

Financial Accounting and Reporting 2

Errata for 2007 Edition
Last Updated July 31, 2007

Section A: TEXT AND LECTURE ERRATA

Item A.1

Flashcard FARE 2-25

Question:

How are gains/losses on *nonmonetary* exchanges recognized?

Answer:

Exchange has commercial substance - always recognize gains and losses on the exchange equal to the difference between the FMV of what is given up and the FMV of what is received.

Comment:

This answer is clearly incorrect. A gain or loss for financial accounting purposes is calculated as the difference between the FV of what is given and the BV of what is given:

$$\text{Gain/loss} = \text{FV given} - \text{BV given}$$

In a nonmonetary exchange, as well as all arms-length transactions, it is assumed that the fair value given is equal to the fair value received.

Item A.2

Page F2-53: Kristi Corporation Example

There is a typo in the Translation Method portion of this example. Translated accounts payable should be equal to \$3,400 (34,000 LCU x 0.10 exchange rate), not \$3,430.

Section B: PASSMASTER, SIMULATIONS, & QUIZZES ERRATA

Item B.1

Question CPA-05238

Question:

Which of the following conditions must exist in order for an impairment loss to be recognized?

- I. The carrying amount of the long-lived asset is less than its fair value.
 - II. The carrying amount of the long-lived asset is not recoverable.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

Explanation:

Choice "b" is correct. A long-lived asset is impaired if the carrying amount of the asset is less than its fair value and if that carrying amount is not recoverable (the fair value would be recoverable, but the difference would not be). That means that both of the conditions must exist. An impairment loss would then be recognized for the amount of the difference.

Choice "a" is incorrect. Both of the conditions must exist for an impairment loss to be recognized.

Choice "c" is incorrect. Both of the conditions must exist for an impairment loss to be recognized.

Choice "d" is incorrect. Both of the conditions must exist for an impairment loss to be recognized.

Comments:

Choice "b" is the correct answer. However the explanations for all of the answer options are incorrect. Of the two conditions listed, only Condition II must exist for an impairment loss to be recognized. If Condition I exists, then there is no impairment. An impairment loss must be recognized when the carrying amount of the long-lived asset is GREATER THAN (not less than) its fair value.

Item B.2

Question CPA-01279

Question CPA-01282

Question CPA-01595

These questions are a set of question that were all directed at foreign currency transactions prior to SFAS No. 133 – Accounting for Derivative Instruments and Hedging Activities. The accounting described in these questions has been superseded by SFAS No. 133 and these questions should be deleted from PassMaster.

Item B.3

Financial 2 Simulation Adjustments Tab: Question 4

The following wording should be added to Question 4, which currently has no numbers for you to determine the adjustment:

The installment receivable was \$600,000 at the beginning of 20X1.

Item B.4

F4 (Yes, F4) Simulation Cost Determination Tab, Question 3

Please note: We realize that this question is in the F4 Simulation, but the question is about non-monetary exchanges so it is really relates to an F2 topic. Thus, it is covered in this online update. There is a slight typo in the answer.

Comments

For Question 2, Link paid so there is no gain to be recognized by Link. The Journal Entry is as follows:

Dr New Land	\$370,000	
Cr Cash		\$50,000
Cr Old Land		\$320,000

The new land has to be \$370,000 to make the Journal Entry balance. This part of the answer is correct.

For Question 3, Link paid so Club received and Club recognizes a proportionate part of the gain. Total consideration received by Club is \$500,000, with \$50,000 in cash and \$450,000 in land, or 10%. The realized gain is \$150,000 (fair value of \$500,000 - carrying amount of \$350,000). So \$15,000 of gain is recognized, and \$135,000 of gain is not. The new land is the plug. The Journal Entry is as follows:

Dr New Land	\$315,000	
Dr Cash	\$50,000	
Cr Old Land		\$350,000
Cr Gain		\$15,000

The difference between this answer and the one listed is that the listed answer switches the cash and the basis of the new land in the Journal Entry. Everything else is correct.

Item B.5

F7 (Yes, F7) Online Quiz Question 7

This question would be better presented in the F2 Online Quiz because the topic on Financial Reporting and Changing Prices (and on Foreign Currency Accounting) is presented in F2. However, for overall CPA exam purposes, it really does not make any difference.

This question appears to be incorrect. The question and answer are as follows:

Question

During a period of rising prices, a company that uses current cost/constant dollar accounting and holds net non-monetary assets likely experiences:

	<i>Purchasing Power Gain/Loss</i>	<i>Appreciation</i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Explanation

Choice "a" is correct. Purchasing power measures the impact of inflation through index adjusted constant dollar accounting. As the monetary unit decreases in value constant dollar accounting will measure purchasing power gains and losses. Non-monetary assets, assets not fixed in monetary value, will likely increase in dollar value resulting in a purchasing power gain. Appreciation is measured by evaluating replacement costs using current dollar accounting. In a period of rising prices, we would anticipate that assets would appreciate in value.

Choice "b" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Non-monetary assets would likely produce a purchasing power gain in a period of rising prices and we would most likely anticipate that asset values would appreciate as well.

Choice "c" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Non-monetary assets normally produce a purchasing power gain in a period of rising prices as well as reflect appreciation.

Choice "d" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Non-monetary would normally display both a purchasing power gain and appreciation in a period of rising prices.

Comments

Purchasing power gains or losses are described in Paragraph 29 of SFAS 33 in terms of net monetary assets, not net non-monetary assets, as follows:

An enterprise is required to disclose:

- a. *Information on income from continuing operations for the current fiscal year on a historical cost/constant dollar basis (paragraphs 39–46)*
- b. *The **purchasing power** gain or loss on net monetary items for the current fiscal year (paragraphs 47–50).*

*The **purchasing power** gain or loss on net monetary items shall not be included in income from continuing operations.*

This question specifically contradicts what is on Page F2-46, Item III.C.2, which is correct. The National Instructor is correct on changes in value of non-monetary assets being called holding gains and losses.

There was very little reference in the authoritative literature to holding gains and losses. What is available is consistent with the material on Page F2-46.

*“The essence of current value accounting is revenue recognition on some prerealization basis. The increases in current cost amounts of assets (so-called “**holding gains**”) arising in a current cost model can be viewed as income equivalents, but that view is not necessary. The model can classify those items as capital maintenance adjustments — necessary to keep the business on a level output trendline.”*

Section C: TEXT AND LECTURE ADDITIONAL OR ENHANCED INFORMATION

Item C.1

Page F2-8: Royalties Received in Advance Example—Applying the Account Analysis Format (AAF, or BASE mnemonic)

This example has caused some of our students a bit of confusion. It is sometimes easier to split the solution into two parts, with one Account Analysis Format for unearned royalties (royalties received in advance) and a second Account Analysis Format for royalties receivable. The national instructor actually introduced Account Analysis Formats while discussing the Radon Industries example on page F1-17, but he did not call them that, and we do not actually cover them formally until page F4-9 in discussing accounts receivable, where they are called the BASE format (Beginning, Add, Subtract, and Ending). Because they are so helpful on the exam, we discuss them in this online update.

Account Analysis Formats (AAF) are T-accounts in a different format. They **will** get you points on the CPA exam, especially in working with unusual accounts, but only if you use them. So the idea is to get some practice on the homework problems with Account Analysis Formats so that they are natural and easy for you to use on the exam. Many homework questions can be readily worked with an AAF, and every so often, two AAFs are used.

Since this is only F2, let's recap the accounts receivable AAF first. Accounts receivable is an asset account. Using the BASE methodology, the generic format without numbers is as follows:

(B) Beginning balance	\$
(A) Add: sales	\$
(S) Subtract: cash collections	\$
(E) Ending balance	\$

Note that the Add to the format is a Debit to Accounts Receivable and a Credit to Sales and that the Subtract from the format is a Debit to Cash and a Credit to Accounts Receivable. On the CPA exam, you will most often be given three of the numbers and will have to figure out what the missing number is. Write down the skeleton (blank) format, write down the numbers that are given in the question, and work backwards (normally) for the missing number. Do not try to rearrange the format because it is too easy to get the signs wrong.

Let's look at the Royalties Receivable (RR) AAF next. Royalties Receivable is an asset account (just like accounts receivable but for royalties instead of accounts). Using the BASE methodology, the format for Year 9 is as follows (the ending balances for Year 8 are the beginning balances for Year 9):

(B) Beginning balance	\$100,000 (given)
(A) Add: royalties earned	175,000 (the plug)
(S) Subtract: cash collections	<u>(180,000) (given)</u>
(E) Ending balance	\$95,000 (given)

To solve the AAF, write down the skeleton format without any numbers. Then insert the numbers that were given in the question. Then, see what is left and work backwards to get it. In this case, the "royalties earned" is the plug. Note that the format is exactly like an accounts receivable format, with royalties earned as the "add" and cash received as the "subtract." If you cannot figure out what the "add" is and what the "subtract" is, think of the Journal Entries involved with the account. In this case, the royalties earned Journal Entry is a Debit to Royalties Receivable (add) and a Credit to Royalties Earned (just like a normal accounts receivable Journal Entry, except that sales is replaced by royalties earned), and the cash collections Journal Entry is a Debit to Cash and a Credit (subtract) to Royalties Receivable. This AAF would represent the royalties earned and would be all that is needed if the unearned royalties were not present. In a simpler problem, that might be all there is. You need to know how to work this kind of AAF.

Unlike Royalties Receivable, Unearned Royalties (UR) is a liability account. Cash has already been received, and something then has to be done to earn the royalties. Using the BASE methodology, the format for Year 9 is as follows:

(B) Beginning balance	\$70,000 (given)
(A) Add: cash collections	180,000 (given)
(S) Subtract: royalties earned	<u>(205,000) (the plug)</u>
(E) Ending balance	\$45,000 (given)

To solve the AAF, write down the skeleton format without any numbers. Then insert the numbers that were given in the question. Then see what is left and work backwards to get it. In this case, the "royalties earned" is the plug. If you cannot figure out what the "add" is and what the "subtract" is, think of the Journal Entries. In this case, the cash collections Journal Entry is a Debit to Cash and a Credit to Unearned Royalties (add to a liability account), and the Royalties Earned Journal Entry is a Debit to Unearned Royalties (subtract from a liability account) and a Credit to Royalties Earned (which is a normal revenue account). This AAF would represent the royalties earned and would be all that is needed if the royalties receivable were not present. In a simpler problem, that might be all there is. You need to know how to work this kind of AAF.

In this question, we can see that \$205,000 for royalties earned is not the right answer. Because there is really no way to separate the cash collections into what was collected to pay off the royalties receivable and what was collected as advance/unearned royalties, the next step to work the question is to realize that royalties receivable (the asset) and unearned royalties (the liability) are "opposite" accounts. Royalties receivable are royalties earned and not yet received, and unearned royalties are royalties received and not yet earned. Given that they are opposites, they can be netted, with a beginning balance of \$30,000 (\$100,000 – \$70,000) and an ending balance of \$50,000 (\$95,000 – \$45,000).

Using the BASE methodology, the format for Year 9 for net royalties receivable is as follows:

(B) Beginning balance	\$30,000 (given)
(A) Add: royalties earned	200,000 (the plug)
(S) Subtract: cash collections	<u>(180,000) given</u>
(E) Ending balance	\$50,000 (given)

Using the BASE methodology, the format for Year 9 for net unearned royalties is as follows:

(B) Beginning balance	\$(30,000) (calculated)
(A) Add: cash collections	180,000 (given)
(S) Subtract: royalties earned	<u>(200,000) (the plug)</u>
(E) Ending balance	\$(50,000) (calculated)

The royalties earned of \$200,000 is the same amount in both formats and is the same amount that was determined on page F2-8. On the CPA exam, very few questions will involve more than one AAF. The unearned subscription revenue (another unusual account) on page F2-9 is a more normal question. Unearned Subscription Receivable is a liability account just like unearned royalties. In the AAF at the bottom of the box, cash receipts is the "add" to the account (Debit to Cash and Credit to Unearned Revenue) and Revenues Recognized/Earned is the "subtract" from the account (Debit Unearned Revenue and Credit Earned Revenue). In this question, however, we only have one account to worry about.

The following is a question from your homework. It illustrates the issues we discussed above.

Question CPA-00616

The discussion above was for royalties receivable and royalties unearned and earned. A similar approach can be taken for rentals receivables and rentals unearned and earned. This kind of question frequently shows up on the exam. The question and answer are as follows:

Question

Tara Co. owns an office building and leases the offices under a variety of rental agreements involving rent paid in advance monthly or annually. Not all tenants make timely payments of their rent. Tara's balance sheets contained the following data:

	1989	1990
Rentals receivable	\$9,600	\$12,400
Unearned rentals	32,000	24,000

During 1990, Tara received \$80,000 cash from tenants. What amount of rental revenue should Tara record for 1990?

- a. \$90,800
- b. \$85,200
- c. \$74,800
- d. \$69,200

Explanation

Choice "a" is correct. \$90,800 rental revenue earned for 1990.

	Asset Rentals Receivable	Liability Unearned Rentals	Net Unearned Rentals
Begin balance at end of 1989	9,600 -	32,000 =	22,400
Add cash collections			80,000
Subtotal			102,400
Less rental revenue earned			(90,800)
Ending balance at end of 1990	12,400 -	24,000 =	11,600

Comments

Note that this question is worked using the "opposite" accounts approach, just like the royalties question. The beginning balance and the ending balance are both netted. The cash collections is the "add" to the net unearned rentals account, and the rental revenue earned is the "subtract." The rental revenues earned is the plug, just like the royalties earned was the plug previously. If you see a question like this on your exam, the format in CPA-00616 is a good format to use.

Item C.2

Page F2-19, Item H: IMPAIRMENT

This section addresses impairment. However, the impairment that is being discussed here is as much the impairment of (fixed) assets (called long-lived assets to be held and used) as it is for intangible assets (not all intangible assets, and certainly not goodwill, are tested for impairment in this manner). Impairment for long-lived assets to be held and used is discussed at length on pages F4-51 through F4-53 and is correct there. This type of impairment testing is often known as the "undiscounted present values" approach. It is a two-step approach where the first step is a screening step and the second step is a computation of impairment step. The idea of the screening step is not to force the calculation and recognition of an impairment loss unless and until it is absolutely necessary.

Impairment testing for intangible assets and goodwill can be different from impairment testing for long-lived assets to be held and used. There are three different impairment tests for intangible assets and goodwill, depending on the type of asset, and two of them have nothing to do with undiscounted cash flows.

Intangible assets can be classified in several ways, and one of the major ways is "life." Intangible assets may have "finite" lives or they may have "indefinite" lives (and that is indefinite, not infinite). If they have finite lives, they are amortized over those lives. If they have indefinite lives, they are not amortized at all (because the life cannot be determined, there is no life to amortize over). Regardless, however, both types of intangible assets are tested for impairment at least annually.

- **Intangible assets with indefinite lives** (and thus not subject to amortization) are tested for impairment by comparing the fair value (however determined) of the intangible asset to its carrying amount. If its fair value is less than its carrying amount, an impairment loss is recognized in an amount equal to that difference. The impairment of these assets is not discussed anywhere in the course, but the concept has certainly shown up on at least one released question so it is not a bad idea to know something about it.
- **Intangible assets with finite lives** (and thus subject to amortization) are tested for impairment using the undiscounted present values approach described here just like long-lived assets to be held and used. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of the entity.

Impairment of goodwill is a totally different approach. It is another two-step approach (it actually has 6 steps, but it has two major steps) that again includes a screening step and a computation step (which is where the name comes from). Goodwill impairment is as follows (these details are not provided anywhere in the course; it is probably not necessary to know all of the details, but it would be advisable to know the general concepts and be able to define a reporting unit):

- Impairment is calculated at a reporting unit level. Impairment is calculated when the carrying amount of the goodwill for a reporting unit exceeds its implied fair value.

- A **reporting unit** is an operating segment, or one level below an operating segment. The goodwill for one reporting unit may be impaired, while the goodwill for other reporting units may or may not be impaired.

Evaluation of goodwill for impairment involves two major steps:

Step 1: Identify potential impairment by comparing the fair value of each reporting unit with its carrying amount, including goodwill.

Assign assets acquired and liabilities assumed to the various reporting units. Assign goodwill to the reporting units.

Determine the fair values of the reporting units and of the assets and liabilities of those reporting units.

If the fair value of a reporting unit is less than its carrying amount, there is potential goodwill impairment. The impairment is assumed to be due to the reporting unit's goodwill since any impairment in the other assets of the reporting unit will already have been determined and adjusted for (**other impairments are evaluated before goodwill**).

If the fair value of a reporting unit is more than its carrying amount, there is no goodwill impairment and Step 2 is not necessary.

Step 2: Measure the amount of goodwill impairment loss by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

Compare the fair value of each reporting unit to the fair value of the net assets of that reporting unit not including goodwill.

Determine the implied fair value of the goodwill of the reporting unit. Compare the implied fair value of the goodwill to its carrying amount. If the implied fair value of the goodwill is less than its carrying amount, recognize a goodwill impairment loss.

Note that each type of impairment discussed above has different rules because the different types of assets tend to have different characteristics. The text sometimes uses the wording "the" impairment approach. Actually, there is not just one impairment approach. There are many approaches. So far in the course, 4 different types of impairment have been identified: long-lived assets to be held and used, goodwill, intangible assets with finite lives, and intangible assets with indefinite lives. There are more that will be covered later in the course.

Item C.3

Textbook Pages F2-32 through F2-35: Background and Additional Information Regarding SFAS No. 153, "Exchanges of Nonmonetary Assets"

The information provided in the textbook addresses accounting for exchanges of nonmonetary assets according to the most recent pronouncement, SFAS No. 153. The details and background of this pronouncement are not included in the textbook, however, and we thought that our students might benefit from the following additional information, especially if the students learned how to account for nonmonetary exchanges under previous guidance.

SFAS No. 153 amends APB No. 29 as it relates to exchanges of nonmonetary assets by eliminating the exception under APB No. 29 that allowed the accounting for exchanges of **similar** nonmonetary assets to be at carryover basis (book value) without using the general rule of fair value (that is used, for example, in monetary transactions). Some of these nonmonetary

transactions were actually deemed to have commercial substance, yet the accounting was still at carryover basis because the transaction met the rules for the exception.

SFAS No. 153, in an effort by the FASB to better represent the economic substance of nonmonetary exchanges, as well as (supposedly) to be more in line with international accounting standards, indicates that the general rule for reporting nonmonetary exchanges is that the fair value of the assets exchanged be used to “measure the transaction.” However, it specifically provides for three general exceptions to the rule of using fair values of the assets exchanged:

1. The fair value of the assets received/relinquished cannot be determined within a reasonable limit.
2. The exchange is made purely to facilitate the sale of the product to a party that is not a party of the exchange (e.g., a customer).
3. The exchange lacks commercial substance.

With all three exceptions, if there is no cash or other property (boot) received or paid, the carryover basis (book value/carrying amount) is used to measure the transaction and record the asset(s) received (this is the accounting illustrated in the “No boot involved” example on page F2-34 of the text; this carryover basis accounting will be called the “general rule” for nonmonetary transactions that lack commercial substance in this document). If boot is received, a proportional amount of the realized gain is recognized, just like under APB No. 29 (the accounting when boot is received is discussed at the end of this section). If boot is paid, no gain is recognized; the asset is recorded at the carryover basis plus the boot paid. Generally, no loss is recognized on these transactions; any such “loss” should already have been recognized as an impairment loss per SFAS No. 144; if an impairment loss has not been previously recognized for some reason, it is recognized in the accounting for the exchange transaction, whether or not boot was paid or received or whether there was any boot at all.

These rules for recognizing gain or loss are basically the same as with APB No. 29, so that all the FASB has really done with SFAS No. 153 is to introduce some new terminology and eliminate the old terminology (“similar” and “dissimilar” productive assets). Even though the FASB said that it had eliminated an exception, it added other exceptions, and we are basically right back to where we started. Many of the questions on the CPA exam are nonmonetary exchanges of similar assets when boot is received; the accounting for these exchanges is basically the same as before SFAS No. 153 (we didn’t want to use the word “similar” here so we used “basically the same”); although, the wording of the question and answer will more than likely change to reflect the change in terminology.

The third exception above (the exchange lacks “commercial substance”) has caused the some confusion, not only among CPA exam candidates, but also among those in the profession. As indicated above, SFAS No. 153 replaced the “similar productive assets” fair value exception of APB No. 29 with a more general exception of exchanges that “lack commercial substance” (again, the “similar” and “dissimilar” wording is now obsolete). The Statement then went on to attempt to explain just what “commercial substance” was. The problem is that, even with the guidance provided in the Statement, it is still very difficult to determine exactly what commercial substance is, especially because, in the end, a qualitative assessment must often be made to arrive at the conclusion.

During the exposure draft period for SFAS No. 153, several respondents requested that the Statement include examples of transactions that illustrate “commercial substance” and those that illustrate a “lack of commercial substance.” While the FASB agreed that it might be helpful to provide example transactions, the Board decided not to include them in the issued Statement because it believed that there was sufficient information already in the Statement and because it believed that examples might restrict the CPA’s use of judgment in classification of the transaction.

SFAS No. 153 does provide some guidance regarding whether a nonmonetary exchange has commercial substance. It indicates that if the future cash flows of an entity are expected to significantly change as a result of the transaction, then the transaction has commercial substance. It further indicates two criteria that will cause the future cash flows of an entity to significantly change:

1. There is a significant difference between the timing, amount, or risk (these three elements together are called the “configuration”) of the expected future cash flows from the assets received compared to the assets relinquished.
2. There is a significant (in relation to the fair values of the assets exchanged) difference between the entity-specific value of the assets received and the entity-specific value of the assets relinquished. The entity-specific value is based on calculation guidance from Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which is different from a fair value measurement of the marketplace as a whole. It is essentially the value that the specific entity would place on the asset for its specific use within the entity.

If neither of the above two criteria is met, the transaction is deemed to lack commercial substance. However, the Statement further indicates that, in some cases, qualitative assessments (e.g., judgment) must be used to reach a final conclusion about whether a transaction/exchange has commercial substance.

The only thing that may be clear thus far is that the guidance in this Statement is not all that clear. In an effort to attempt to make some headway through the confusion, we have provided enhanced explanations for the related questions that appear in your homework and final exams. In these enhanced explanations, we have used “lack of commercial substance” as shorthand for all three of the above exceptions.

Considering how confusing this topic has become, we are hopeful that the examiners, in their questions regarding nonmonetary exchanges, will in the future provide specific wording in the fact pattern of the questions regarding whether or not the exchange has commercial substance (e.g., “this exchange has been deemed to lack commercial substance”) and test on the accounting for the transaction itself (i.e., do we use fair value or carryover value?). However, the editors at Becker CPA Review are confident that if you work the following questions and walk through the enhanced explanations, you will be able to make the “commercial substance” assessment on your own, if necessary.

Be alert for differences in terminology in this area. Carrying value and carrying amount and book value and net book value are all the same. Exchange and transaction and exchange transaction are all the same. Fair value and FMV are essentially the same (even though the appropriate accounting terminology is now really fair value and not FMV (Exposure Draft No. 1201 – *Fair Value Measurements*). SFAS No. 153 also uses wording of “the culmination of the earning process.”

It appears that the “compliance with international accounting standards” that was an objective of SFAS No. 153 was in the “commercial substance” wording. IAS 16, *Property, Plant, and Equipment*, issued in 1982 and revised in 2003, indicates that if an asset is acquired in exchange for another asset (whether similar or dissimilar in nature), the cost of the asset received is fair value unless either the exchange lacks commercial substance or the fair values of the assets involved cannot be determined (two of the three criteria in SFAS No. 153). If the acquired asset is not measured at fair value, it is measured at the carrying amount of the asset relinquished adjusted for any cash/boot given up or received in the transaction. The proportional gain provision does not appear to exist in international accounting standards. How much convergence was achieved with SFAS No. 153 is thus a matter of debate. Luckily, for now, international accounting standards are outside the scope of the CPA exam.

Item C.4

Page F2-34, Item II, EXCHANGES LACKING COMMERCIAL SUBSTANCE

Because of the way that SFAS No. 153 was written, with no nice new statement but just as amendments to existing pronouncements, it has been quite difficult to determine what was and was not included in the statement, at least in one area: the 25% rule. That rule was originally introduced in EITF 86-29, *Nonmonetary Transactions: Magnitude of Boot and the Exception to the Use of Fair Value*. EITF 86-29 was implemented by EITF 01-02, and EITF 81-02 was partially nullified by SFAS No. 153. Does that mean that EITF was also partially (or completely) nullified by SFAS No. 153? The consensus is that it was not, and that is the way it is now reflected in the text.

To be sure, a good place to start is the 12th edition of *Intermediate Accounting*, Kieso, Weygandt, and Warfield, which was published after SFAS No. 153, assuming that you can lift it. It contains the new rules and still discusses the 25% rule and EITF 86-29.

The 2006 edition of the Miller GAAP Guide, Levels B, C, and D, *Restatement and Analysis of Other Current FASB, EITF, and AICPA Pronouncements*, indicates the FASB No. 153 did not affect the consensus position in Issues 8(a), 8(b), 9, 11, and 12. Issue 8(a). Issue 8(a) dealt with the 25% rule; it thus is still in effect.

Item C.5

Enhancement to textbook page F7-34: Accounting for Nonmonetary Exchange Transactions That Lack Commercial Substance When Boot is Received (This section includes an example on how to calculate proportional gain)

If boot is received in a nonmonetary exchange that lacks commercial substance (or that qualifies under one of the other two criteria), a proportional amount of the realized gain is recognized, just like under APB No. 29. However, there are still two different approaches to recognizing this gain depending on the amount of boot received compared to the total consideration received. One of these approaches came from EITF 86-29 (EITF were discussed on page F1-5 as "Emerging Issues Task Force Consensus Positions" which is why they are called EITF in this document) and the other approach was in the original APB No. 29.

When the boot received equals or exceeds 25% of the total consideration received (including the boot), the transaction is viewed as a monetary exchange and all of the gain is recognized (EITF 86-29). When the boot received is less than 25% of the total consideration received, a proportional amount of the gain is recognized (APB No. 29). A ratio of (the total boot received / the total consideration received) is calculated, and that proportion of the total gain realized is recognized.

Assume the following:

- Machine A is exchanged for Machine B and \$2,000 boot
- Machine A, carrying value (BV) = \$6,000
- Machine A, fair market value (FMV) = \$12,000
- Machine B, fair market value not known (assumption is that the B FMV is \$10,000)

Calculate the realized gain as follows:

FMV of asset(s) received or given up – BV of asset(s) given

$$\$12,000 - \$6,000 = \$6,000 \text{ realized gain}$$

Note that this gain was buried in the asset prior to the exchange

Calculate the **recognized gain** as follows:

$$\begin{aligned} & \$2,000 \text{ boot received} / (\$2,000 \text{ boot received} + \$10,000 \text{ FMV of asset(s) received}) \\ & \times \$6,000 \text{ realized gain} \\ & = 2/12 \times \$6,000 \text{ realized gain} \\ & = \$1,000 \text{ recognized gain} \end{aligned}$$

Note that part of the gain that was previously buried in the asset is now recognized.

Journal Entry to record the above transaction:

DR Machine B	\$5,000 [plug]
DR Cash	2,000
CR Machine A	\$6,000
CR Gain on exchange	1,000

Note that Machine B is recorded at \$5,000 when its FMV is \$10,000. The \$5,000 of gain not recognized (\$6,000 - \$1,000) accounts for this difference. Note also that in this exchange, $2/12 = 12.5\%$, which is less than 25%, so the proportional gain, and not the full gain, is recognized. If the full gain had been recognized, Machine B would have been recorded at its \$10,000 FMV.

Item C.6

Page F2-47, Foreign Currency Translation and Remeasurement

Many people are confused by foreign currency translation and remeasurement. In many cases, it is just the unfamiliar terminology; in other cases, it is confusion about where translation and remeasurement should be used. The text is reasonably clear (as clear as a discussion of this subject can possibly be), but it is sometimes difficult to apply the rules to a specific situation.

It is important to remember what we are trying to do in this area. Assume that a company has a number of 100%-owned subsidiaries in a number of different foreign countries (a very common situation these days). For U.S. financial reporting, the company must prepare consolidated financial statements. If all of the subsidiaries' financial statements were in US \$, it would be no problem (assuming that the information in F3 has been mastered). Just add everything across, prepare the proper eliminating Journal Entries, and everybody is happy.

Unfortunately, the subsidiaries' financial statements are not all in US \$. In that case, the financial statements of the subsidiaries have to be converted into US \$. If exchange rates had not changed during the year, all that would be necessary would be to multiply or divide the amounts on each subsidiary's financial statements by some (conversion rate) factor, and then everything could be added across and eliminated as normal. However, it is impossible for exchange rates not to change during a year (they normally change on a daily basis because they are market driven), so there are numerous conversion factors to contend with. In addition, the accounting for foreign currency conversion (we are specifically not using the words translation or remeasurement here) says that certain financial statement line items are converted using one set of rates and others are converted using other sets of rates. When we do all that, the converted financial statements will no longer balance. As accountants, we cannot have that. The conversion gains and/or losses are what it takes to get the financial statements back into balance again.

Depending on the situation, we treat the financial statement conversion gains and/or losses differently. Some are called remeasurement gains and losses, and they go to the income statement, and others are called translation gains or losses, and they go to accumulated other comprehensive income (the PUFÉ mnemonic). So what is done when?

The key to remembering what is done when is on Page F2-49, Items III.I and III.J.

Remeasurement is what it takes to convert (restate) foreign currency financial statements into the functional currency. **Translation** is what it takes to convert (restate) foreign financial statements from the functional currency into US \$ (the US \$ is assumed to be the reporting currency—see item III.G). So once the functional currency is identified (which is almost always given on the CPA exam), we have to see whether or not we have a remeasurement. If not, we have a translation. Of course, because this is accounting and very little in accounting is simple, it is possible to have both translation and remeasurement at the same time.

EXAMPLE: Assume a three-company situation. Company C headquartered in Houston has a Subsidiary A in Dublin; Ireland is a Euro country. Subsidiary A has a Subsidiary B in London; England is still a pounds country. Subsidiary B keeps its books in pounds (the local currency), but for some reason its functional currency is Euros. Because the books are kept in pounds, the Subsidiary B financial statements will first be prepared in pounds (assume everything is according to US GAAP for simplicity). Those financial statements then have to be **converted to Euros, the functional currency**. That conversion is a **remeasurement**. Then the Euro-denominated financial statements have to be **converted to US \$, the reporting currency**. That conversion is a **translation**. In this situation, there is both a remeasurement and a translation, for the same subsidiary, Subsidiary B.

EXAMPLE: As another example, there are three companies, but the situation is a little different (this example appeared as a discussion question on a 1990 CPA exam). Jay Company has two 100%-owned foreign subsidiaries: JayA and JayF. The functional currencies are US \$ for JayA and francs for JayF (1990 was before Euros). Under the assumption that JayA's books are kept in Australian \$ (this assumption was not stated in the question but it is reasonable), the conversion of the JayA financial statements from Australian \$ to US \$ is a **remeasurement** (conversion from the local currency to the functional currency). No translation would be necessary because the financial statements would already be in US \$. Under the assumption that JayF's books are kept in francs (this assumption was not stated in the question but it is again reasonable), the conversion of the JayF financial statements from francs to US \$ would be a **translation** (conversion from the functional currency to US \$). In this example, there are a remeasurement and a translation, but for separate subsidiaries, not for the same subsidiary.

Note that the same process is discussed in the text. Page F2-51, Item IV.D.4 is "**Remeasure the Financial Statements into the Functional Currency.**" Item IV.D.5 is "**Translate the Financial Statements into the Reporting Currency.**" These are the same two steps that were discussed in the examples above.

Item C.7

Page F2-53, Item IV.D.5.d, Kristi Corporation Example

The National Instructor discusses this example in extreme detail. However, with this type of concept and the detail that is involved, it is sometimes hard to keep the forest and the trees separate. In this update, we attempt to provide some additional perspective and to leave you with something in writing in addition to what the National Instructor said. We will not discuss "which rates are used when" because that is fully described on Pages F2-49 and F2-50 and does not need to be repeated.

This particular example incorporates both a translation and a remeasurement and treats the example as two separate examples. Note that these two examples are two different situations and not a translation after a remeasurement. The first example is translation from the functional currency (LCU) to US dollars, the reporting currency. The second example is remeasurement from LCU into the functional currency, which is US \$. This second example is the same as the Jay example in **Item C.7, above**.

For the translation, using the various exchange rates as appropriate, the financial statements are converted. Because the exchange rate for the income statement is \$.1275/LCU for every line, it will "balance." Note that the net income of \$5,354 is $20,000 \text{ LCU} \times \$.1275/\text{LCU}$, and note that the computation was a multiplication with the foreign currency units ending up as \$, just like we wanted. Because the exchange rates for the various line items on the balance sheet are different (\$.10/LCU and \$.18/LCU), the balance sheet will not balance. The plug of \$(17,154) makes it balance. As this example is a "translation," the plug ends up being recorded in accumulated other comprehensive income (PUFE) on the balance sheet. So, it is really not as bad as it looks!

For the remeasurement, using the exchange rates as appropriate, the financial statements are converted. The exchange rates for the income statement are not the same for every line, and the income statement will not balance. There is really no way to tell what the plug is at this point, and we have to proceed to the balance sheet. But we do know, as this example is a remeasurement, that the plug ends up on the income statement.

Again, for the balance sheet, the exchange rates for the various line items on the balance sheet are different, and the balance sheet will not balance. Plug #1 of \$11,053 makes it balance. Because the plug is effectively to retained earnings (and in this question to net income, as there is no beginning retained earnings), the plug can be moved up to the income statement as net income. Plug #2 of \$(6,854) makes the income statement produce the correct net income (balance). Again, really not as bad as it looks!

Certainly, a full translation/remasurement question like Kristi could not be presented in other than a rather long simulation. However, it is important to at least understand what is being done, because the concepts or parts of the computations could show up as multiple choice questions.

**Section D: PASSMASTER, SIMULATIONS, & QUIZZES
ADDITIONAL OR ENHANCED INFORMATION**

Item D.1

Question CPA-00850

This question has caused some confusion; although, it is correct. The question and answer are as follows:

Question

Several of Fox, Inc.'s customers are having cash flow problems. Information pertaining to these customers for the years ended March 31, 1991 and 1992 follows:

	3/31/91	3/31/92
Sales	\$10,000	\$15,000
Cost of sales	8,000	9,000
Cash collections		
on 1991 sales	7,000	3,000
on 1992 sales	-	12,000

If the cost recovery method is used, what amount would Fox report as gross profit from sales to these customers for the year ended March 31, 1992?

- a. \$2,000
- b. \$3,000
- c. \$5,000
- d. \$15,000

Explanation

Rule: Under the cost recovery method no profit is recognized until cash collections (including principal and interest) exceed the cost of sales.

	3/31/91	3/31/92	Total
Cash collections			
On 1991 sales	7,000	3,000	
On 1992 sales	-	12,000	
Totals	7,000	15,000	22,000
Cost of sales	8,000	9,000	17,000
Gross profit (deficit)	(1,000)	6,000	5,000

Choice "c" is correct. \$5,000 gross profit for the year ended 3/31/92 (using cost recovery method), since collections were less than cost at prior year-end (3/31/91).

Comments

The confusion with this answer seems to have come from the fact that the words "principal and interest" came out of nowhere. Neither principal nor interest was mentioned in the question. If either of them had existed, the rule given would have been correct. With this answer, the "principal and interest" is merely providing additional information that might be useful on other questions.

Item D.2

Question CPA-01281

This question has generated some confusion, but it is correct. The question and answer are as follows:

Question

On October 1, 1992, Velec Co., a U.S. company, contracted to purchase foreign goods requiring payment in francs one month after their receipt at Velec's factory. Title to the goods passed on December 15, 1992. The goods were still in transit on December 31, 1992. Exchange rates were one dollar to 22 francs, 20 francs, and 21 francs on October 1, December 15, and December 31, 1992, respectively. Velec should account for the exchange rate fluctuation in 1992 as:

- a. A loss included in net income before extraordinary items.
- b. A gain included in net income before extraordinary items.
- c. An extraordinary gain.
- d. An extraordinary loss.

Explanation (references to SFAS and APB removed)

Choice "b" is correct. The transaction would first be journalized when title transfers to the buyer. At fiscal year-end, the exchange rate has increased so a foreign exchange gain would be recognized.

Choice "a" is incorrect. The transaction would first be journalized when title transfers to the buyer. At fiscal year-end, the exchange rate has increased so a foreign exchange gain would be recognized.

Choice "c" is incorrect. Foreign exchange gains and losses are not classified as extraordinary items.

Choice "d" is incorrect. Foreign exchange gains and losses are not classified as extraordinary items.

Comments

There is no question here that the two "extraordinary" answers can be almost immediately eliminated. There is nothing extraordinary about foreign transaction gains and losses, and there never has been.

However, it is not quite so clear whether the transaction results in a gain or a loss. Many people use the exchange rate at October 1 and the exchange rate at December 31 and calculate a loss. For example, with a made-up number, 10,000 francs is \$454.56 on October 1 and \$476.60 on December 31 (\$1 = 22 francs on October 1 so 1 franc = \$.045456, and **\$10,000 francs = \$454.56**; \$1 = 21 francs on December 31 so 1 franc = \$.047619, and **\$10,000 francs = \$476.19**). Because there is a payable involved, more dollars are seemingly being paid and the transaction seemingly would result in a loss.

The word "seemingly" in the previous paragraph gives it away. The only thing wrong with the previous paragraph is that October 1 is not the correct date to use. In this particular question, the sale was contracted for on October 1, but at that date, title has not transferred. At that date, the contract is merely an executory contract (see R5 on contract law) that does not warrant accounting recognition. Title passes on October 15, and that is the date for the transaction to be booked. With that date, the exchange rate has gone from 20 francs to 21 francs (instead of 22 francs to 21 francs), and what looked like a loss has turned into a gain.

Item D.3

Question CPA-01275

The answer to this question has caused some confusion; although, it is correct. The answer is as follows:

Explanation

Choice "c" is correct, cumulative foreign exchange translation loss should be reported as a component of other comprehensive income. A cumulative foreign exchange translation loss would be a debit in other comprehensive income; therefore, contra to shareholders' equity.

Rule: "Translation" adjustments are not included in determining net income for the period but are disclosed and accumulated as a component of other comprehensive income in consolidated equity until sale or until liquidation of the investment takes place.

Choice "a" is incorrect. Discount on convertible bonds that are common stock equivalents should be shown as a contra account to bonds payable and are shown as part of the "carrying amount" of bonds payable on the balance sheet.

Choice "b" is incorrect. Bond premiums are included as part of the "carrying amount" of bonds payable on the balance sheet.

Choice "d" is incorrect. Organization costs are expensed as incurred.

Comments

The first part of the answer is the problem. There is no question that a translation loss is reported as a component of other comprehensive income (and reported on the statement of other comprehensive income). However, the "accumulated" transaction loss (which implies cumulative from inception) is not. Instead, the cumulative transaction loss is a debit in accumulated other comprehensive income and thus, a contra to stockholders' equity.

This answer confuses other comprehensive income (a temporary account) and accumulated other comprehensive income (a permanent account). Accumulated other comprehensive income is where other comprehensive income is closed at the end of the accounting period (just like net income is closed to retained earnings).

Item D.4

Question CPA-01284 (and Page F2-55 Example)

This question has caused some confusion; although, it is correct. The question and answer are as follows:

Question

On September 1, 1990, Cano & Co., a U.S. corporation, sold merchandise to a foreign firm for 250,000 francs. Terms of the sale require payment in francs on February 1, 1991. On September 1, 1990, the spot exchange rate was \$.20 per franc. At December 31, 1990, Cano's year end, the spot rate was \$.19, but the rate increased to \$.22 by February 1, 1991, when payment was received. How much should Cano report as foreign exchange gain or loss in its 1991 income statement?

- a. \$0
- b. \$2,500 loss.
- c. \$5,000 gain.
- d. \$7,500 gain.

Explanation

Choice "d" is correct. Foreign exchange gains and losses are recorded at year end on uncompleted contracts. The gain for 1991 is the exchange rate change from 12/31/90 to 2/1/91 ($\$.22 - \$.19$) or $.03 \times \$250,000 = \$7,500$

Comments

This question is obviously again from the old days when we had interesting currencies such as marks and francs, instead of just "plain old dull euros." In this question, Cano sold merchandise on September 1 with the receivable denominated in francs. On that date, the spot rate (sometimes called the spot exchange rate in this question, but in any case, the exchange rate for an exchange of currencies on September 1) was $\$.20/\text{franc}$. That means that the 250,000 francs were worth $\$50,000$ ($\$.20/\text{franc} \times 250,000$ francs). On December 31, the spot rate was $\$.19/\text{franc}$, and the 250,000 francs were worth $\$47,500$ ($\$.19/\text{franc} \times 250,000$ francs). On February 1, the spot rate was $\$.22/\text{franc}$, and the 250,000 francs were worth $\$55,000$ ($\$.22/\text{franc} \times 250,000$ francs).

Overall, there was a gain of $\$5,000$ ($\$55,000 - \$50,000$). It just has to be split in two pieces, one from 1990 and one for 1991. The 1990 piece was a loss of $\$2,500$, and the 1991 piece was a gain of $\$7,500$, for an overall gain of $\$5,000$.

We can tell the difference between losses and gains in this question by remembering that Cano sold merchandise and has a receivable. If the receivable (translated into dollars) increased in value, there was a gain. If the receivable (translated into dollars) decreased in value, there was a loss.

Note that the example on Page F2-55, Item VI.E illustrates both a transaction gain and a transaction loss, but with a payable rather than a receivable. The exchange rates went from $\$.10/\text{peso}$ to $\$.08$ to $\$.09$. In Question CPA-01284, the exchange rates went from $\$.20/\text{franc}$ to $\$.19$ to $\$.22$, the same kind of down-and-then-up pattern. In Question CPA-01284, the exchange rate changes produced a loss and then a gain. In the example, the exchange rate changes produced a gain and a loss. That is what we expected because CPA-01284 was a receivable and the example is a payable. The effects should be opposite.

To be able to translate from a foreign currency into U.S. dollars, we have to remember whether to multiply or divide by the exchange rate. In this question, we multiplied, but how did we know to do that? The trick is to keep the currency units in mind and to make sure they come out logical. For example, on September 1, we computed $250,000 \text{ franc} \times \$.20/\text{franc}$. Ignoring the numbers, we computed $\text{franc} \times \$/\text{franc}$. The francs cancel and we are left with $\$$, which is what we wanted. If we had divided, we would have computed $250,000 \text{ franc} / \$.20/\text{franc}$, or $\text{franc} / \$/\text{franc}$, and we would have ended up with $\text{franc}^2/\$$, which makes no sense whatsoever, even on Pluto, back when Pluto was a planet.

Note that all of the exchange rates in this question were spot rates. There were no forward or future exchange rates. If you are taking the BEC course, see the BEC Glossary for more information on spot rates and forward rates.

Item D.5

Question CPA-04685

This question has caused some confusion because the solution is somewhat different from the solution of the example in the text on Page F2-14.

Comments

The example in the text utilizes a discount account, and this question does not. There are some slight differences in the two questions, but not enough to account for the difference. Question CPA-04685 is not incorrect, but the text solution provides a better explanation.

To be consistent with the text, the solution would be as follows:

Choice "c" is correct. The franchisor should report revenue from initial franchise fees when all material conditions of the sale have been "substantially performed." Baker will recognize the entire initial franchise fee in the current year.

Dr Cash	\$25,000
Dr Note receivable	\$40,000
Cr Franchise revenue	\$59,000
Cr Discount on note receivable	\$6,000

Even though the question did not indicate that a note was used, there would almost certainly have to be one. As four payments of \$10,000 each are going to be received, the note should be recorded at the \$40,000 that is going to be received. The note will be reported on the financial statements, however, net of the discount.

Note that this change does not affect the letter answer at all.

Item D.6

Financial 2 Simulation Research Tab

The question for the F2 research tab is: **“What are the guidelines for identifying a developmental stage enterprise?”** The solution indicates that the answer is found in SFAS No. 7, Paragraph 8. Paragraph 8 is as follows:

For purposes of this Statement, an enterprise shall be considered to be in the development stage if it is devoting substantially all of its efforts to establishing a new business and either of the following conditions exists:

- a. Planned principal operations have not commenced.*
- b. Planned principal operations have commenced, but there has been no significant revenue therefrom.*

This answer is in the Original Pronouncements section of the database (called the FASB-OP). If you are not sure how to determine that, click on “FASB Literature” in the left-hand part of the search screen. FASB-OP is original pronouncements (the original material that was published; original pronouncements are arranged by pronouncement number by type of pronouncement such as APB, FASB, etc.). FASB-CT is current text (a topical arrangement of the original pronouncements where the information is supposedly updated for any changes from later pronouncements; current text is arranged by topic such as A07 for Accounting Changes and Error Corrections, E11 for Earnings per Share, and L10 for leases). Most full services used in practice have more sections than just Original Pronouncements and Current Text (RIA, for example, has Original Pronouncements, Original Pronouncements Amended, Current Text, EITF, Exposure Drafts, and many others). The service that is used on the CPA exam has more sections but not as many as a full service.

So how do we go about getting to the answer (the remaining discussion assumes that you are working along in the Research question)? Let's try a key word of "development stage enterprise." These words are not words that are used extensively in the authoritative literature, but it should give us something. It does. It gives 6 different hits (results) with the Becker 2007 database, many of which can be eliminated just by looking at them. **Normally**, in a Research question, results that say "Appendix" can be ignored or at least placed way down the possible answer list in priority; SFAS appendices provide rationale/justification, examples, history, implementation guidance, pronouncements that have been changed, and the like, but do provide the rules; the rules are in the body of the statement itself. Take those two off the list. **Normally**, in a Research question, results that say "Summary" can also be ignored (as long as the detail presentation shows up in the list); the summaries at the front of Statements are reasonably short and the detail is in the body of the statement itself. There aren't any of those here, so there is nothing to do. **Normally**, in a Research question, results that say "Status" can also be ignored. There aren't any of those here, so again there is nothing to do. **Normally**, in a Research question, results that say "Introduction" can also be ignored (for the same reason as "Summary"). Take that one off the list, and there are two hits left.

Of the two remaining hits, one is titled "Ability to Raise Capital", and the other is titled "Guidelines for Identifying a Development Stage Enterprise." We know that the question was, "What are the guidelines for identifying a development stage enterprise?" The answer is now obvious, and we are done (except for the cutting and pasting). But note that there were only 6 hits in the Becker 2007 database. What about a full service database?

Trying the same key word of "development stage enterprise" in a full service such as RIA produces 13 hits in Original Pronouncements only. Seven of the hits are in the SFAS section, four hits are in the Financial Interpretations section, and two hits are in the Financial Accounting Concepts section. With this kind of distribution, the best place to start is in the SFAS section because SFAS statements are higher in the hierarchy of GAAP (page F1-5) than FINs and SFACs. Of the hits in the SFAS section, one is for SFAS No. 7. There are many individual hits inside SFAS No. 7. One of them is Paragraph 8, "Guidelines for Identifying a Development Stage Enterprise." So we are done again, in a slightly different manner.

If possible, it is a good idea to practice with the service/tool that is going to be used on the exam. A temporary **free** license can be obtained by going to www.cpa-exam.org and clicking on "Prepare for the Exam." You can obtain a license only if you have a current valid candidate number. The following is the announcement from the www.cpa-exam.org website:

"The Uniform CPA Examination consists of multiple-choice questions and condensed case studies called simulations. Within the simulations, candidates must do an online search of professional literature databases to answer questions. Here are some ways that candidates, students, educators, and schools can get access to helpful online resources.

CPA Exam Candidates: Free On-line Access to Professional Literature Package
CPA exam candidates can get a free six-month subscription to professional literature used in the computerized CPA Examination. This online package includes AICPA Professional Standards, FASB Current Text, and FASB Original Pronouncements. Only candidates who have applied to take the CPA exam, and have been deemed eligible by state boards of accountancy, will receive access to this package of professional literature."

The Becker service/tool has been developed from official information we received regarding the actual service that would be used. As such, one would expect some differences between this service and services such as RIA. If you would like to experiment further with the research questions, use our questions and their service and see what you get. At the very least, as the

database will be a full database, you will get practice slogging through a larger number of hits to see which one is correct. The more practice you can get, the better. You don't want to be surprised by anything on the exam.

Depending on the specific question, there are various approaches to finding the answers to Research questions. We have included these comments in the various online updates to demonstrate most or all of the possible approaches.

Item D.7

Question CPA-04677

This question has caused some confusion because the solution is different than the solution of the example on text page F2-14 and the solution shown in CPA-04685.

Comments

The example in the text and CPA-04685 both show that revenue from the initial franchise fee should be reported at the present value of the periodic payments to be paid by the franchisee. In this problem, the franchisee (Heath Co.) paid the franchisor (Macklin) \$10,000 at the signing of the franchise agreement, with the \$40,000 balance to be paid in \$10,000 increments over the next 4 years. The correct way to record this agreement would be to record franchise revenue at the present value of the total payments to be paid by Heath to Macklin. However, no present value information is given in the problem and therefore, according to the solution, the franchise revenue is recorded at the total undiscounted amount to be received. This is not technically correct; however this problem is an actual CPA exam question, which illustrates the fact that not all CPA exam questions are perfect.

To illustrate a "better" answer to this question, we could assume that the present value of the four \$10,000 payments is \$34,000. The correct journal entry would be recorded as follows:

Dr	Cash	\$10,000	
Dr	Note receivable	40,000	
Cr	Franchise revenue		\$44,000
Cr	Discount on note receivable		6,000

When studying this topic, focus on the example in the text and CPA-04685, as they are technically correct.

Item D.8

Question CPA-01285

The answer to this question is somewhat unclear. The question and answer are as follows:

Question

A balance arising from the translation or remeasurement of a subsidiary's foreign currency financial statements is reported in the consolidated income statement when the subsidiary's functional currency is the:

	<i>Foreign currency</i>	<i>U.S. dollar</i>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

Explanation

Choice "b" is correct. When the subsidiary's functional currency is not the U.S. dollar, the subsidiary's financial statements must be "remeasured" to U.S. dollars. The resulting gain or loss on remeasurement is reported in the consolidated financial statements. If the subsidiary's functional currency is the local currency, the subsidiary's financial statements must be "translated" to U.S. dollars. The resulting adjustment is reported as other comprehensive income.

Comments

The explanation below is a little clearer:

Choice "b" is correct. A subsidiary's financial statements are usually maintained in its local currency. If the subsidiary's functional currency is the local currency, the subsidiary's financial statements are simply "translated" to U.S. dollars (the reporting currency). The resulting adjustment is reported as other comprehensive income. If the subsidiary's functional currency is not the same as its local currency (the functional currency may be the U.S. dollar or a 3rd currency), the subsidiary's financial statements must first be "remeasured" into the functional currency. The resulting gain or loss on remeasurement is reported in the consolidated income statement.

Note that the same process is discussed in the text. Page F7-51 IVD4 is **Remeasure the Financial Statements into the Functional Currency**. IVD5 is **Translate the Financial Statements into the Reporting Currency**.

EDITORS' COMMENTS

Note: From time to time, we issue a PassMaster updater that updates your PassMaster questions and answers. Normally, error corrections to at least some of the question are included in the updater. Thus, if you have run the updater, some of the errors discussed above may already have been corrected. We do not update the online documents when a PassMaster updater is available because not everybody runs them (although they should).

Also, if you are still using the 2006 Version of the text and PassMaster, there may be some errors that were corrected in the 2007 Version and thus will not appear in this Online Update.

Some of the Items above have come from our internal review process, some have come from questions and comments from Becker instructors around the world, and some have come from questions asked by various candidates, either from Becker Profhelp or in online or live classes. We wish to thank all of these individuals as a group for their efforts to improve our materials.