

Revenue and Expense Recognition Under GAAP

Revenue and expense recognition are at the heart of GAAP financial reporting, and getting them right matters for everything from audits to lending decisions. This course covers the principles and rules governing when and how income and costs are recorded under GAAP. It's a practical refresher for CPAs and financial professionals who prepare, review, or rely on GAAP-based financial statements and want to stay sharp on one of the most consequential areas of accounting.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the accounting for environmental contamination costs.
- Identify examples of costs associated with exit activities.
- Recognize how an entity should account for revenue when treated as an agent.

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TABLE OF CONTENTS

CHAPTER

01

Section 1 4

1.01 H. Current Liabilities 4

1.02 I. Notes Payable 7

1.03 J. Other Liabilities 12

1.04 K. Stockholders' Equity 25

Test Your Knowledge 36

CHAPTER

02

Section 2 44

2.01 II. Revenue And Expenses 44

2.02 A. Income Statement Title 44

2.03 B. Involuntary Conversions 44

2.04 C. Reporting Revenue Gross Versus Net 45

2.05 D. Accounting For Revenue From Prepaid Stored-Value Cards 46

2.06 E. Losses On Onerous Contracts 53

Test Your Knowledge 57

Final Exam Copy 64

Index

Section 1

Chapter Objective

After completing this section, you should be able to:

- Identify the accounting for environmental contamination costs.
- Identify examples of costs associated with exit activities.

H. CURRENT LIABILITIES

1. Accrual for Employer Co-Insurance Arrangements

Question: A company has a self-insured medical insurance program with a “stop-gap” insurance policy covering medical expenses in excess of \$10,000 per employee. What amount should the company accrue to cover its liability?

Response: Although ASC 450, *Contingencies*, excludes employment-related costs, that statement guidance may be appropriate for this situation. In accordance with ASC 450, a liability should be accrued if the loss is probable and the amount can be estimated. *The company should record a liability for medical expenses incurred by the employees during the year yet not paid at year end*, including expenses incurred during the reporting period but submitted subsequent to the balance sheet date. Any liability will be reduced by any excess over \$10,000 which will be covered by the insurance policy.

2. Accrual for Sick Pay

Question: A company is concerned that its employees will vote for a union. In order to safeguard against this, they institute several benefits including a sick or personal days option. Under this policy, employees earn one personal day each quarter that they work. At the end of the year, the employees can take any unused personal days in the form of cash paid out in January of the following year. In January 20X1, the company paid \$76,000 for personal days earned but not taken in 20X0. Should the \$76,000 be recorded as a liability as of December 31, 20X0?

Response: Yes. ASC 710-10, *Compensation-General*, requires a company to record a liability for any compensated absence (vacation, holiday or sick pay) if *four criteria* are met:

- The compensation has been earned.
- It vests or accumulates.
- It is probable that it will be paid.
- The amount can be estimated.

Based on the above information, the *four criteria* have been met and the liability should be accrued. Although in this example, sick pay is accrued, usually, sick pay does not satisfy the four criteria and is therefore not usually accrued.

3. Accrual for Sabbatical Leave and Other Similar Benefits

Question: A company offers its employees sabbatical leave under which its employees are entitled to paid time off after working for the company for 10 years. During the sabbatical leave, the individual is still a compensated employee of the company and is not required to perform any duties for the company.

Should the employer record an accrual for the liability for the sabbatical leave similar to an accrual for vacation pay?

Response: An entity may provide its employees with a benefit in the form of a compensated absence known as a sabbatical leave under which the employee is entitled to paid time off after working for an entity for a specified period of time. During the sabbatical leave, the individual continues to be a compensated employee and is not required to perform any duties for the entity.

Historically, companies have followed the guidance of ASC 710-10, *Compensation-General*, in determining whether the cost of a sabbatical or other arrangement should be accrued.

ASC 710-10 states that an employer shall accrue a liability for employees' compensation for future absences if four criteria are met:

1. The compensation has been earned.
2. The obligation relates to rights that vest or accumulate.
3. Payment of the compensation is probable.
4. The amount can be reasonably estimated.

Vested rights are those for which the employer has an obligation to make payment, even if an employee terminates, and are not contingent on an employee's future service. Rights *accumulate* if rights have been earned but unused rights may be carried forward to future periods, even if there may be a limit to the amount that can be carried forward.

ASC Subtopic 710-10-25, *Sabbatical Leave Benefits*, provides further guidance by stating:

“An employee's right to a compensated absence under a sabbatical or other similar benefit arrangement a) that requires the completion of a minimum service period, and b) in which the benefit does not increase with additional years of service, accumulates under ASC 710-10 (e.g., the second criterion is met) as long as the employee”:

- 1) Continues to be a compensated individual, and
- 2) Is not required to perform duties for the entity during the absence.

That is, the third criterion for accrual (the obligation relates to rights that vest or accumulate) is satisfied if the above-noted guidance is satisfied.

Therefore, assuming the other three requirements for accrual are also met (e.g., compensation is earned, payment is probable, and amount can be reasonably estimated), the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period to earn the sabbatical leave. For example, if an employee must work 10 years to earn a thirty-day sabbatical leave with pay, that thirty days of sabbatical leave pay should be accrued during the 10 years over which the employee earns the sabbatical pay.

Arrangements in which employees are required to engage in research or public service to enhance the reputation of or otherwise benefit the employer are not within the scope of ASC 710-10.

4. Environmental Liabilities

Question: A company must remove underground storage tanks and remediate the soil in accordance with the environmental laws. The costs will be approximately \$100,000.

Should the cost be expensed or capitalized?

Response: ASC 410, *Asset Retirement and Environmental Obligations*, provides guidance.

General Rule: Environmental contamination treatment costs should be charged to expense.

However the ASC provides exceptions which the entity may elect (but is not required) to capitalize the expenditure if any one of the following criteria is met:

- a. The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company.

Note: For purposes of this criterion, the condition of the property after the costs are incurred must be improved as compared with the condition when originally constructed or acquired, if later.

- b. The costs mitigate or prevent environmental contamination that has yet to occur and that may result from future operations or activities, of property owned by the company.

Note: As with condition a) the costs must improve the property compared with its condition when constructed or acquired.

- c. The costs are incurred in preparing the property for sale.

Note

ASC 410-30 states that the costs incurred for removal of asbestos may be capitalized as the removal improves the safety and efficiency of the property.

In this example, the costs to remove the tanks and remediate the soil should be expensed since the activity does not satisfy any of the three (3) exceptions noted previously.

Change the facts: Not only are the old tanks removed for \$100,000, but the company also spends \$200,000 to install new tanks.

Response: The \$100,000 expenditure to remove the tanks should be expensed. However, the \$200,000 to install new tanks should be capitalized as a fixed asset addition.

Change the facts: The Company is required by law to remove the tanks and install the tanks by November 30, 20X2. In preparing the December 31, 20X1 financial statements, should the company accrue a liability for the \$100,000 removal expenditure? For the \$200,000 cost of installation of the new tanks?

Response: Yes for the \$100,000, and no for the \$200,000. The \$100,000 should be recorded as a liability in accordance with ASC 450, *Contingencies*, which states that a loss should be recorded when it is probable that an asset has been impaired or liability incurred and the amount can be reasonably estimated. Both of these criteria have been met with respect to the \$100,000 as of December 31, 20X1. However, the \$200,000 should not be recorded. ASC 450 only applies to loss contingencies, not capital expenditures. Therefore, the company should not record a \$200,000 liability using the probable and estimable criteria. Instead, the \$200,000 should be recorded when the expenditure is actually incurred in 20X2.

Question: A company is required to remove asbestos from basement pipes. The asbestos was in place when the company purchased the property. Should the cost be capitalized or expensed?

Response: ASC Subtopic 410-30 deals with how to handle the costs of removing asbestos from property. In accordance with the ASC, the costs of removing asbestos may be capitalized since the removal is considered to improve the safety of the property as compared with its original condition when constructed or acquired.

I. NOTES PAYABLE

1. Prepaid Interest

Question: A company records its installment loans as follows:

Cash (principal portion)

XX

Prepaid interest (accumulated interest during the loan) XX

Installment loan (total P& I loan payments) XX

How should the prepaid interest (discount) on an installment loan be presented- as a prepaid asset or as a direct reduction of the installment loan?

How should the interest be amortized during the life of the loan?

Response: ASC 835, *Interest*, requires the deferred or prepaid interest be shown as a direct reduction of the loan payable. It should not be classified as a separate deferred charge (asset) because it is not an asset separable from the note which gives rise to it. Further, a portion of the deferred interest should be allocated between the current and long-term portion of the loan.

In accordance with ASC 835, *the deferred interest should be amortized using the effective interest method* (carrying value of note x interest rate). A straight-line method should not be used unless the result is not materially different than that derived from using the effective interest method.

2. Amortization of Debt Issuance Costs

Question: A company pays \$20,000 for refinancing costs and points on a mortgage refinancing. The note term is three years with an amortization period of fifteen years. The bank has informally indicated a willingness to extend the note for another three years provided the borrower is in good standing after three years.

Over what period should the \$20,000 be amortized?

Response: The refinancing costs represent a deferred charge incurred to secure the mortgage note. These costs *should be amortized over a three-year period*, not six years nor fifteen years. Although it is possible that the note may be extended by another three years, the mortgage does not provide the borrower with the legal right to extend it. Therefore, the additional three-year period should not be considered until a legal right to this extension is obtained. (The fifteen-year period is used to amortize the loan and has nothing to do with the note term.)

Question: When the debt issuance costs are amortized, what expense account should the expense be recorded in?

Response: Interest expense. A common error accountants make is to record the amortization of debt issuance costs as amortization expense, when the correct category is interest expense. ASC 835-30, *Interest- Imputation of Interest*, states that amortization of debt issuance costs shall be reported as interest expense, not amortization expense.

Question: Should the amortization of debt issuance costs be included as part of the disclosure of total amortization expense and the estimate of amortization expense during each of the five subsequent years?

Response: No. The amortization of debt issuance costs is part of interest expense, not amortization expense. Consequently, that amortization is disclosed as part of interest expense and not amortization expense.

Question: How should the debt issuance costs be presented on the balance sheet?

Response: ASC 835-30 *Interest—Imputation of Interest*, (as amended by ASU 2015-03), amends the presentation of debt issuance costs (deferred financing costs).²¹

ASC 835-30 states the following:

- a. Debt issuance costs related to a note payable shall be presented on the balance sheet as a *direct deduction from the face amount of a note*.
- b. Debt issuance costs *shall not be classified* on the balance sheet as an asset, such as deferred charge or deferred credit.

Note

The ASU states that debt issuance costs should be treated similar to the way in which a bond discount or premium is presented, which is a direct reduction or increase in the bond payable. Such costs are not an asset or liability separable from the note that gives rise to it.

Example: Company X has \$10 million of notes payable and \$200,000 of debt issuance costs. Assume there is no current portion of debt for simplicity purposes.

Conclusion: X must present the \$200,000 of debt issuance costs as a reduction in the \$10 million of notes outstanding in accordance with ASC 835-30.

There are two approaches to the presentation on the balance sheet.

Presentation 1: Debt issuance costs are presented separately from the gross amount of the debt:

Long-term debt:

Principal amount	\$10,000,000
Less unamortized debt issuance costs	<u>(200,000)</u>
Total long-term debt	<u>\$9,800,000</u>

Presentation 2: Debt issuance costs presented net:

Long-term debt:

\$9,800,000

[\$10,000,000 face amount, less **unamortized debt issuance costs of**
\$200,000]

3. Balance Sheet Classification of Revolving Line of Credit

Question: A company has a revolving line of credit with a bank. The company is only required to pay monthly interest. If the credit line is called, the principal is due 12 months after the call date. Should this loan be classified as a current or long-term liability?

Response: ASC 210, *Balance Sheet*, states that liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, should be classified as current liabilities. If the line of credit has not been called at the balance sheet date, it should be presented as a long-term liability because it will not be paid off within 12 months. The exception is where, despite a requirement to do so, the company has the ability and intent to repay the line within 12 months. In this case, ASC 210, requires that the line be presented as a current liability.

Change the facts: The company has had the line of credit with the same bank for ten years. Although the note is payable upon demand, the company does not plan to pay it off within one year and, there is no indication that the bank will call the loan within the next year. Should the loan be shown current or long-term on the balance sheet?

Response: The note should be shown current. ASC 210 states that a demand loan is shown as a current liability. The exception is where the entity has both the ability and intent to repay the loan beyond the current operating cycle. In this instance, the company has the intent, but not the ability to repay the loan beyond the current operating cycle.

4. Violation of a Loan Agreement Covenant

Question: At December 31, 20X1, a company was in violation of its long-term debt covenant. Upon request, the bank was unwilling to provide a waiver of the default. In the 20X1 financial statements, the loan was classified as current and properly disclosed as a violation in the notes. In 20X2, the violation was cured. How should the loan be classified in the 20X2 financial statements for both 20X2 and 20X1, comparatively?

Response: Reference should be made to ASC 470, *Debt*, which states that a long-term liability should be classified as current if the liability is callable because the debtor either violates the debt agreement or does not cure a violation within a specified grace period. The exception is when the creditor waives the violation.

In this situation, the debt should be presented as long-term in the 20X2 financial statements because the violation was cured. However, in the 20X1 financial statements presented comparatively with 20X2, the debt should remain as a current liability because it was a current liability using the facts in place at the 20X1 balance sheet date.