

FAR Complete Study Guide, Part 2

Olivia Anderson · True North Accounting & Business Solutions · Study notes for educational use. Always confirm details against the current AICPA Blueprints and authoritative standards.

Financial Accounting and Reporting, Area II: Select Balance Sheet Accounts (30–40% of the FAR section), plus equity and contingencies.

Cash and Cash Equivalents

Cash includes currency on hand, demand deposits and savings accounts.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and have an **original maturity of three months or less** to the holder, such as Treasury bills, money market funds and commercial paper.

Not cash equivalents: investments bought with original maturities over three months, even if they are now close to maturity, and equity securities.

Bank Reconciliations

BANK SIDE	BOOK SIDE
Balance per bank statement	Balance per books
+ Deposits in transit	+ Collections made by the bank, such as a note collected
– Outstanding checks	+ Interest earned
± Bank errors	– NSF customer checks
	– Bank service charges
	± Book errors
= Adjusted bank balance	= Adjusted book balance

The two adjusted balances must be equal. **Only book-side items require journal entries.** Bank-side items are timing differences or the bank's errors.

Example entry for a customer's NSF check: debit Accounts Receivable and credit Cash.

Restricted Cash and Compensating Balances

Restricted cash, such as a sinking fund, escrow deposit or legally restricted compensating balance, is reported separately. It is current if the restriction relates to a current obligation or ends within a year, and noncurrent otherwise.

A **compensating balance** that isn't legally restricted can be included in cash, with the arrangement disclosed.

Petty Cash (Imprest System)

Establish a \$500 fund: debit Petty Cash 500, credit Cash 500.

Replenish after spending \$300 on supplies and \$100 on postage: debit Supplies Expense 300 and Postage Expense 100, and credit Cash 400. The Petty Cash account stays at \$500 and changes only if the fund size changes.

Receivables

Accounts Receivable and Credit Losses

Receivables are reported at amortized cost, net of an **allowance for credit losses**. Under ASC 326, the current expected credit loss (CECL) model, the allowance reflects losses expected over the life of the receivables, based on past events, current conditions and reasonable forecasts.

Aging method (balance sheet focus). Apply loss rates to aging categories to find the required ending allowance, then adjust the existing balance.

AGE	AMOUNT	LOSS RATE	EXPECTED LOSS
Current	\$50,000	1%	\$500
31–60 days	\$30,000	5%	\$1,500
61–90 days	\$15,000	10%	\$1,500
Over 90 days	\$5,000	25%	\$1,250
Total	\$100,000		\$4,750

- If the allowance has a \$1,000 **credit** balance before adjustment, record \$3,750 of credit loss expense.
- If it has a \$1,000 **debit** balance, from write-offs exceeding the allowance, record \$5,750.

Percentage-of-sales method (income statement focus). Credit loss expense equals credit sales times an estimated rate, such as $\$100,000 \times 2\% = \$2,000$. It's simple but doesn't directly target the ending allowance, so it fits poorly with CECL's balance sheet focus.

Entries

- Write-off: debit Allowance, credit Accounts Receivable. A write-off doesn't change net receivables.

- Recovery after write-off: reinstate (debit Accounts Receivable, credit Allowance), then record the collection (debit Cash, credit Accounts Receivable).
- The **direct write-off method** is not GAAP unless the effect is immaterial.

Notes Receivable

Interest = face value × stated rate × time. A \$10,000, 6%, 90-day note earns $\$10,000 \times 6\% \times 90/360 = \$150$, so \$10,150 is collected at maturity.

Long-term notes with no interest or below-market interest are recorded at present value using a market rate, with the discount amortized to interest revenue using the effective interest method.

Example: a \$10,000 non-interest-bearing note due in two years, received for goods, with a 6% market rate. The present value is $\$10,000 \div 1.06^2 = \$8,900$. Debit Notes Receivable 10,000, credit Discount on Notes Receivable 1,100 and credit Sales Revenue 8,900.

Transfers of receivables (ASC 860), such as factoring or discounting a note, are sales only if the transferor surrenders control. If so, the receivable is removed and a gain or loss recognized, with any recourse obligation recorded as a liability. Otherwise the transfer is a secured borrowing.

Inventory

Perpetual and Periodic Systems

- **Perpetual:** inventory and cost of goods sold are updated with every purchase and sale.
- **Periodic:** purchases go to a Purchases account, and cost of goods sold is computed at period-end: beginning inventory + purchases – ending inventory.

Cost Flow Assumptions

METHOD	ASSUMPTION	WITH RISING PRICES
Specific identification	Actual cost of each unique item	Matches actual flow
FIFO	Oldest costs are sold first	Higher ending inventory, lower COGS, higher income
LIFO	Newest costs are sold first	Lower ending inventory, higher COGS, lower income and taxes. Not allowed under IFRS
Weighted average	Average cost of units available	Between FIFO and LIFO

The **LIFO conformity rule** requires a company that uses LIFO for taxes to use it for financial reporting too.

Example: 100 units at \$10, then 200 at \$12, then 100 at \$14, for 400 units costing \$4,800. 300 units are sold, using periodic costing.

METHOD	COST OF GOODS SOLD	ENDING INVENTORY
FIFO	$100 \times \$10 + 200 \times \$12 = \mathbf{\$3,400}$	$100 \times \$14 = \mathbf{\$1,400}$
LIFO	$100 \times \$14 + 200 \times \$12 = \mathbf{\$3,800}$	$100 \times \$10 = \mathbf{\$1,000}$
Weighted average	$300 \times \$12 = \mathbf{\$3,600}$	$100 \times \$12 = \mathbf{\$1,200}$

Measuring Inventory Below Cost

- **FIFO and average cost:** lower of cost and **net realizable value**, where NRV is the estimated selling price less reasonably predictable costs of completion, disposal and transportation.
- **LIFO and the retail inventory method:** lower of cost or **market**. Market is replacement cost, but no higher than NRV (the ceiling) and no lower than NRV less a normal profit margin (the floor).

Example (FIFO): cost is \$100 per unit, the selling price is \$110 and costs to sell are \$15, so NRV is \$95. Write 1,000 units down by \$5 each: debit Loss on Inventory Write-Down 5,000 and credit Inventory 5,000.

Under U.S. GAAP, the written-down amount becomes the new cost basis. Later recoveries are not recognized, except for declines within the same fiscal year in interim reporting. IFRS allows reversals up to original cost.

LIFO Layers, Liquidations and the LIFO Reserve

Each year's increase in inventory forms a new LIFO **layer**. Selling more than you buy dips into old, cheaper layers (a **LIFO liquidation**), which matches old low costs against current prices and inflates profit.

Example: layers of 100 units at \$10 from an earlier year and 100 units at \$12 from this year. Selling 150 units costs $100 \times \$12 + 50 \times \$10 = \$1,700$.

The **LIFO reserve** is the difference between FIFO and LIFO inventory: FIFO inventory = LIFO inventory + LIFO reserve.

Dollar-value LIFO applies LIFO to pools of dollars using price indexes:

1. Convert ending inventory at current prices to base-year prices.
2. Compare with the prior year in base-year dollars to see whether a real increase occurred.
3. Convert any new layer to current-year prices using that year's index.
4. Add the layers together.

Property, Plant and Equipment

Initial Measurement

Capitalize all costs necessary to get an asset ready for its intended use.

- **Land:** purchase price, closing costs, surveys, clearing and grading, and the cost of removing an old building when the land is bought to build on, less salvage proceeds. Land is not depreciated.
- **Land improvements:** parking lots, fences, landscaping and sprinkler systems. These are depreciated.
- **Buildings:** purchase price or construction costs (materials, labor and overhead), architects' fees, permits and renovation needed before use.
- **Equipment:** purchase price, sales tax, freight, installation and testing.

After acquisition: capitalize costs that extend useful life, increase capacity or improve efficiency, such as a new roof. Expense ordinary repairs and maintenance.

Capitalized interest is required for assets constructed for the entity's own use or for sale as discrete projects. Capitalize avoidable interest, based on weighted-average accumulated expenditures times the interest rate, limited to actual interest incurred, until the asset is ready for use.

Depreciation

METHOD	FORMULA
Straight-line	$(\text{Cost} - \text{salvage}) \div \text{useful life}$
Units of production	$(\text{Cost} - \text{salvage}) \div \text{total expected units} \times \text{units this period}$
Double-declining balance	$\text{Book value} \times (2 \div \text{useful life})$. Salvage is ignored in the rate, but don't depreciate below salvage
Sum-of-the-years'-digits	$(\text{Cost} - \text{salvage}) \times \text{remaining life} \div \text{sum of the years}$

Examples using cost of \$100,000, salvage of \$10,000 and a five-year life:

- **Double-declining balance at 40%:** year 1, \$40,000. Year 2, $\$60,000 \times 40\% = \$24,000$. Year 3, $\$36,000 \times 40\% = \$14,400$. Continue until book value reaches \$10,000.
- **Sum-of-the-years'-digits (sum = 15):** year 1, $\$90,000 \times 5/15 = \$30,000$. Year 2, $\$90,000 \times 4/15 = \$24,000$. Year 3, $\$90,000 \times 3/15 = \$18,000$.

Partial years: prorate by months. An asset placed in service October 1 with \$10,000 of annual straight-line depreciation gets \$2,500 in the first year.

Component depreciation, depreciating significant parts such as a building's roof and HVAC separately, is permitted under U.S. GAAP and required under IFRS.

Disposals

1. Record depreciation up to the disposal date.
2. Remove the asset's cost and accumulated depreciation.
3. Record a gain or loss equal to proceeds minus book value.

Example: equipment costing \$50,000 with \$30,000 of accumulated depreciation, sold for \$25,000. Debit Cash 25,000 and Accumulated Depreciation 30,000. Credit Equipment 50,000 and Gain on Sale 5,000. If sold for \$15,000, the loss would be \$5,000.

Impairment of Assets Held and Used (ASC 360)

Test when events indicate the carrying amount may not be recoverable, such as a significant drop in market price, a change in how the asset is used, an adverse legal or business change, or costs significantly over budget.

1. **Recoverability test:** compare **undiscounted** future cash flows to the carrying amount. If cash flows are lower, the asset is impaired.
2. **Measurement:** impairment loss = carrying amount – **fair value**.

Example: carrying amount \$100,000, undiscounted cash flows \$80,000 and fair value \$70,000. The asset fails the recoverability test, so the loss is **\$30,000**, and the new basis of \$70,000 is depreciated over the remaining life.

U.S. GAAP prohibits reversing impairment losses on assets held and used. IFRS allows reversals.

Assets **held for sale** are measured at the lower of carrying amount or fair value less costs to sell, and are not depreciated.

Investments

Debt Securities (ASC 320)

CATEGORY	WHEN	MEASUREMENT	UNREALIZED GAINS AND LOSSES
Held-to-maturity (HTM)	Positive intent and ability to hold to maturity	Amortized cost	Not recognized
Available-for-sale (AFS)	Neither HTM nor trading	Fair value	OCI
Trading	Bought to sell in the near term	Fair value	Net income

Credit losses on HTM securities are recorded through an allowance under CECL. Credit losses on AFS securities are recorded through an allowance limited to the amount by which fair value is below amortized cost.

Effective interest amortization (HTM): interest revenue = carrying amount × market rate. Cash received = face value × stated rate. The difference is amortization.

Example: a \$100,000, 6%, five-year bond bought for about \$92,000 to yield 8%.

- Interest revenue: $\$92,000 \times 8\% = \$7,360$
- Cash received: $\$100,000 \times 6\% = \$6,000$
- Discount amortization: \$1,360
- Entry: debit Cash 6,000 and Investment 1,360, credit Interest Revenue 7,360
- New carrying amount: \$93,360

AFS entries

- Fair value above amortized cost: debit Investment, credit Unrealized Gain (OCI).
- On sale, reclassify the accumulated unrealized gain or loss out of AOCI into net income as a realized gain or loss.

Equity Securities

No significant influence (generally under 20%): measured at **fair value through net income**. Dividends are income.

Example: 1,000 shares bought at \$50 rise to \$55 at year-end. Debit Investment 5,000 and credit Unrealized Gain (income) 5,000.

Equity securities without readily determinable fair values may use a **measurement alternative**: cost less impairment, adjusted for observable price changes.

Significant influence (generally 20% to 50%): the equity method.

- The investor's share of investee income increases the investment.
- Dividends received reduce the investment.

Example: buy 30% for \$100,000. The investee earns \$50,000 and pays \$10,000 of dividends.

- Share of income: debit Investment 15,000, credit Equity in Investee Earnings 15,000
- Dividends: debit Cash 3,000, credit Investment 3,000
- Ending investment: $\$100,000 + \$15,000 - \$3,000 = \mathbf{\$112,000}$

If the price paid exceeds the investor's share of the investee's book value, the excess related to depreciable assets is amortized, which reduces equity method income.

Control (generally over 50%): consolidate. Consolidation is covered in Part 3 and tested mainly in BAR.

The Fair Value Option

An entity may elect to measure eligible financial assets and liabilities at fair value, with changes through net income. The election is made instrument by instrument, usually at initial recognition, and is irrevocable.

Intangible Assets

Intangible assets lack physical substance and provide future benefits: patents, copyrights, trademarks, franchises, customer lists and software.

- **Finite-lived intangibles** are amortized over the shorter of useful life or legal life, and tested for impairment when indicators exist.
- **Indefinite-lived intangibles**, such as a trademark that can be renewed indefinitely, are not amortized. They are tested for impairment at least annually.

Purchased intangibles are capitalized at cost. **Internally developed intangibles** are generally expensed as incurred, except for certain legal and registration costs and software costs.

Research and Development

R&D costs are **expensed as incurred**, including lab research, product design, building and testing prototypes and design modifications.

Not R&D: routine quality control testing, troubleshooting in production and routine adaptations for a customer.

- Equipment and facilities with **alternative future uses** are capitalized and depreciated, with the depreciation treated as R&D expense.
- Items with **no alternative future use** are expensed immediately.
- Under ASC 805, **in-process R&D** acquired in a business combination is capitalized as an indefinite-lived intangible until the project is completed or abandoned.

Software Costs

Internal-use software (ASC 350-40)

- Preliminary project stage: expense.
- Application development stage, such as coding, testing and installation: capitalize.
- Post-implementation stage, such as training and maintenance: expense.

ASU 2025-06 removes these project stages and instead starts capitalization when management commits to funding and completion is probable. It's effective for annual periods beginning after December 15, 2027, so check which rules the exam is testing when you sit.

Software to be sold (ASC 985-20)

- Before **technological feasibility** is established, through a detailed program design or working model: expense as R&D.
- After technological feasibility and until the product is available for general release: capitalize.

- Amortize starting at release, using the greater of the revenue-based amount or the straight-line amount.

Goodwill

Goodwill arises only in a business combination. It equals the consideration transferred, plus any noncontrolling interest, less the fair value of identifiable net assets acquired. It is never internally generated.

- Public companies don't amortize goodwill. They test it for impairment at the **reporting unit** level at least annually.
- **Impairment loss** = carrying amount of the reporting unit – its fair value, limited to the goodwill allocated to that unit. A qualitative assessment may come first.
- Goodwill impairment cannot be reversed.
- Private companies may elect to amortize goodwill over up to ten years.

Example: a reporting unit carries \$200,000, including \$50,000 of goodwill, and has a fair value of \$180,000. The impairment is **\$20,000**, leaving \$30,000 of goodwill.

Under the current blueprints, goodwill impairment, internally developed software and R&D are tested in **BAR**. Intangibles in general are tested in FAR.

Payables and Accrued Liabilities

Accounts Payable and Purchase Discounts

Terms of 2/10, n/30 on a \$10,000 purchase:

	GROSS METHOD	NET METHOD
Purchase	Inventory and AP 10,000	Inventory and AP 9,800
Paid within 10 days	AP 10,000. Cash 9,800. Purchase Discount 200	AP 9,800. Cash 9,800
Paid after 10 days	AP 10,000. Cash 10,000	AP 9,800. Purchase Discounts Lost 200. Cash 10,000

The net method is considered theoretically better because it highlights discounts lost, but the gross method is more common.

Accrued Liabilities

Recognize a liability when an obligation exists and the amount can be reasonably estimated: wages, interest, taxes and warranties.

Payroll example: gross wages of \$10,000, employee withholdings of \$2,000 and employer payroll taxes of \$1,000.

- Debit Wage Expense 10,000 and Payroll Tax Expense 1,000
- Credit Withholdings Payable 2,000, Payroll Taxes Payable 1,000 and Wages Payable 8,000

Warranties

- **Assurance-type warranty**, included with the product, assuring it works as promised: accrue the estimated cost when the product is sold. With \$100,000 of sales and a 3% estimate, debit Warranty Expense 3,000 and credit Warranty Liability 3,000. Claims reduce the liability.
- **Service-type warranty**, sold separately or providing service beyond assurance: a separate performance obligation under ASC 606. Record a contract liability when paid, and recognize revenue over the coverage period.

Exit and Disposal Costs (ASC 420)

Costs associated with exit activities are recognized **when the liability is incurred**, not when management commits to a plan.

- **One-time termination benefits** are recognized when the plan is communicated to employees. If employees must keep working beyond a minimum retention period, the cost is recognized over that service period.
- **Contract termination costs** are recognized when the contract is terminated.
- Costs to retrain or relocate employees, and future operating losses, are expensed as incurred.

Lease-related exit costs are generally handled under ASC 842, such as impairment of the right-of-use asset.

Long-Term Debt

Bonds Payable

MARKET RATE COMPARED WITH STATED RATE	BONDS SELL AT
Market rate below stated rate	A premium
Market rate equal to stated rate	Par
Market rate above stated rate	A discount

Effective interest method: interest expense = carrying amount × market rate. Cash paid = face value × stated rate. The difference is the amortization of the discount or premium.

Discount example: \$100,000, 6% (3% semiannual), five-year bonds issued to yield 8% (4% semiannual) for **\$91,889**.

- At issue: debit Cash 91,889 and Discount on Bonds Payable 8,111, credit Bonds Payable 100,000.

- First period: interest expense = $\$91,889 \times 4\% = \$3,676$. Cash paid = $\$3,000$. Discount amortization = $\$676$.
New carrying amount = $\$92,565$.

Premium example: the same bonds issued to yield 4% (2% semiannual) for **\$108,982**.

- First period: interest expense = $\$108,982 \times 2\% = \$2,180$. Cash paid = $\$3,000$. Premium amortization = $\$820$.

Straight-line amortization is allowed only if the results aren't materially different from the effective interest method.

Debt issuance costs are presented as a direct reduction of the debt's carrying amount and amortized as interest expense.

Covenant violations that make debt callable generally require current classification, unless the lender waives the right for more than a year or other specific exceptions apply.

Notes Payable

Long-term notes with no interest or below-market interest are recorded at present value.

Installment notes: each payment covers interest and principal.

Example: \$100,000 at 6%, repaid in five annual payments of \$23,740.

- Year 1 interest: $\$100,000 \times 6\% = \$6,000$
- Principal: $\$23,740 - \$6,000 = \$17,740$
- Entry: debit Interest Expense 6,000 and Notes Payable 17,740, credit Cash 23,740
- New balance: $\$82,260$

Troubled Debt Restructurings by Debtors (ASC 470-60)

A debtor in financial difficulty receives a concession from the creditor.

Settlement by transferring assets or equity. Gain on restructuring = carrying amount of the debt – fair value of what is given up. If an asset is transferred, first adjust it to fair value and recognize a gain or loss on the asset.

Example: debt of \$100,000 is settled by transferring an asset with a fair value of \$70,000 and carrying amount of \$50,000.

- Gain on asset transfer: $\$70,000 - \$50,000 = \$20,000$
- Gain on restructuring: $\$100,000 - \$70,000 = \$30,000$
- Entry: debit Debt 100,000, credit Asset 50,000, Gain on Asset Transfer 20,000 and Gain on Restructuring 30,000

Modification of terms. Compare total undiscounted future cash payments to the carrying amount.

- If future payments are **less** than the carrying amount, reduce the debt to the future payments, recognize a gain and record no future interest expense.
- If they are **greater**, recognize no gain. Compute a new effective interest rate for future interest expense.

Stockholders' Equity

Common Stock

Issue 1,000 shares of \$1 par stock for \$50 a share: debit Cash 50,000, credit Common Stock 1,000 and Additional Paid-in Capital 49,000. No-par stock without a stated value is credited entirely to common stock.

Preferred Stock

- Preference over common for dividends and in liquidation, and usually nonvoting
- **Cumulative:** unpaid dividends accumulate as **dividends in arrears**, which are disclosed but not accrued. They must be paid before common dividends.
- **Participating:** shares in dividends beyond the stated rate along with common.
- **Convertible:** the holder may convert to common.
- **Callable:** the issuer may redeem at a set price.
- **Mandatorily redeemable** preferred stock is classified as a **liability**.

Treasury Stock (Cost Method)

- Buy 100 shares at \$50: debit Treasury Stock 5,000, credit Cash 5,000.
- Reissue 50 shares at \$60: debit Cash 3,000, credit Treasury Stock 2,500 and Paid-in Capital from Treasury Stock 500.
- Reissue 50 shares at \$40: debit Cash 2,000 and Paid-in Capital from Treasury Stock 500, credit Treasury Stock 2,500. If that paid-in capital account isn't large enough, debit retained earnings for the rest.

Treasury stock is a contra-equity account, not an asset. It receives no dividends, doesn't vote and is excluded from shares outstanding for EPS.

Retained Earnings

Increased by net income and decreased by net losses and dividends. Prior period adjustments correct the opening balance. Legal, contractual or board-designated restrictions are disclosed.

Dividends

- **Declaration date:** a liability arises. Debit Retained Earnings, credit Dividends Payable.
- **Record date:** determines who receives the dividend. No entry.
- **Payment date:** debit Dividends Payable, credit Cash.

Property dividends: remeasure the asset to fair value at declaration, recognizing a gain or loss, and record the dividend at fair value.

Stock dividends move amounts within equity and don't change total equity.

- **Small (less than about 20% to 25%):** record at fair value. *Example:* a 10% dividend on 10,000 shares of \$1 par stock with a \$50 market price distributes 1,000 shares. Debit Retained Earnings 50,000, credit Common Stock 1,000 and APIC 49,000.
- **Large (more than about 20% to 25%):** record at par. A 30% dividend distributes 3,000 shares: debit Retained Earnings 3,000, credit Common Stock 3,000.

Stock splits reduce par value and increase shares proportionately, with only a memo entry. In a 2-for-1 split, 10,000 shares at \$1 par become 20,000 shares at \$0.50 par.

Accumulated Other Comprehensive Income

Reported in equity. Typical components are pension and postretirement adjustments, unrealized gains and losses on AFS debt securities, foreign currency translation adjustments and cash flow hedge gains and losses.

Contingencies and Commitments (ASC 450)

LIKELIHOOD OF LOSS	REASONABLY ESTIMABLE	NOT ESTIMABLE
Probable (likely to occur)	Accrue and disclose	Disclose
Reasonably possible (more than remote, less than likely)	Disclose	Disclose
Remote (slight chance)	Generally no disclosure	Generally no disclosure

Ranges: accrue the best estimate in the range. If no amount is better than any other, accrue the **minimum** and disclose the range.

Gain contingencies are not recognized until realized. They may be disclosed, with care not to mislead.

Guarantees (ASC 460): a guarantor recognizes a liability at inception for the fair value of the obligation it takes on, even if the chance of having to pay is remote. *Example:* guaranteeing another company's \$100,000 loan, with a guarantee fair value of \$2,000, gives a \$2,000 liability.

Commitments, such as purchase commitments, are disclosed. A loss on a firm, noncancelable purchase commitment is recognized when the market price falls below the contract price.

Example: a commitment to buy 10,000 units at \$10 when the market price drops to \$8. Debit Loss on Purchase Commitment 20,000, credit Liability 20,000.

Question: A company is sued for \$500,000. Its lawyer says a loss is reasonably possible, but not probable, and would range from \$300,000 to \$500,000. What's required?

Answer: Disclose only. Describe the lawsuit and the possible loss range of \$300,000 to \$500,000. Don't accrue, because the loss isn't probable.