance obligation is to combine those inputs and deliver a completed building. Since the contractor provides the service of combining goods and services into a combined output, he should view himself as having a single performance obligation.

C. Step 3: Determine the Transaction Price

The transaction price is the amount the seller expects to be entitled to receive from the customer in exchange for providing goods or services. When company determines the transaction price, the following factors must be considered if applicable:

- Variable consideration
- Time value of money
- Noncash consideration
- Consideration paid or payable to the customer

1. Variable Consideration

A transaction price is uncertain because some of the price depends on the outcome of future events. Companies use either the expected value, which is a probability-weighted amount, or the most likely amount in a range of possible amounts to estimate variable consideration. To avoid overestimate variable consideration by seller, seller should only include an estimate of variable consideration in the transaction price to the extent it is "probable" that a significant reversal of revenue recognized to date will not occur once any uncertainty tied to the consideration is resolved in the future.

2. Time Value of Money

Transaction price should be accounted for the time value of money if the contract involves a significant financing component. The seller recognizes the same amount of revenue for goods or services that it would recognize if the customer paid cash at the time the seller delivers those goods or services. If the period between delivery and payment is less than a year, the time value of money is not significant and can be ignored.

3. Noncash Consideration

Companies generally recognize revenue based on the fair value of what is received.

4. Consideration Payable to a Customer

Consideration paid or payable may include discounts, volume rebates, coupons, free products, or services. In general, these elements reduce the consideration received and the revenue to be recognized unless the entity is receiving goods or services transferred by the customer.

Example
Facts: On July 1, 2017, SEK Company sold goods to Grant Company for $900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of $1,416,163. The goods have an inventory cost on SEK's books of $590,000.
Required: Record journal entry for SEK Company for 2017 Year
Solution: SEK should record revenue of $900,000 on July 1, 2017, which is the fair value of the inventory in this case. SEK is also financing this purchase and records interest revenue on the note over the 4-year period. In this case, the interest rate is imputed and is determined to be 12%. SEK records interest revenue of $54,000 (12% × ½ × $900,000) on December 31, 2017.
The entry to record SEK's sale to Grant Company and the cost of goods sold on July 1, 2017:
Notes receivable 1,416,163
Discount on notes receivable 516,163
Sales revenue 900,000
Cost of goods sold 590,000
Inventory 590,000
The entry to record interest revenue on December 31, 2017:
Discount on notes receivable 54,000
Interest revenue 54,000*
*12% X ½ X $900,000 = $54,000

D. Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

1. Allocation Defined

If a contract includes more than one performance obligation, the seller allocates the transaction price to each one in proportion to the stand-alone selling prices of the goods or services underlying all the performance obligation in the contract.

2. Stand-alone Selling Price

The stand-alone selling price is the amount at which the good or services is sold separately under similar circumstances. The stand-alone selling price should be determined at contract inception.

3. Discounts

When the total of stand-alone prices for each performance obligation within a contract exceeds the total transaction price for the contract, a discount exists. The discount should be allocated proportionally to all performance obligations within the contract.

4. Variable Consideration

If applicable, variable consideration may be attributable to the entire contract, individual performance obligations within a contract, or distinct goods or services within a single performance obligation.

5. Transaction Price Changes

If the transaction price of the contract changes after contract inception, we should allocate the change to the performance obligation in the contract on the same basis that was used at contract inception. Changes in stand-alone selling prices of some performance obligation within a contract after inception should not be reallocated.

Example

Facts: Handler Company is an established manufacturer of equipment used in the construction industry. Unit selling prices of Handler's products range from $600,000 to $4,000,000 and are quoted inclusive of installation and training. The installation process does not involve changes to the features of the equipment and does not require proprietary information about the equipment for the installed equipment to perform to specifications. Handler has the following arrangement with Chai Company.

Chai purchases equipment from Handler for a price of $2,000,000 and chooses Handler to do the installation. Handler charges the same price for the equipment irrespective of whether it does the installation or not. The installation service included in the arrangement is estimated to have a standalone selling price of $20,000.

The standalone selling price of the training sessions is estimated at $50,000. Other companies can also perform these training services.

Chai is obligated to pay Handler the $2,000,000 upon the delivery and installation of the equipment.

Handler delivers the equipment on September 1, 2017 and completes the installation of the equipment on November 1, 2017. Training related to the equipment starts once the installation is completed and lasts for 1 year. The equipment has a useful life of 10 years.

Required: What are the performance obligations for the sale of equipment? How should the payment of $2,000,000 be allocated to various components?

Solution: The entity identifies three performance obligations in the contract for the following goods and services:

Equipment

Installation

Training

The total revenue of $2,000,000 should be allocated to the three components based on their relative standalone selling prices. The standalone selling price of the equipment is $2,000,000, the installation fee is $20,000, and the training is $50,000. The total standalone selling price therefore is $2,070,000 ($2,000,000 + $20,000 + $50,000). The allocation is as follows.

Equipment $1,932,367 = [($2,000,000÷$2,070,000)×$2,000,000]

Installation $19,324 = [($20,000÷$2,070,000)×$2,000,000]

Training $48,309 = [($50,000÷$2,070,000)×$2,000,000]

Handler makes the following entry on November 1, 2017, to record both sales revenue and service revenue on the installation, as well as unearned service revenue. Assuming the cost of the equipment is $1,500,000, the entry to record cost of goods sold is as follows.

Cash	2,000,000	
Service Revenue (installation)		19,324
Unearned Service Revenue		48,309
Sales Revenue		1,932,367
Cost of Goods Sold	1,500,000	
Inventory		1,500,000

E. Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

1. Transfer of Control

A company satisfies its performance obligation when the customer obtains control of the good or service. The customer controls the product or service when it has the ability to direct the use of and obtain substantially all the remaining benefits of the asset or service. Performance obligations may be satisfied either over time or at a point in time.

2. Satisfied Over Time

Revenue is recognized over time if any:

- The customer consumes the benefit of the seller's work as it is performed, as when a company provides cleaning services to a customer for a period of time, or
- The customer controls the asset as it is created,
- The seller is creating an asset that has no alternative use to the seller, and the seller has the legal right to receive payment for progress to date.

If a performance obligation meets at least one of these criteria, we recognize revenue over time, in proportion to the amount of the performance obligation that has been satisfied.

a. Output Methods

Sellers sometimes use an output-based estimate of progress toward completion, measured as the proportion of the goods or services transferred to date.

Examples of output methods include: units produced or delivered as tons produced, floors of a building completed, mils of a highway completed, etc. Output methods should only be used when the output selected represents the entity's performance toward complete satisfaction of the performance obligation.

b. Input Methods

Other times sellers use an input-based estimate of progress toward completion, measured as the proportion of effort expended thus far relative to the total effort expected to satisfy the performance obligation. For example, sellers often use the ratio of costs incurred to date compared to total costs estimated to complete the job.

There is a disadvantage of input methods that no direct relationship exists between an entity's inputs and the transfer of control. If inputs are used evenly throughout the performance period, revenue can be recognized on a straight-line basis.

If an entity expects to recover its costs and there is no reliable information used to measure progress, revenue may be recognized to the extent that costs are recovered until it can reasonably measure the outcome of the performance obligation.

3. Satisfied at a Point in Time

If the performance obligation is not satisfied over time, companies recognize revenue at a point in time. Revenue should be recognized at the point in time when the customer obtains control of the asset or service.

a. The customer is more likely to control a good or service if the customer has:

b. An obligation to pay the seller

c. Legal title to the asset

d. Physical possession of the asset

e. Assumed the risks and rewards of ownership

f. Accepted the asset

Example
TrueTech Industries sells the Tri-Box, a gaming console that allows users to play video games individually or in multiplayer environments over the Internet. A Tri-Box is only a gaming module and includes no other goods or services. When should TrueTech recognize revenue for the following sale of 1,000 Tri-Boxes to CompStores?
December 20, 2017: CompStores orders 1,000 Tri-Boxes at a price of $240 each, promising payment within 30 days after delivery. TrueTech has received the order but hasn't fulfilled its performance obligation to deliver Tri-Boxes. In light of this and other indicators, TrueTech's judgment is that control has not been transferred and revenue should not be recognized.
January 1, 2018: TrueTech delivers 1,000 Tri-Boxes to CompStores, and title to the Tri- Boxes transfers to CompStores. TrueTech has delivered the Tri-Boxes, and CompStores has accepted delivery, so CompStoreshas physical possession, legal title, the risks and rewards of ownership, and an obligation to pay TrueTech. TrueTech's performance obligation has been satisfied, so TrueTech can recognize revenue and a related account receivable of $240,000. *
Account Receivable ($240X1,000) 240,000
Sales Revenue 240,000
January 25, 2018: TrueTech receives $240,000 from CompStores. This transaction does not affect revenue. We recognize revenue when performance obligations are satisfied, not when cash is received. TrueTech simply records collection of the account receivable.
Cash 240,000
Account Receivable 240,000

Example
TrueTech Industries sells one-year subscriptions to the Tri-Net multiuser platform of Internet-based games. TrueTech sells 1,000 subscriptions for $60 each on January 1, 2018.
TrueTech has a single performance obligation to provide a service to subscribers by allowing them access to the gaming platform for one year. Because Tri-Net users consume the benefits of access to that service over time, TrueTech recognizes revenue from the subscriptions over the one-year time period.
On January 1, 2018, TrueTech records the following journal entry:
Cash 60,000
Deferred revenue 60,000
TrueTech recognizes no revenue on January 1. Rather, TrueTech recognizes a deferred revenue liability for $60,000 associated with receiving cash prior to satisfying its performance obligation to provide customers with access to the Tri-Net games for a year.
Tri-Net subscribers receive benefits each day they have access to the Tri-Net network, so TrueTech uses "proportion of time" as its measure of progress toward completion. At the end of each of the 12 months following the sale, TrueTech would record the following entry to recognize Tri-Net subscription revenue:
Deferred revenue ($60,000÷ 12) 5,000
Service revenue 5,000
After 12 months TrueTech will have recognized the entire $60,000 of Tri-Net subscription revenue, and the deferred revenue liability will be reduced to zero.

II. Expenses Recognition

Expense recognition often matches revenues and expenses that arise from the same transactions or other events.

Sometimes costs are incurred, but it is impossible to determine in which period or periods, if any, related revenues will occur. We recognize such expense in the period incurred.

A. Product Costs

Product costs are the direct materials, direct labor, and manufacturing overhead used in making its products. The product costs are also “inventoriable” costs. Product costs are capitalized and become an expense only when the product is sold. This is known as cause-and-effect relationship.

B. Period Costs

Period costs are not a necessary part of the manufacturing process. Period costs cannot be assigned to the products or the cost of inventory. The period costs are usually associated with the selling function of the business or its general administration. The period costs are reported as expenses in the accounting period in which they best match with revenues,1) when they expire, or 2) in the current accounting period.

Task 2
Revenue and Expense Recognition Types

I. Accruals and Deferrals

A. Accrual-Basis Accounting - Transactions that change a company's financial statements are recorded in the periods in which the events occur, even if cash was not exchanged. Both deferrals and accruals are under accrual accounting method.

1. Revenue— recognition of revenue when earned, even if cash was not received
2. Expense— recognition of expenses when incurred, even if cash was not paid

B. Accrual

1. **Accrued Asset (or accrued revenue)**
   Accrued assets involve the recognition of revenue for goods or services transferred to customers before cash is received.
2. **Accrued Liability (or accrued expense)**
   Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses.
3. **Estimates**
   Accountants often must make estimates of future events to comply with the accrual accounting model.

C. Deferral

Deferral occurs when the cash flow precedes either expense or revenue recognition. Deferral typically results in the recognition of a liability or an asset.

1. **Unearned revenue**—recognition of revenue is deferred, but cash is received in advance
2. **Prepaid expense**—recognition of expense is deferred, but cash is paid in advance
3. A **deferral postpones** recognition of revenue by placing the amount in liability accounts and recognition of expense by placing the amount in asset accounts.

D. Cash Basis and Accrual Basis

Under cash-basis accounting, companies record revenue when they receive cash. they record an expense when they pay out cash. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails to record revenue for a company that has performed services but has not yet received the cash. As a result, it does not match expenses with revenues. Cash basis is subject to manipulation. Cash-basis accounting is not in accordance with generally accepted accounting principles (GAAP).

Accrual basis accounting means that transactions that change a company's financial statements are recorded in the periods in which the events occur, even if cash was not exchanged. The conversion between cash basis to accrual basis or otherwise is often tested topic in ton the CPA examination.

E. Comparison between Deferrals and Accruals

1. **Deferrals**:
   a. Prepaid expenses: Expenses paid in cash before they are used or consumed.
   b. Unearned revenues: Cash received before services are performed.
2. **Accruals**:
   a. Accrued revenues: Revenues for services performed but not yet received in cash or recorded.
   b. Accrued expenses: Expenses incurred but not yet paid in cash or recorded.

Receivables are reported as assets when they are earned.	Receivables are not reported as assets.
Revenues are reported when they are earned.	Revenues are reported when cash is received.
Payables are reported as liabilities when they are incurred.	Payables are not reported as liabilities.
Expenses are reported when they best match revenues or when they are used up.	Expenses are reported when cash is paid.
Net income is based on revenues earned and expenses incurred during an accounting period.	Net income is based more on cash receipts and cash disbursements rather than the revenues earned and expenses incurred during the accounting period.
The balance sheet is more complete as far as the reporting of assets, liabilities and the amount of stockholders' equity.	The balance sheet omits certain assets, liabilities. The amount of stockholders' equity will also be affected.
The accrual method is required by GAAP.	The cash method is likely to violate the matching principle in accounting.

Accrual Basis Net Income Deduct Increase in Accounts Receivable (or Add Decrease in Accounts Receivable)
Deduct Increase in Merchandise Inventory (or Add Decrease in Merchandise Inventory)
Deduct Increase in Prepaid Expenses (or Add Decrease in Prepaid Expenses)
Add Increase in Accounts Payable (Or Deduct Decrease in Accounts Payable)
Add Increase in Accrued Expenses (Or Deduct Decrease in Accrued Expenses)
Add Depreciation and Amortization Expenses for the Year
= Cash Basis Net Income

II. Revenue and Expense Recognition Types

A. Royalty income

Royalty income is a payment received for the use and exploitation of artistic or literary works, patents and mineral rights. Royalties can take many different forms and the calculations can be complex however, fundamentally they depend on the amount to which the asset is used by the licensee. For example, a publisher might pay a royalty to an author for each copy of his/her book sold, or a manufacturer might pay a royalty to an inventor based on the revenue earned from the sale of his/her invented products. Royalty income is recognized when earned.

EXAMPLE - Accrual of Royalty Revenue

Golden Publications wrote a novel and sold it to ABC Company for royalties of 25% of sales. Golden collected royalty payments semiannually on March 31 (for July through December sales of the previous year) and on September 30 (for January through June sales of the same year). During Year 1 and Year 2, ABC Company received the following checks from ABC Company:

	31-March	***30-September***
Year 1	$14,000	$17,000
Year 2	$12,000	$20,000

Golden estimated that novel sales would total $60, 000 for the last half of Year 2. How much royalty revenue should Golden Publications report in its Year 2 income statement for the year ended December 31, Year 2?

September 30, Year 2 check (for January 1- June 30)	$20,000
Earned July 1 through December 31, Year 2 (25% × $60, 000)	15,000
Royalty revenue for Year 2	$35,000

EXAMPLE - Royalties Received in Advance

Golden Company receives royalties on its patents in two ways: advance royalty payments and royalty payments within 60 days after year end. Two related accounts are included in Golden Company's December 31 balance sheets for Year 1 and 2:

	Year 1	*Year 2*	*Difference*
Royalties receivable	$105,000	90,000	($15,000)
Unearned royalties	80,000	45,000	(35,000)

During Year 2, Golden Company received royalty payments of $180, 000. In its income statement for Year 2, what should Golden Company's royalty income be?

Royalty collections	$180,000
Plus: Reduction in unearned royalties ($80,000-$45,000)	35,000
Less: Reduction in royalty receivable ($105,000-$90,000)	(15,000)
Year 2 royalty income	$200,000

Pass Key

Journal entry for receipts of advance royalty payments

DR	Cash	$XXX	
CR	Unearned royalty		$XXX

Journal entry to recognize royalty income

DR	Unearned royalty	$XXX	
CR	Royalty income		$XXX

B. Unearned Revenue

Companies record cash received before services are performed by increasing a liability account called unearned revenue. Unearned revenue will be decreased as revenue is recognized when the revenue is earned, and no further future service is required. Items like rent, and customer deposits for future service may result in unearned revenues.

EXAMPLE

Golden Publications collects magazine subscriptions from customers at the time subscriptions are sold. Subscription revenue is recognized over the term of the subscription. Golden collected $2 million in subscription sales during its first year of operations. On December 31, Year 1, the average subscription was one-fourth expired.

Information for Year 2:

Sale of subscriptions $1,400,000

Subscription revenue $1,200,000

In its December 31, Year 2 balance sheet, how much should Golden Publications report as subscriptions collected in advance?

Y1:

Cash	2,000,000	
Subscriptions collected in advance		2,000,000

(sale of subscription in Year 1)

Y2:

Cash	1,400,000	
Subscriptions collected in advance		1,400,000

(sale of subscription in Year 2)

Subscriptions collected in advance	1,200,000	
Subscriptions revenue		1,200,000

(subscription revenue recognized when product is delivered)

The ending balance in the subscriptions collected in advance is calculated as follows:

Balance at 12/31/Y1	$1,500,000
Sale of subscriptions in Y2	1,400,000
	2,900,000
Revenue recognized in Y2	(1,200,000)
Balance at 12/31/Y2	$1,700,000

C. Franchise Agreements

Franchise agreement is a contractual arrangement under which a franchisor grants the franchisee the exclusive right to use the franchisor's trademark or trade name and certain product rights. Payments to the franchisor usually include an initial payment plus periodic payments over the life of the franchise agreement.

1. Initial Franchise Fees

Initial franchise fees compensate the franchisor for the right to use its name and sell its products, as well as for such services as assistance in finding a location, constructing the facilities, and training employees. The initial franchise fee usually is a fixed amount, but it may be payable in installments.

2. Continuing Franchise Fees

Unlike initial franchise fees, continuing franchise fees compensate the franchisor for ongoing rights and services provided over the life of the franchise agreement. These fees sometimes are a fixed annual or monthly amount, a percentage of the volume of business done by the franchise, or a combination of both. GAAP required that they be recognized by the franchisor as revenue over time in the periods the services are performed by the franchisor, which generally corresponded to the periods they are received.

3. Franchisor Accounting (franchise fee revenue)

a. Unearned Revenue

Any contract amounts related to future services should be reported at present value as unearned revenue. The unearned revenue should be recognized as revenue once those future services are performed or substantially performed.

b. Earned Revenue

U.S. GAAP requires that substantially all of the initial services of the franchisor required by the franchise agreement be performed before the initial franchise fee could be recognized as revenue. If the initial franchise fee was collectible in installments, and if a reasonable estimate of bad debts could not be made, the installment sales or cost recovery methods were required.

4. Franchisee Accounting

a. Initial Franchise Fees

The present value of the initial franchise fees paid by a franchisee is recorded as an intangible asset and amortized over the expected life of the franchise.

b. Continuing Franchise Fees

Continuing franchise fees should be reported by the franchise as an expense in the period incurred.

Example

On January 1, Year 1, the Chicken Wing Corporation entered into a 10-year franchise agreement with Thomas Keller. In exchange for an initial franchise fee of $50,000, Chicken Wing will provide initial services over five years. $10,000 is payable on January 1, Year 1, with the remaining $40,000 payable in four annual installments beginning January 1, Year 2. The present value of the four annual payments is 37,950. In addition, the franchisee will pay annual continuing franchise fees of $10,000 at every year end for advertising and promotion provided by Chicken Wing, beginning immediately after the franchise begins operations.

Franchisor's (Chicken Wing) journal entry to record fees on January 1, Year 1:

DR	Cash	10,000	
DR	Notes receivable	40,000	
CR	Discount on notes receivable (contra asset)		2,050
CR	Unearned franchise fee revenue		47,950

Journal entry to record the receipt of continuing franchisee fee on December 31, Year 1:

DR	Cash	10,000	
CR	Service revenue		10,000

Journal entry to record the recognition of unearned franchise fee revenue on December 31, Year 1:

DR	Unearned franchisee fee revenue	9,590	
CR	Franchise fee revenue		9,590

Franchisee’s (Thomas Keller) journal entry to record the franchise at January 1, Year1:

DR	Franchises	47,950	
DR	Discount on notes payable (contra liability)	2,050	
CR	Notes payable		40,000
CR	Cash		10,000

Journal entry to record the payment of continuing franchisee fee on December 31, Year 1:

DR	Franchise expense	10,000	
CR	Cash		10,000

The discount will be recognized as interest expense by the franchisee over the payment period using the effective interest method. The franchise account would be shown as intangible assets on balance sheet for Franchisee and would be amortized over the expected life of the franchise:

Annual Amortization = (Franchise balance/Expected life) = $47,950/10 = $4,795

DR	Amortization expense	4,795	
CR	Franchise		4,795

5. Summary of Franchise

	Franchisor	**Franchisee**
Initial Franchise Fee (services are unperformed)	**Unearned Revenue (Present Value)**	**Intangible Asset (Present Value)**
Journal Entry	Dr. Cash Notes Receivable Cr. Unearned Revenue (PV) Discount on Notes Receivable Dr. Cash Cr. Notes Receivable Dr. Discount on Notes Receivable Cr. Interest Revenue	Dr. Franchise (PV) Discount on Notes Payable Cr. Cash Notes Payable Dr. Notes Payable Cr. Cash Dr. Interest Expense Cr. Discount on Notes Payable
Continuing Franchise Fee	**Revenue**	**Expense**
Journal Entry	Dr. Cash/Accounts Receivable Cr. Franchise Revenue	Dr. Franchise Expense Cr. Cash/Accounts Payable

D. Start-up Costs

Start-up costs are incurred for one-time activities to start a new operation. Start-up costs include opening a new plant, introducing a new product/service, conducting business in a new territory, or legal and state fees incurred to organize a new business entity. An entity should expense start-up costs as incurred for book purposes.

Start-up costs include costs of the one-time activities associated with:	**Start-up costs do NOT include costs associated with:**
Organizing a new entity (e.g., legal fees for preparing a charter, partnership agreement, bylaws, original stock certifications, filing fees, etc.).	Routine, ongoing efforts to refine, enrich, or improve the quality of existing products, services, processes, or facilities.
Opening a new facility.	Business mergers or acquisitions.
Introducing a new product or service.	Ongoing customer acquisition.
Conducting business in a new territory or with a new class of customer.	
Initiating a new process in an existing facility.	

Task 3 Installment Method and Cost Recovery Method

Businesses determine which method to use based on the type of transaction and the type of revenue collection uncertainty they face. Where there is extreme uncertainty, accountants use either the installment method or the cost recovery method.

If a product is sold through an installment plan, in which the customer is allowed to make payments over a long period of time, then a company would use an installment method. The cost recovery method is used in much more uncertain transactions, in which accountants are either unable to assume payment confidently or if the value of the sale is difficult to estimate.

I. Installment Method

Installment method is a method of revenue recognition in which gross profit is deferred until cash from the sale is received. Thus, revenue recognition takes place at the point of cash collection rather than the point of sale. Installment sales accounting can only be used where "collection of the sale price is not reasonably assured" (ASC Topic 605) (APB 10). Use of the installment method requires an enhanced level of record keeping for the duration of the associated installment payments. The accounting staff should track the remaining amount of deferred revenue on each contract that has yet to be recognized, as well as the gross profit percentage on installment sales in each separate year.

A. Problem Solving Formulas

1. Gross profit = Sale -Cost of goods sold
2. Gross profit percentage = Gross profit / Sales price = 1 – COGS percentage
3. Earned gross profit = Cash collections x Gross profit percentage
4. Deferred gross profit = Installment receivable x Gross profit percentage

EXAMPLE

Golden Company made installment sales of $400,000 on January 1, Year 1. By the end of Year 1, balance in installment accounts receivable was $150,000. If the Golden Company had $300,000 as its cost of goods sold regarding to the installment sales, realized profit and deferred profit in Year 1 would be calculated as follows:

Step 1: calculate gross profit and gross profit percentage on the installment sales

Gross profit = Sales – COGS: $400,000 – 300,000 = $100,000

Gross profit percentage = Gross profit/Sales: $100,000/400,000 = 25%

Step 2: calculate earned gross profit in Year 1

Cash collections in Year 1 = Sales – Ending Installment accounts receivable for Year 1: $400,000 – 150.000 = $250,000

Earned gross profit = Cash collections in Year 1 x Gross profit percentage: $250,000 X 25% = $62,500

Step 3: calculate deferred gross profit at 12/31/Year 1

Deferred gross profit at 12/31/Y1 = Ending Installment accounts receivable for Year 1 X Gross profit percentage: $150,000 X 25% = $37,500

Golden Company would record the following journal entries during Year 1.

Journal entry to record the installment sale:

DR	Installment sale accounts receivable	$400,000	
CR	Inventory		$300,000
CR	Deferred gross profit (contra-receivable)		100,000

Journal entry to recognize cash collection:			
DR	Cash	$250,000	
CR	Installment sale accounts receivable		$250,000
Journal entry to record profit on collection:			
DR	Deferred gross profit	$62,500	
CR	Realized gross profit on installments sales		$62,500

B. Balance Sheet Presentation

Under the installment method, only the gross profits on those sales for which cash payment has been received are recognized. All gross profits associated with uncollected receivables are parked on the balance sheet as an offset to receivables, where they remain until customer payments are received

As such, the deferred profit appears as a contra account immediately below the accounts receivable line item in the assets section of the balance sheet. When this approach is used, the content of the relevant line items in the balance sheet are:

Accounts receivable	XXX
Less: deferred gross profit*	(XX)
Net accounts receivable	XX

* The deferred gross profit is a contra asset account.

II. Cost Recovery Method

A. General

Cost recovery is an even more conservative method of revenue recognition. Here, all gross profit is deferred until the cost of the item sold is recovered.

At the time of sale, a business does not recognize any income related to a sale transaction until the cost elements of the sale have been paid in cash by the customer. Once the cash payments have recovered the seller's costs, all remaining cash receipts are recorded in income as received.

EXAMPLE

Golden Company made cost recovery sales of $400,000 on January 1, Year 1. By the end of Year 1, balance in cost recovery accounts receivable was $150,000. If the Golden Company had $300,000 as its cost of goods sold regarding to the cost recovery sales, realized profit and deferred profit in Year 1 would be calculated as follows:

Cost recovery sale	$ 400,000
Cost of goods sold	(300,000)
Total gross profit	$ 100,000
Cash collections:	
Year 1	$ 250,000
Year 2	150,000

Journal entry to record the sale under the cost recovery method:

DR	Cost recovery account receivable	$400,000	
CR	Inventory		$300,000
CR	Deferred gross profit (contra-receivable)		100,000

Journal entry to recognize cash collection in Year 1:

DR	Cash	$250,000	
CR	Cost recovery accounts receivable		$250,000

In Year 1, since the cost of sales is $300,000, the cash collection $250,000 is treated as recovery of the cost which left $50,00 cost is un-recovered.

Journal entry to record the cash collection in Year 2:

DR	Cash	$150,000	
CR	Cost recovery accounts receivable		$150,000

Journal entry to recognize gross profit in Year 2:

DR	Deferred gross profit	$100,000	
CR	Realized gross profit		$100,000

During Year 2, the first $50,000 collected is treated as recovery of cost of the inventory. The remaining $100,000 collected is gross profit since the cost of inventory $300,00 is fully recovered.

III. Distinguish between the Installment Method and the Cost Recovery Method of Accounting

The installment method recognizes gross profit by applying the gross profit percentage on the sale to the amount of actual cash received each period. The cost recovery method defers all gross profit recognition until cash has been received equal to the cost of the item sold.

The cost recovery method is similar to the installment sales method in that it may only be used when receivables are collected over an extended period and there is no reasonable basis for estimating their collectability.

Because no profit is recognized until all costs have been recovered, cost recovery method is by far the most conservative of all revenue recognition methods.

A. Installment Sales:

1. **Step 1: To calculate gross profit**
   Gross profit = Sales – COGS
2. **Step 2: To calculate gross profit percentage on the installment sales**
   Gross profit percentage = Gross profit / sales
3. **Step 3: To calculate gross profit recognized in the current period**
   Gross profit recognized this period = Cash collections this period X Gross profit percentage
4. **Step 4: To calculate deferred gross profit by the end of period**
   Deferred gross profit = Ending installment receivable X Gross profit percentage

B. Cost Recovery Method

1. Under cost recovery method, every dollar received is applied to cost of sales until cost is fully recovered, then recognize as gross profit.

C. Installment Sales vs. Cost recovery Method

1. **Installment**
   Used only when there is no reasonable basis for estimating the degree of collectability.
2. **Cost Recovery**
   Also used at absence of a reasonable basis for collectability:
   a. unable to assume payment confidently, or
   b. if the value of the sale is difficult to estimate
   *Cost Recovery method is more conservative than installment sales method

Task 4 Fair Value Measurements and Fair Value Option

I. Overview

A fair value measurement assumes an orderly transaction to sell or otherwise dispose of an asset or transfer a liability in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability.

A. Applying the Fair Value Measurement Approach Involves the Following Six Steps:

Step 1: Identify the asset or liability to be measured.

Step 2: Determine the principal or most advantageous market.

Step 3: Determine the valuation premise.

Step 4: Determine the appropriate valuation technique (market, income, or cost approach).

Step 5: Obtain inputs for valuation (Level 1, Level 2, or Level 3).

Step 6: Calculate the fair value of the asset.

II. Terminology

A. Fair Value

Fair value is the exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability.

1. Fair value is measured for a specific asset or liability, a group of assets and/or liabilities, or an entity's own equity instrument (e.g. an equity interest issued as consideration in a business combination).
2. Fair value is a market-based measurement, not an entity-specific measurement.
3. Fair value is measured in the principal market or the most advantageous market in the absence of a principal market.
4. Fair value is the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).
5. The reporting entity must evaluate information about market participant assumptions that is reasonably available without undue cost and effort. The market participant assumptions include assumptions about risk.
6. Fair value is not adjusted for transactions costs, but is adjusted for transportation costs, if location is a characteristic of the asset.
7. The fair value of a nonfinancial asset assumes the highest and best use of the asset.
8. A fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled).
9. An entity uses a valuation technique to measure the fair value of the item from the perspective of a market participant that owes the liability or that issued the equity instrument.
10. A fair value measurement of a liability or an entity's own equity instrument assumes that the item is transferred in an orderly transaction between market participants at the measurement date and assumes that the liability or equity interest would remain outstanding and would not be settled, cancelled, or extinguished on the measurement date.

B. Orderly Transaction

An orderly transaction assumes exposure to the market for a period before the measurement date to allow for market activities that are usual and customary for transactions involving such assets or liabilities. An orderly transaction is not a forced transaction (e.g. a forced liquidation or distress sale).

C. Market Participants

Market participants are buyers and sellers in the principal (or most advantageous) market who are independent (not related parties), knowledgeable about the asset or liability, able to enter into a transaction for the asset or liability, and willing to transact for the asset or liability.

D. Principal Market

The principal market is the market with the greatest volume and level of activity for the asset or liability. A fair value measurement assumes that the transaction takes place in the principal market for the asset or liability. Only in the absence of a principal market does the entity assume that the transaction takes place in the most advantageous market.

E. Most Advantageous Market

The most advantageous market is the market that would maximize the amount that would be received to sell an asset or minimize the amount that would be paid to transfer a liability, taking into transaction cost and transportation costs.

Fair value is considering transportation cots but not transaction costs. Transaction cost is considered to identify the most advantageous market, but not used to measure fair value. The price in the most advantageous market will be the fair value measurement only if an entity can't identify a principal market.

EXAMPLE

Golden Co. holds Clan Co. stock, which trades on two exchanges (Golden Co. can access both the New York and Tokyo markets).

The stock price and transaction costs at the measurement date are as follows:

Exchange	*Quoted Stock Price*	*Transactions Costs*	*Net*
New York	$52	($4)	$48
Tokyo	$54	($3)	$51

What is the fair value of Clan stock?

1) If New York is the principal market: fair value = $52

2) If Tokyo is the principal market: fair value = $54

3) If no principal market, with Tokyo's price (net of transaction costs) having the most advantageous result: fair value = $54

F. Highest and Best Use

1. Nonfinancial Assets

Highest and best use is a valuation concept which represents the use of a nonfinancial asset by market participants that would maximize the value of the asset or the group of assets and liabilities within which the asset would be used.

The highest and best use of a nonfinancial asset establishes the valuation premise that is used to measure the asset's fair value.

A fair value measurement of a nonfinancial asset considers a market participant's ability to generate economic benefits by using the asset at its highest and best use or by selling it to another market participant who would use the asset in its highest and best use.

2. Liabilities and Financial Assets

The highest and best use concept is not relevant when measuring the fair value of financial assets or liabilities because financial assets/liabilities do not have alternate uses and their fair values do not depend on their use within a group of other assets or liabilities.

EXAMPLE - Highest and Best Use
Company J acquires land in a business combination. The land is currently developed for industrial use as a factory site. Although the land's current use is presumed to be its highest and best use unless market or other factors suggest a different use, Company J considers the fact that nearby sites have recently been developed for residential use as high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Company J determines that the land currently used as a factory site could be developed as a residential site (e.g. for high-rise apartment buildings) and that market participants would consider the potential to develop the site for residential use when pricing the land. The highest and best use of the land is determined by comparing the following. – The value of the land as currently developed for industrial use (i.e. an assumption that the land would be used in combination with other assets, such as the factory, or with other assets and liabilities); and – The value of the land as a vacant site for residential use, considering the costs of demolishing the factory and other costs necessary to convert the land to a vacant site. The value under this use would consider risks and uncertainties about whether the entity would be able to convert the asset to the alternative use (i.e. an assumption that the land would be used by market participants on a stand-alone basis).

III. Fair Value Measurement Framework

In measuring the fair value of an asset or a liability, an entity selects those valuation approaches and techniques that are appropriate and for which sufficient data is available to measure fair value.

A. Valuation Approaches

A valuation approach is a broad category of techniques, while a valuation technique refers to a specific technique such as a particular option pricing model.

The technique chosen should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. A change in valuation approach is accounted for as a change in accounting estimate, which is accounted for prospectively.

Valuation approaches used to measure fair value fall under three categories:

1. Market Approach

Valuation techniques that fall under the market approach the market approach include quoted prices in an active market, but often derive market multiples from a set of comparable assets.

2. Income Approach

Valuation techniques that fall under the income approach convert future amounts such as cash flows or income streams to a current amount on the measurement date.

3. Cost Approach

Valuation techniques under the cost approach reflect the amount that would be required to replace the service capacity of an asset.

B. Hierarchy of Inputs

The fair value hierarchy is made up of three levels, with Level 1 being the highest level. Valuation techniques should maximize the use of observable inputs (Level 1 and Level 2) and minimize the use of unobservable inputs (Level 3).

Inputs are categorized into three levels.

1. **Level 1 Inputs**

   Level 1 uses unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

2. **Level 2 Inputs**

   Level 2 inputs would refer to quoted prices for similar assets or liabilities in all markets, adjusted as appropriate for differences.

   - **a.** Quoted prices for similar assets or liabilities in active markets.
   - **b.** Quoted prices for identical or similar assets in markets that are not active.

3. **Level 3 Inputs**

   Level 3 inputs are unobservable inputs for the asset or liability. Level 3 inputs may only be used to measure fair value if observable inputs are not available (i.e., there is little market activity for the asset or liability).

   These unobservable inputs may reflect the reporting entity's own assumptions about the market and are based on the best information available. Usually, there are no current observable prices for shares in private companies and accordingly the measurement of fair value is based on valuation techniques that use unobservable inputs.

C. Disclosure for Fair Value Measurement

Additional footnote disclosures are required for fair value measurements.

Fair value measurements are reported by class of assets or liabilities. The class is determined on the basis of the nature and risks of the assets or liability.

1. **Assets and Liabilities that are Measured at Fair Value on a Recurring Basis**

   For assets and liabilities that are measured at fair value on a recurring basis, the following disclosures are required for each major class of assets and liabilities:

   - **a.** The fair value measurement at the end of the reporting date.
   - **b.** The level within the fair value hierarchy used, segregating the fair value measurements, which use Levels 1, 2, and 3 inputs.
   - **c.** The amount of any transfers between Level 1 and Level 2 of the fair value hierarchy and the reason for the transfer along with the entity's transfer policy. Transfers into and out of each level are disclosed separately.
   - **d.** For fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3), a description of valuation techniques used, the inputs used to determine fair values of each class of assets or liabilities. If there is a change in valuation techniques, the reason for the change must be disclosed.
   - **e.** For fair value measurements using unobservable inputs (Level 3) a reconciliation of the beginning and ending balance, showing
     - **(1)** Total gains and losses for the period realized and unrealized, presenting gains and losses in earnings and gains and losses in other comprehensive income, and a description of where those gains or losses are included in the income statement, or in other comprehensive income.
     - **(2)** Purchases, sales, issues, and settlements shown separately.
     - **(3)** Transfers in and out of Level 3 are shown separately with reasons for the transfers, along with the entity's transfer policy.
   - **f.** For fair value measurements using unobservable inputs (Level 3) the amount of total gains or losses for the period included in earnings from unrealized gains and losses for those assets and liabilities still

held at the end of the reporting period and the line item in the statement of income (or activities) where the gains and losses are recognized.

g. For fair value measurements using unobservable inputs (Level 3) a description of the valuation processes (policies, procedures, and analyses of change from period to period), the sensitivity of the measurement, and any interrelationships.

h. For fair value measurements, a description of nonfinancial assets with a current use differing from the highest and best use.

2. Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis

For assets and liabilities that are measured at fair value on a nonrecurring basis, the following information must be disclosed in interim and annual period financial statements:

a. The fair value measurement at the end of the reporting period and the reasons for the measurement.

b. The level within the fair value hierarchy, Level 1, 2, and 3.

c. For fair value measurements categorized within Level 2 or Level 3 of the fair value hierarchy, the inputs and valuation techniques used to measure fair value.

d. For fair value measurements using significant unobservable inputs (Level 3), a description of valuation processes (policies, procedures, and analyses of change from period to period).

e. For fair value measurements a description of nonfinancial assets with a current use differing from the highest and best use.

f. The date the nonrecurring measurement was measured, if not as of the period's end.

IV. The Fair Value Option for Reporting Financial Assets and Financial Liabilities

An election can be made to measure, at fair value and on an instrument-by-instrument basis, certain financial assets and financial liabilities that are not currently reported at fair value. A financial asset is a non-physical asset whose value is derived from contractual claim, such as bonds, and stocks. A financial liability is a contract that imposes an obligation to deliver cash or another financial instrument.

A. Fair Value Option Applies

GAAP allows this treatment for the following items:

1. A financial asset or financial liability, including available-for-sale, held-to-maturity, and equity method investments

2. A firm commitment that only involves financial instruments

3. A loan commitment

4. An insurance contract where the insurer can pay a third party to provide goods or services in settlement, and where the contract is not a financial instrument

5. A warranty in which the warrantor can pay a third party to provide goods or services in settlement, and where the contract is not a financial instrument

B. Fair Value Option Not Applies

The fair value option cannot be applied to the following items:

1. An investment in a subsidiary or variable interest entity that will be consolidated

2. Deposit liabilities of depository institutions

3. Financial assets or financial liabilities recognized under leases

4. Financial instruments classified as an element of shareholders' equity

5. Obligations or assets related to pension plans, post-employment benefits, stock option plans and other types of deferred compensation

C. Fair Value Election

A company can elect to measure the applicable financial assets or financial liabilities at fair value on the election date, which can be the date when an item is first recognized, when there is a firm commitment, when qualification for specialized accounting treatment ceases, or there is a change in the accounting treatment for an investment in another entity. The fair value option is irrevocable unless a new election date occurs.

The fair value option permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date.

D. Instrument-by-instrument Basis

When the fair value option is elected, it should be applied on an instrument-by-instrument basis. The fair value option is applied only to entire instruments and not to portion of instruments.

For example, a company has two available-for-sale securities, Security A and Security B. The company can account for Security A using the cost adjusted fair value method and it can elect the fair value option and account for Security B at fair value. Therefore, any unrealized gains and losses on Security B would be reported on the income statement rather than in other comprehensive income.

For a held to maturity security being elected fair value option, the company would no longer report the investment at amortized cost. Instead, the held-to-maturity security would be measured to fair value at the end of the period, and the resulting unrealized gain or loss would be reported on the income statement rather than ignored. The rules remain in effect for classifying items on the statement of cash flows as operating or investing activities.

E. Others

If a reporting entity holds a group of financial assets and financial liabilities that are exposed to market and credit risks of counterparties, the reporting entity may elect fair value option for the net position if the following conditions are met:

1. The group of financial assets and financial liabilities are managed on the basis of net exposure;
2. Information about the group is provided on a net basis; and
3. The reporting entity has elected or is required to measure the group at fair value.

Additional financial statement disclosures are required if the fair value option is elected. Items valued at fair value can be presented on the balance sheet either as a separate line item or aggregately with similar items with the amount of fair value presented parenthetically.