FINANCIAL 10
lecture outline

I. FAIR VALUE MEASUREMENT
A. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal (or most advantageous) market at the measurement date under current market conditions.
B. Entities can use the market approach, the cost approach, the income approach, or a combination of these approaches when measuring the fair value of an asset or liability.
C. The fair value hierarchy prioritizes the inputs used in the market, cost, and income valuation techniques. Level 1 inputs have the highest priority and Level 3 inputs have the lowest priority.

II. PARTNERSHIPS
A. Contributions by a partner to a partnership are recorded at fair value less the present value of liabilities assumed by partnership.
B. Admission of new partners may be accounted for using the exact, bonus, or goodwill method. The bonus method adjusts the partners’ capital accounts for any difference and the goodwill method adjusts the assets (goodwill) and the existing partners’ capital accounts for the difference. No adjustment is required to the partners’ capital accounts under the exact method.
C. Withdrawals of partners also use the bonus and goodwill methods.
D. When a partnership is liquidated, assets are sold, gains or losses are allocated to partners, liabilities are paid, and the partners are entitled to receive the balance in their capital account. Partners who wind up with debit (overdrawn) balances owe that deficiency to the partnership and the other partners. If the capital deficiency remains outstanding, the deficiency must be absorbed by the remaining partners.

III. VARIABLE INTEREST ENTITIES (VIEs)
A. A variable interest entity is a corporation, partnership, trust, LLC or other legal structure used for business purposes that either does not have equity investors with voting rights or lacks the sufficient financial resources to support its activities.
B. Under U.S. GAAP, the primary beneficiary of a variable interest entity must consolidate the variable interest entity. There is a private company accounting alternative for consolidation of a variable interest entity for common control lease arrangements that permits a private company lessee to not consolidate a lessor entity that would otherwise be consolidated under existing VIE guidance if certain criteria are met.
C. The primary beneficiary is the entity that has the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and:
   1. absorbs the expected VIE losses; or
   2. receives the expected VIE residual returns.
D. IFRS focus on the accounting for special purpose entities.

A special purpose entity is an entity created by a sponsoring company to hold assets or liabilities, often for structured financing purposes (e.g., sales of receivables, synthetic leases, and securitization of loans). SPEs are a specific type of VIE. Under IFRS, a sponsoring company controls, and must consolidate, an SPE when the company:

1. is benefited by the SPE's activities.
2. has decision-making powers that allow it to benefit from the SPE.
3. absorbs the risks and rewards of the SPE.
4. has a residual interest in the SPE.

IV. ASSET RETIREMENT OBLIGATIONS (AROs)

A. An asset retirement obligation is a legal obligation associated with the retirement of a tangible long-lived asset that results from the acquisition, construction, or development and/or normal operation of a long-lived asset, except for certain lease obligations (minimum lease payment and contingent rentals).

B. When an asset retirement obligation exists and qualifies for recognition, an entity records an asset (ARC) and a liability (ARO) on the balance sheet equal to the fair value of the asset retirement obligation, if a reasonable estimate of fair value can be made. Fair value is generally equal to the present value of the future obligation.

C. In subsequent periods after the initial measurement, the ARO liability is adjusted for accretion expense due to the passage of time and depreciation expense is recognized on the ARC asset.

V. TROUBLEDEBT RESTRUCTURING

A. A troubled debt restructuring generally involves a creditor granting concessions to a debtor that would not be likely under normal circumstances in order to increase the likelihood of collection. The debtor will recognize a gain for the excess of the carrying amount of the payable (including accrued interest) over the fair value of the assets given up. An ordinary gain or loss may result from the difference between the FV and the NBV of the asset transferred. A restructuring may involve a combination of asset transfers, equity transfers, and modification of terms.

B. If an equity interest is transferred, there may be a gain to the extent that the FV of the equity transferred exceeds the face of the payable.

C. If there is a modification of terms, the debtor does not change the carrying amount of the debt unless it exceeds the total future cash payments specified under the new terms.

D. From the creditor's standpoint, these loans are treated as impaired if it is probable that the creditor will be unable to collect the amounts due under the original contract. Bad debt expense (and a corresponding allowance for credit losses) may be recorded by the creditor when there is a modification of terms associated with the impairment.
VI. OTHER LIABILITIES AND DEBT COVENANTS
   A. Current liabilities are obligations with maturities within one year or the operating cycle, whichever is longer. Current liabilities are valued at their settlement values. Settlement value is also known as net realizable value.
   B. Long-term receivables and payables (contractual rights to receive or pay money at a fixed or determinable rate) must be recorded at present value at the date of issuance. If a note is noninterest bearing or the interest rate is unreasonable (usually below market), the value of the note must be determined by imputing the market rate of the note and by using the effective interest method.
   C. Creditors use debt covenants in lending agreements to protect their interest by limiting or prohibiting the actions of debtors that might negatively affect the positions of the creditor. When debt covenants are violated, the debtor is in “technical default” and the creditor can demand repayment. Most of the time, concessions are negotiated and real default, as opposed to technical default, is avoided.

VII. ESTIMATED AND ACCRUED LIABILITIES
   A. An estimated liability represents recognition of a probable future charge that results from a prior act, such as estimated liability for warranties, trading stamps, or coupons.
   B. An accrued liability represents an expense recognized or incurred (through passage of time or other criteria) but not yet paid, such as accrued interest, accrued wages, accrued unemployment taxes, and accrued employer's portion of FICA taxes.

VIII. CONTINGENCIES
   A. Contingencies are existing conditions whose outcome depends on some future event or occurrence. The three categories of contingencies are probable, reasonably possible and remote.
   B. Loss contingencies that are probable and can be reasonably estimated must be accrued. If a range of losses is given, the best estimate of the loss is accrued. If no best estimate can be made, the minimum amount is accrued and the remaining amount is disclosed in a footnote. Gain contingencies that are probable are not accrued but are disclosed.
   C. The nature and amount (range) of a loss or gain contingency that is reasonably possible is disclosed in the footnotes and is not accrued.
   D. Remote contingencies are generally ignored. Remote contingencies that are guarantees must be disclosed.
   E. Unassisted claims follow similar rules for disclosure and/or accrual as loss contingencies.
IX. SUBSEQUENT EVENTS

A subsequent event is an event or transaction that occurs after the balance sheet date but before the financial statements are issued or are available to be issued. Subsequent events can be divided into two categories:

A. Recognized Subsequent Events

Subsequent events that provide additional information about conditions that existed at the balance sheet date. Entities must recognize the effects of all recognized subsequent events in the financial statements.

B. Nonrecognized Subsequent Events

Subsequent events that provide information about conditions that occurred after the balance sheet date and did not exist at the balance sheet date. Entities should not recognize nonrecognized subsequent events in the financial statements.

X. FINANCIAL INSTRUMENTS

A. The fair value option allows companies to measure eligible financial instruments at fair value at specified election dates. Under the fair value option, unrealized gains and losses are reported in earnings. The fair value option is irrevocable.

B. Under U.S. GAAP, entities must disclose concentrations of credit risk arising from all financial instruments, whether from a single party or a group of parties engaged in similar activities and that have similar economic characteristics. This disclosure is required by all firms except "small" private firms (assets < $100 million and no derivatives). Market risk disclosure of financial instruments is encouraged but not required under U.S. GAAP.

C. Under IFRS, entities are required to disclose the nature and extent of financial instrument risks, including credit risk, liquidity risk, and market risk.

D. Derivatives are financial instruments that derive their values from some other instrument and have the following characteristics:

1. One or more underlying (a price, rate, or other variable) and one or more notional amounts (currency units, shares, pounds, etc.).

2. Require little or no initial net investment.

3. Terms require or permit a net settlement, or ready settlement outside the contract, or delivery of an asset that gives substantially the same results.

E. The candidate should be familiar with the common derivative contracts including options, forward, futures, and swap contracts.

F. All derivative instruments are reported at fair value. The reporting of unrealized gains and losses depends on the derivative designation.

1. If there is a no-hedging designation, any gain or loss must be reported in the income statement. This is similar to the treatment of trading securities.
2. When hedging the fair value of an asset or liability currently in the balance sheet, the gain/loss on the asset/liability and the loss/gain on the hedge are both reported in the income statement for the current year. The derivative must be expected to be highly effective in reducing the risk (otherwise this is speculating, not hedging).

3. If hedging the variability in future cash flows pertaining to a particular risk, the effective portion of the cash flow hedge goes into other comprehensive income and is deferred until the hedge transaction affects earnings. The ineffective portion of the cash flow hedge is reported in net income for the current period.

4. Foreign currency hedges can be classified as fair value hedges, cash flow hedges, or hedges of a net investment in a foreign operation.

5. Specific disclosures are required for all companies that hold derivatives.

XI. PRESENTATION OF FINANCIAL STATEMENTS: LIQUIDATION BASIS OF ACCOUNTING

When liquidation is imminent, an entity must prepare its financial statements using the liquidation basis of accounting. This requirement applies to public and private companies and not-for-profits. The liquidation basis is applied prospectively at the time liquidation is deemed imminent.