

Generally accepted accounting principles and accounting pronouncements

[Business](#), [Accounting](#)



As a newly hired Staff I there will be a responsibility to analyze the work papers for the organization's clients. In this situation a client is not clear about why a Staff I is asking for information on adjusting lower of cost or market inventory valuation, capitalizing interest on building construction, recording gain or loss on asset disposal, and adjusting goodwill for impairment and requires explanations on these topics. An explanation of each is provided to include sources from accounting websites, Generally Accepted Accounting Principles (GAAP), and accounting pronouncements.

In addition to the explanation for each accounting practice there is also an explanation of the impact it will have on the financial statements and examples of calculations to aid with real-world application. Client Understanding Paper When beginning a job in the accounting field it is likely that the newly hired staff will be responsible for analyzing the documentation of clients within the organization. If a client becomes confused why certain documents are required to be analyzed explanations will need to be provided to the client for his or her understanding.

Within this paper is an explanation of some of the topics a newly hired accountant may encounter when working with clients. These topics cover adjusting lower of cost or market inventory on valuation, capitalizing interest on building construction, recording gain or loss on asset disposal, and adjusting goodwill for impairment. Adjusting Lower of Cost or Market Inventory on Valuation A requirement of Generally Accepted Accounting Principles (GAAP) is that inventory is recorded at the lower of cost or the market value and is known as Lower of Cost and Market (LCM).

This pronouncement is covered under Accounting Research Bulletin No. 43 (ARB). The need for LCM typically occurs because the inventory has become obsolete, it has deteriorated, or the market prices have declined for the inventory. When using LCM inventory cannot be reported higher than the net realizable value less expenses known as ceiling and cannot be reported lower than the net realizable value plus normally attainable profit known as the floor (Investopedia, 2013).

Net realizable value (NRV) is defined by AccountingCoach (2013) as “ the expected selling price in the ordinary course of business minus the cost necessary for completion and disposal” (para. 08). NRV is considered to be a main component when determining market value. The definition of market found in the term “ lower of cost or market” is considered to be the cost upon replacement. However, as mentioned above the market amount must fall between the market ceiling and floor. For example, if the replacement cost is in the middle of the ceiling and floor that figure will be the market cost.

If the cost is above ceiling, the ceiling will be the market value, and if the replacement cost is below the floor, the floor amount will become the market value. Once LCM is determined GAAP permits it to be applied in three ways: inventory total basis, item by item basis, or inventory categories basis. Inventory total basis will yield the smallest loss on the income statement and smallest reduction of cost to inventory, and the loss is reported in the accounting period when the loss took place.

Item by item basis is the opposite of inventory total basis because it results in the largest loss reported on the income statement and largest reduction of cost to the inventory. Item by item basis is also reported in the accounting period when the loss took place. Inventory category basis settles in the middle of inventory total basis and item by item basis, and reports loss on the income statement when the market value drops below cost (AccountingCoach, LLC. , 2013).

There is an inquiry for capitalizing interest on building construction because the interest created from the debt for the assets construction is added to the cost of the construction instead of expensing on the income statement of the current period. According to, the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 34, Capitalization of Interest Cost the interest will be added to the construction cost and reported on the balance sheet. It eventually will be reported on the income statement but will show as part of the assets depreciation expense.

The ability to capitalize on the interest ends upon completion of the assets creation and does not include minor modifications. For example, if multiple pieces of equipment are in construction and after each is completed it is prior to the completion of others then the interest may be capitalized on each individual unit upon completion. Recording Gain or Loss on Asset Disposal Under GAAP when a company disposes of a long-term asset at a cost different from the book value of the asset the difference will require an adjustment to net income on the cash flow statement.

The difference between the disposal price and book value is considered either a gain or loss. For example, if a vehicle has a cost of \$20,000 less accumulated depreciation of \$17,000 the book value will be the difference equating to \$3,000. If the vehicle is disposed of for \$3,500 the difference between the book value and disposal amount equates to \$500. This \$500 is recognized as a gain on the sale of the asset and increases net income. Using the same example if the asset sold for \$2,000 a loss of \$1,000 would be recognized on the asset resulting in a reduction of net income.

In the operating section of the cash flow statement any gain recognized will need to be deducted and any loss will need to be added. These additions and deductions must occur to avoid double counting because a requirement of asset disposal is that the proceeds recognized from the sale must be reported in the investing activities section of the cash flow statement that directly follows the operating activities section. If no loss or gain occurs because there are no proceeds and the asset has been fully depreciated a debit will be made to accumulated depreciation, and a credit will be made to fixed assets.

Adjusting Goodwill for Impairment When a company purchases an intangible asset for more than the assets book value then goodwill impairment occurs. The difference between the purchase price of the asset and the book value is the goodwill and will require an adjustment. For example, if ABC Insurance is sold for \$10 million to Progressive Insurance but only has a book value of \$8 million then the difference of \$2 million is considered goodwill and is reported as an asset on Progressive's balance sheet.

If after the sale occurs Progressive decides to remove all of ABC Insurance's local offices and designates them as an online company only resulting in a loss in sales of 50% this may result in a drop in fair market value to \$5 million. The drop in fair market value will require Progressive to make a goodwill impairment. Progressive will combine the current market value of \$5 million to the goodwill of \$2 million comparing the total of \$7 million to the purchase price of \$10 million.

The difference created of \$3 million must be reflected in the books by reducing goodwill by \$3 million. Recording goodwill impairments is important because it can represent a large portion of a company's net worth. If these changes are not reported the net worth can seem overinflated and mislead investors. This very reason is why companies are required to have their goodwill tested annually, comparing the actual value of the assets in question to their recorded value and adjusting for the difference every year (InvestingAnswers Inc. 2013). In summary, clients may have limited accounting background and may require explanations of accounting terms and documentation, accounting authority, accounting procedures, and the purpose and impact of certain accounting practices. Explained within this paper is a brief overview regarding common accounting practices, such as LCM to include NRV, how to apply LCM, and the impact it will have on the financial statements.

Also included is when and what interest can be capitalised on building construction, how to record gain or loss on the disposal of an asset, a

definition of goodwill, and how and why it must be adjusted if there is an impairment.