NINJA CPA REVIEW®

NINJA Notes 2017
Financial Accounting & Reporting
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The N.I.N.J.A. Framework

NAIL THE CONCEPTS

Watch your CPA Review videos first – before working any assigned homework questions.

The CPA Review industry says to watch a section of CPA Review video and then work the accompanying MCQs. This perspective stems from the old-school approach to the paper and pencil exam where you had to sit in a live classroom and learn from an instructor on weekends.

Today, there is a smarter way to study. You don’t have to go to a weekend live course. You can fire up the laptop on a Tuesday morning and knock out two hours of material before you even brush your teeth. If you work MCQs in week one over your week one topic, guess what? You will work them again in week 5 or 6 when you review because you will forget what you learned.

If you watch a video in week one and score an 85 on the corresponding MCQs, will you be able to score an 85 four weeks later? Not likely. You will need to work them again anyway, and it’s not a smart use of study time.

Instead, let the N.I.N.J.A. Framework guide you.

INTENSE NOTES

Repeat after me: “PUT THE HIGHLIGHTER DOWN.”

Which method do you think will help you learn the material better – painting printed words in a book with pretty florescent colors or writing them down on a legal pad and thinking about the information?
Grab a stack of legal pads, put the highlighter down, and *start writing*.

Many people have said that instead of taking their own notes, they just *re-write the material inside of this study guide*, which is fine too.

**NON-STOP MCQS**

*Now* is the time to start working **NINJA MCQ** and do them with a focused frenzy. Do so many MCQs that you’re absolutely sick of them. As you encounter little “fact nuggets” that you didn’t know or are prone to forget, *write it down* and add it to your voluminous stack of notes.

**JUST RE-WRITE IT**

This is where it gets tedious. This is also where the payoff happens. You may be familiar with the fact that if you had a choice between $3 Million and 1¢ doubled daily for 31 days, the penny doubled for 31 days ends up *tripling the* $3 Million. The payoff, however, doesn’t happen until the 31st day. The road is long, but ends up being worth it in the end.

The same goes for re-writing your study notes. The thought of grabbing that stack of legal pads and going to town re-writing what you’ve already written may sound like a ridiculous suggestion at first, but I am a firm believer in its impact.

Merely writing down your notes and then reviewing them before your exam doesn’t have near the impact as taking your furious scribbles and converting them into re-packaged, easily digestible “fact nuggets.”

Not only will your notes mean more when you’ve whittled away the non-essentials, but you are actually learning the
material twice. Re-processing the material by re-writing your notes is like letting the information marinade in your mind. Just like a well-prepared steak, you will taste the payoff of this extra step.

Don’t like taking notes? No problem. Re-write these **NINJA Notes instead.** You will absorb the material better vs. reading only.

**Plan wisely because this will likely take a week to complete.**

"I have found this to be unbelievably helpful! This is now my second section that I have followed this piece of advice and, once again, I am amazed at how much the material "clicks" as I review and write the notes a second time.

Sure, it's time-consuming, but for me, it is worth it. No questions asked. Not only does it help with processing and understanding the material, but it also results in a better, more organized set of study notes to use for review up until exam date.” – Sandy

**ALL COMES TOGETHER**

You have watched the videos. You’ve taken ridiculous notes and have done hundreds (thousands?) of multiple-choice questions. You’ve re-written your notes.

Now, study that stack of review Gold in your hands multiple times, **aim for a NINJA MCQ Trending Score of 85%** heading into exam day, study your notes even more, and then go in and **PASS the CPA Exam.**
How to use NINJA Notes

READING

You've invested in the NINJA Notes, now let it go to battle for you. You should read them *as many times as possible.*

**Carry it with you wherever you go.**

Do you have an iPhone®, iPad®, or similar device(s)?

Simply load the PDF onto the device, and if you have 5 minutes of downtime, you have 5 minutes of study time.

It is recommended that you read the NINJA Notes at least **five times** leading up to your final two weeks of exam prep.

If you have 6 weeks to study, then you need to complete this in 4 weeks. 5 weeks to study, then complete it in 3. 4 weeks = 2 weeks. You get the picture. The point is: plan, plan, plan and budget, budget, budget, budget because exam day is looming.

**6-Week Plan:** Approx. 112 pages x 5 reads /4 weeks / 7 days per week = Approx. 20 pages per day

**5-Week Plan:** Approx. 112 pages x 5 reads /3 weeks / 7 days per week = Approx. 27 pages per day

**4-Week Plan:** Approx. 112 pages x 5 reads /2 weeks / 7 days per week = Approx. 40 pages per day

**3-Week Plan:** Approx. 112 pages x 5 reads /1 weeks / 7 days per week = Approx. 80 pages per day

RE-WRITING
This step is optional, but it won over a lot of skeptics with its results. This is not mainstream advice. This is the NINJA way. The mainstream way of studying for the CPA Exam is old-fashion and outdated.

Forget the old way. **You are a NINJA now.**

Now is the time to either

1. Re-write your own CPA Exam notes or
2. Re-Write the NINJA Notes.

Plan on investing a week doing this and you should expect to get through 16 pages a day (Approx. 112 pages / 7) in order to stay on track.
III. Financial Reporting

ACCOUNTING CONCEPT BASICS

- Primary Objective of Accounting: Measure Income
  - Income measures a firm’s efficiency
- Monetary Units are the basis of all economic activity
- The FASB Codification
  - The most authoritative set of accounting pronouncements. All pronouncements fall under the Codification “umbrella.”
- Codification (Two levels of GAAP)
  - Authoritative
  - Non-authoritative
- Financial vs. Managerial Accounting Comparison
  - Managerial Accounting = “Timeliness” focus
  - Managerial Accounting does not follow GAAP

FINANCIAL REPORTING BASICS

- Financial Reports are used for
  - Providing financial information that is useful to
    - Existing and potential investors
Lenders and other creditors

Filed with SEC

- Form 10K (Annual and *Audited*)
- Form 10Q (Quarterly and *Reviewed*)

**Primary Constraints of Financial Reporting**
- Cost vs. Benefit
- Materiality

**Secondary Constraints of Financial Reporting**
- Consistency - Year vs. Year
- Comparability - Company vs. Company

**Qualitative Characteristics of Financial Reporting**

- Relevance - Makes a difference to the user
  - Predictive Value – Future Trends
  - Confirming Value – Past Predictions
  - Materiality – Could affect User Decisions

- Faithful Representation
  - Completeness
    - Nothing omitted that would impact the decision-making of a user
- Neutrality
  - Information presented is without bias
- Freedom from Error
  - No material errors or omissions

- Enhancing Qualitative Characteristics
  - Comparability
    - Allows users to compare different items among various periods
  - Verifiability
    - Different people would reach a similar conclusion on the information presented
  - Timeliness
    - Information is made available early enough to impact the decision making of users
  - Understandability
    - Information is easy to understand

- Accrual vs. Deferral
  - Accrual – Earned (Revenue) or Incurred (Expense), but no Cash Receipt/Outlay yet
    - Revenue Example: Sell an item on credit
    - Expense Example: Monthly rent expense for December not paid until January
Deferral – Cash Receipt/Outlay, but not Earned (Revenue) or Incurred (Expense)

- Revenue Example: Customer pre-pays for a repair done to their car
- Expense Example: Company pre-pays insurance premiums and is amortized

Recognition

- When an item is recorded and included in the financial statements

Conservatism

- When an estimate is necessary due to uncertainty, conservatism chooses the best option that won’t overstate the financial position of the company

Fair Value

- The price you would receive if you sold the asset
- Assumes asset is at its highest and best value
- Market Assumes
  - Asset is sold in its most advantageous market to get the best price possible
  - Buyer and Seller are not Related
  - Buyer and Seller are Knowledgeable
- Buyer and Seller are **able to transact**
  - This isn’t a hypothetical transaction for Fair Value measurement purposes
  - Buyer actually has $10M to purchase
  - Buyer and Seller are **motivated** to buy/sell

- **Fair Value Hierarchy**
  1. **Level 1** – Top Level
     - Uses price quotes or market prices
       - NYSE or NASDAQ
  2. **Level 2** – Mid Level
     - Interest Rates
     - Prime Rate
  3. **Level 3** – Lowest Level
     - Unobservable
     - Uses assumptions or forecasts

- **Acceptable Valuation Techniques**
  1. **Market Approach**
     - Market transactions/prices value asset
  2. **Income Approach**
     - Present value discounts earnings
Cost Approach

- Replacement cost values the asset

ASSETS

- Current Assets
  - Cash
  - Inventory or assets expected to be converted or consumed during a business’ operating cycle
  - Deferred Gross Profit on Installment Sales (Contra Asset)
  - Receivables expected to be collected < 12 months

LIABILITIES

- Current Liabilities
  - Will use current assets during the present operating cycle

- Accrued Liability vs. Current Liability
  - Accrued Liability (Deferred Expense)
    - Expense that has been incurred, but not paid
    - Rents Payable
  - Current Liability (Deferred Revenue)
    - Payments that have been received but cannot be recorded as revenue yet
• Tenant pre-pays rent – Landlord must still “perform” to earn

**REVENUE**

- Recognized when *earned*
  - The Company has “performed”

- Accrued Revenue is Earned but *not Received*

- Gains
  - Increase in equity from an activity or event that is not central to the main activities of the business
    - Can be operating or non-operating

- Losses
  - Decrease in equity from an activity or event that is not central to the main activities of the business
    - Can be operating or non-operating

- Operating Cycle
  - Average time to turn materials/services to cash

- Asset Measurement & Valuation Methods
  - Present Value of Future Cash Flows
    - Current value of a Future Amount of Money
    - Uses Specific Interest Rate
o Historical Cost
  ▪ Asset Cost – (Net of Depr. & Amortization)

o Replacement (Entrance) Cost
  ▪ Cost to re-acquire an asset

o Market (Exit) Cost
  ▪ Sale Price of an Asset

o Net Realizable Value
  ▪ Sale Price of an Asset – Selling/Disposal Fee

➢ Royalty Income
  o Recognized when earned
  o If the Royalty % is applied against Net Sales
    ▪ (Gross Sales – Estimated Returns) x %

➢ Installment Sales
  o Revenue recognized upon receipt of cash
  o Only used when cash collection is uncertain

➢ Deferred Gross Profit
  o Can’t be recognized until cash is received
  o D.GP = Gross Profit % x Accounts Receivable
  o Pay attention to the year if GP% varies
Example

- Installment Sales: $500k
- COGS on Installment Sales: $250k
- Cash Collected: $100k
- Normal Sales: $200k
- COGS on Normal Sales: $100k
- GP% = $100k/$200k = 50%
- D.GP = 50% x $400k (AR = 500k - 100k)
  - $200k
- If you were solving for AR:
  - AR = ($200k / .5)
    - $400k

Cost Recovery Method

- Most conservative method of revenue recognition when collection of sale price is uncertain
- No revenue recognized until all costs are recovered from purchase of the asset

Subscription Revenue

- Recorded as Deferred Revenue (Liability) on Balance Sheet
  - Payment received; performance not complete
- As company performs, revenue is recognized

- Franchise Revenue
  - Franchisor
    - Startup Franchise Revenue deferred until performance takes place
  - Franchisee
    - Franchise Costs deferred until corresponding revenue is recognized

- Revenue: Cash to Accrual Basis (**SPEAR-BAR**)
  
  \[
  \text{Sales (i.e. Customer Payments)} + \text{Ending Accounts Receivable} - \text{Beginning Accounts Receivable}
  \]
  
  Sales Revenue on an Accrual Basis

- **COGS from Cash Basis (**CRAP-I**)**
  
  \[
  \text{Cash Remitted (i.e. paid – made acronym easier)} + \text{Increase in Accounts Payable} - \text{Increase in Inventory}
  \]
  
  COGS on an Accrual Basis

- Discontinued Operations
  
  - Company ceases operating a business segment
    - Must represent a strategic shift
      - Major effect on operations and financials
o Disposal Assets must be
   - Held for Sale
   - Sold
   - Disposed of another way

o Includes
   - Income (or Loss) from the period
   - + Gain (or Loss) from disposal

o Reported
   - **Net of Tax** after Continuing Operations in the period it’s classified as held for sale and all prior periods presented in the financial statements

➢ Unusual or Infrequent Items
   o Formerly Extraordinary Items
   o Two Options for Reporting
      - Income Statement
         - Above Income from Continuing Operations
      - Footnotes to Financial Statements
   o Change: No longer net-of-tax
Treatment in Financial Statements

- Retrospective or Prospective Treatment
  - Additional disclosures required for previous extraordinary classifications

Constant Dollar Accounting

- Uses CPI to adjust assets to reflect a consistent level of purchasing power due to inflation

EXPENSE

- Recognized when incurred; Accrue if not yet paid

- Product costs
  - Expenses matched with associated revenues
    - Ex: Sales commission on a used car sale

- Period Costs
  - Expenses amortized & recognized with the passage of time

- Impaired assets are written down and expensed

- General and Administrative (G&A) Expense
  - Office staff salaries, rent, and supplies
    - Sales staff salaries and portions of the building assigned to Sales should be allocated to Selling Expense, not G&A
Business Start-up Costs

- One-time costs for opening a new business
- Expensed as they are incurred

Interest Expense

- Interest on projects (software) for internal use is not expensed, but is instead capitalized

**COMPREHENSIVE INCOME**

- Net Income + Other Comprehensive Income (OCI)
  - Revenues/Expenses
  - Gains/Losses
    - Comprehensive Income includes some Gains and Losses that are not a part of Earnings
  - Cumulative Accounting adjustments
    - Foreign Currency Translation Adjustments
    - Unrealized Gains on AFS Securities
    - Minimum Pension Liability adjustment for Defined Benefit Plans
  - Reclassification Adjustment
    - Avoids double-counting items that were included in both Net Income and OCI
• Ex: AFS Securities previously included in OCI are now sold at a Loss and reported on the Income Statement

- **Non-owner** changes in Equity
  - Investment by owners is not included

- Reported in a Single or Combined Income Statement
  - Earnings Per Share is not required for OCI

**FINANCIAL STATEMENT DISCLOSURES**

- Accounting Policies must be disclosed
  - Includes
    - Accounting Principles used
    - Basis of Consolidation
    - Inventory Pricing Methods
    - Depreciation Method
    - Amortization of Intangibles

- Risks and Uncertainties must be disclosed
  - Nature of Operations
  - Use of Estimates & listing of Significant Estimates
  - Concentration vulnerability
Going Concern Doubts

- Management must evaluate whether the entity will continue to operate as a going concern within 1 year of financial statement issuance.

- Substantial Doubt Raised – Alleviated
  - Management has a plan to alleviate threat.
  - Disclosures Required
    - Events that led to GC Doubt
    - Management evaluation of event
    - Management plans to alleviate

- Substantial Doubt Raised – Not Alleviated
  - Management plan – doubtful success
  - Statement Required
    - There is substantial doubt that entity will continue as GC within 1 year of financial statement issuance date
  - Disclosures Required
    - Events that led to GC Doubt
    - Management evaluation of event
    - Management plans to alleviate
SPECIAL PURPOSE FRAMEWORKS

- Alternatives to GAAP Accounting
  - Cash Basis
  - Modified Cash Basis
  - Incomes Tax Basis
  - FRF for SMEs
  - Public Business Entities Framework

- Cash Basis Accounting
  - Revenue Recognized with Cash Inflow
  - Expense Recognized when Cash Outflow
  - OK for Tax Returns
  - Not GAAP

- Modified Cash Basis Accounting
  - Avoids GAAP complexities while providing more information than Cash Basis Accounting
  - Not GAAP

- Income Tax Basis Accounting – 3 Options
  - Cash Basis
  - Accrual Basis
  - Hybrid Method (Cash + Accrual for Inventory)

- Developed by the AICPA
- Not GAAP
- Has No Authoritative Status

Simplifies reporting for small companies
- Uses Historical Cost as measurement basis (instead of Fair Value)
- Targeted/Relevant Disclosures only

Provides efficiency and flexibility

Reduces Book vs. Tax differences

Income Taxes – Two Options
- Deferred Taxes Method
- Taxes Payable Method

Startup Costs – Two Options
- Expensed
- Amortized (15 years)

Goodwill
- Amortized (15 years)
Public Company Framework
- Developed by the FASB
- GAAP
- Small Company Lease Accounting
  - Private companies can bypass Variable Interest Entity rules for Leases
  - Instead, Lease disclosures are made
- Accounting for Goodwill
  - Amortize Goodwill over 10 years
    - Will reduce impairment likelihood
    - Less than 10 if more appropriate
  - Must test for impairment – Two Options
    - Entity Level
    - Reporting Unit Level
- Interest Rate Swaps
  - Simplified Hedge Accounting approach
    - Simplifies the process from moving from a variable-rate borrowing + interest rate swap to a fixed-rate borrowing
LIQUIDATION BASIS FINANCIAL STATEMENTS

- Used when liquidation is imminent
  - Board approves liquidation plan
  - Creditors/Investors force liquidation
  - Chance of liquidation being blocked or company surviving post-liquidation is *remotely probable*

- Assets measured at liquidation value

- Unrecognizable items (trademarks) expected to be liquidated are now recognized

- Required Statements
  - Statement of Net Assets in Liquidation
  - Statement of Changes in Net Assets in Liquidation

REGULATION S-K

- Under the Securities Act of 1933

- When an issuer issues an IPO, they must adhere to Regulation S-K

- Included in Regulation S-K (note: Registration S-K contains a lot of information and sub-topics. For purposes of passing the CPA Exam, this list is general in nature.)
  - General Business & Securities information
  - Financial information
**DEVELOPMENT STAGE ENTITIES**

- A DSE is a company that is still in the formation stage and hasn’t yet begun principal operations or produced significant revenue

- New GAAP rules relax the reporting requirements for a DSE by **removing** the need for
  - Incremental Financial Reporting
  - Data Maintenance
  - Inception-to-Date Reporting
  - Attaching the DSE label to the F/S
  - Disclose descriptions of DSE Activities
  - Disclose first-year entity is no longer a DSE

- Benefit: Cost savings without sacrificing F/S usefulness