

FAR Complete Study Guide, Part 3

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 III: Select Transactions (25–35% of the FAR section). Topics that the current blueprints test in FAR are marked so you can prioritize.

Revenue Recognition (ASC 606)

ASC 606 applies to contracts with customers, except those covered by other standards such as leases, insurance and financial instruments.

The Five Steps

1. Identify the contract.
2. Identify the performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognize revenue when, or as, each obligation is satisfied.

Step 1: Identify the Contract

A contract exists when:

1. The parties have approved it and are committed to perform.
2. Each party's rights are identifiable.
3. Payment terms are identifiable.
4. It has commercial substance.
5. Collection of the consideration is **probable**.

If these criteria aren't met, cash received is recognized as revenue only when the entity has no remaining obligations and substantially all the consideration has been received and is nonrefundable, or the contract has been terminated and the consideration is nonrefundable. Until then, it's a liability.

Contract modifications

- A modification that adds distinct goods or services at their standalone selling prices is a **separate contract**.
- Otherwise, if the remaining goods or services are distinct, account for it **prospectively**, as if the old contract ended and a new one began.
- If the remaining goods or services are not distinct, use a **cumulative catch-up** adjustment.

Step 2: Identify Performance Obligations

A performance obligation is a promise to transfer a **distinct** good or service. A good or service is distinct if both:

1. The customer can benefit from it on its own or with readily available resources.
2. The promise is separately identifiable, meaning it isn't highly integrated with, or significantly modifying, other promises in the contract.

Separate obligations: equipment plus a routine installation others could perform, or a software license plus support.

A single obligation: equipment plus highly specialized, integral installation, or construction of a custom building where many inputs create one output.

A **series** of substantially the same distinct goods or services with the same pattern of transfer, such as monthly service for a year, is treated as one performance obligation.

Step 3: Determine the Transaction Price

The transaction price is the amount the entity expects to be entitled to.

Variable consideration, such as discounts, rebates, refunds, bonuses and penalties, is estimated using either:

- The **expected value**, a probability-weighted amount, which suits many possible outcomes, or
- The **most likely amount**, which suits two possible outcomes

Then apply the **constraint**: include variable consideration only to the extent it is **probable** that a significant reversal of cumulative revenue won't occur.

Example: a \$100,000 contract with a \$10,000 bonus for early completion. The seller estimates an 80% chance of earning it. With two outcomes, the most likely amount, \$110,000, is appropriate, if it's probable a significant reversal won't occur. If the outcome is highly uncertain, the constraint limits the price to \$100,000.

Significant financing component: adjust for the time value of money when payment timing provides significant financing. As a practical expedient, no adjustment is needed if the time between transfer and payment is one year or less.

Example: equipment with a cash price of \$100,000 is sold for \$110,000 due in two years, an implicit rate of about 4.88%. Recognize revenue of \$100,000 at delivery, and recognize interest income using the effective interest method: about \$4,881 in year 1 and \$5,119 in year 2.

Noncash consideration is measured at fair value. If fair value can't be reasonably estimated, use the standalone selling price of the goods or services promised.

Consideration payable to a customer, such as coupons, rebates and slotting fees, reduces the transaction price unless it pays for distinct goods or services from the customer.

Step 4: Allocate the Transaction Price

Allocate based on relative **standalone selling prices** (SSP). If an SSP isn't observable, estimate it using:

- An adjusted market assessment
- Expected cost plus a margin
- The residual approach, only when the SSP is highly variable or uncertain

Example: software with a \$40,000 SSP and one year of support with a \$10,000 SSP sold together for \$45,000.

- Software: $\$45,000 \times 40/50 = \mathbf{\$36,000}$
- Support: $\$45,000 \times 10/50 = \mathbf{\$9,000}$

Discounts and variable consideration are allocated to all obligations, unless they relate entirely to one or more specific obligations and meet the criteria for allocating them there.

Step 5: Recognize Revenue

Over time, if any of these is met:

1. The customer simultaneously receives and consumes the benefits as the entity performs, as with cleaning or storage services.
2. The entity's performance creates or enhances an asset the customer controls, such as building on the customer's land.
3. The entity's performance creates an asset with **no alternative use** to the entity **and** the entity has an **enforceable right to payment** for performance to date, as in custom manufacturing.

Measure progress with **output methods** (units delivered, milestones) or **input methods** (costs incurred, labor hours, time elapsed).

At a point in time otherwise, when control transfers. Indicators include a present right to payment, legal title, physical possession, the significant risks and rewards of ownership, and customer acceptance. Under FOB shipping point terms, control usually transfers at shipment. Under FOB destination, at delivery.

Common Situations

Bill-and-hold: revenue is recognized before delivery only if there's a substantive reason for the arrangement, the product is identified as the customer's, it is ready for transfer and the seller can't use it or direct it to another customer.

Consignment: the consignor recognizes revenue when the consignee sells to an end customer. Indicators of consignment include the dealer not obtaining control and being able to return unsold goods.

Right of return: recognize revenue only for goods not expected to be returned. Record a refund liability and an asset for the right to recover the goods.

Example: 1,000 units sold at \$100 each, costing \$70, with 5% expected returns.

- Debit Accounts Receivable 100,000, credit Sales Revenue 95,000 and Refund Liability 5,000
- Debit COGS 66,500 and Asset for Expected Returns 3,500, credit Inventory 70,000

Principal or agent: a principal controls the good or service before it transfers to the customer and reports revenue **gross**. An agent arranges for another party to provide it and reports its fee or commission **net**. Indicators of a principal include primary responsibility for fulfillment, inventory risk and pricing discretion.

Warranties: an assurance-type warranty is accrued as a cost. A service-type warranty is a separate performance obligation.

Licenses of intellectual property

- **Functional IP**, such as software, film or music, gives a right to use the IP as it exists. Revenue is recognized at a point in time.
- **Symbolic IP**, such as brands, trademarks and logos, gives a right to access the IP over the license period. Revenue is recognized over time.

Contract costs

- **Incremental costs to obtain a contract**, such as sales commissions, are capitalized if expected to be recovered. As a practical expedient, they can be expensed if the amortization period is one year or less.
- **Costs to fulfill a contract** are capitalized if they relate directly to the contract, create or enhance resources used to satisfy it and are expected to be recovered.
- Capitalized costs are amortized consistently with the transfer of the related goods or services.

Question: Equipment (SSP \$100,000) and installation that others could perform (SSP \$12,000) are sold together for \$108,000. How much revenue is recognized when the equipment is delivered?

Answer: There are two performance obligations. Equipment gets $\$108,000 \times 100/112 = \mathbf{\$96,429}$, recognized at delivery. Installation gets $\$108,000 \times 12/112 = \mathbf{\$11,571}$, recognized when it's performed.

Lessee Accounting (ASC 842)

Is It a Lease?

A contract contains a lease if there is an **identified asset** and the customer has the **right to control** its use, meaning the right to obtain substantially all its economic benefits and to direct its use. If the supplier has a substantive right to substitute the asset, it's a service contract, not a lease.

Classification

A lease is a **finance lease** if any of these five criteria is met (often remembered as "OWNES"):

1. **O**wnership transfers to the lessee by the end of the term.
2. **W**ritten purchase option the lessee is reasonably certain to exercise.
3. **N**et present value of payments and any lessee-guaranteed residual value equals or exceeds substantially all (often 90% or more) of the asset's fair value.
4. **E**conomic life: the term is a major part (often 75% or more) of the asset's remaining economic life.
5. **S**pecialized asset with no alternative use to the lessor at the end of the term.

Otherwise it's an **operating lease**.

Initial Measurement

Both types record a **right-of-use (ROU) asset** and a **lease liability** at the present value of the lease payments.

- **Discount rate:** the rate implicit in the lease if readily determinable, otherwise the lessee's incremental borrowing rate. Private companies may elect a risk-free rate.
- **Lease payments include** fixed payments, variable payments based on an index or rate, a purchase option price the lessee is reasonably certain to exercise, termination penalties when termination is expected and amounts probable of being owed under residual value guarantees.
- Variable payments not based on an index or rate are excluded and expensed as incurred.

Finance Lease Example

A five-year lease with annual payments of \$10,000 at year-end and a 6% rate. The present value is **\$42,124**.

- At commencement: debit ROU Asset 42,124, credit Lease Liability 42,124.
- Year 1 interest: $\$42,124 \times 6\% = \$2,527$. Debit Interest Expense 2,527 and Lease Liability 7,473, credit Cash 10,000.
- Year 1 amortization: $\$42,124 \div 5 = \$8,425$. Debit Amortization Expense 8,425, credit ROU Asset 8,425.
- End of year 1: ROU asset \$33,699 and lease liability \$34,651.

The income statement shows **interest and amortization separately**, so total expense is higher in early years.

Operating Lease Example (Same Facts)

The lessee recognizes a **single straight-line lease cost** of $\$50,000 \div 5 = \$10,000$ a year.

- The liability is still reduced using the effective interest method: $\$10,000 - \$2,527 \text{ interest} = \$7,473$.
- The ROU asset is reduced by the difference between the straight-line cost and the interest accretion: $\$10,000 - \$2,527 = \$7,473$.

- Year 1 entry: debit Lease Expense 10,000, credit Cash 10,000. Debit Lease Liability 7,473, credit ROU Asset 7,473.

Short-Term Leases

For leases of 12 months or less with no purchase option the lessee is reasonably certain to exercise, the lessee may elect, by asset class, not to record an ROU asset or liability and simply expense payments straight-line.

Lessor Accounting

Lessor accounting is tested more lightly. FAR's blueprint focuses on lessee accounting.

- **Sales-type lease:** any of the five criteria is met. The lessor derecognizes the asset, records a net investment in the lease (the present value of payments plus the present value of the residual) and recognizes selling profit or loss at commencement.
- **Direct financing lease:** none of the five criteria is met, but the present value of payments plus any residual value guaranteed by the lessee or a third party equals substantially all of fair value, **and** collection is probable. Selling profit is deferred.
- **Operating lease:** otherwise. The lessor keeps the asset, depreciates it and recognizes lease income, generally straight-line.

Accounting for Income Taxes (ASC 740)

Book income and taxable income differ because of **permanent** differences and **temporary** differences.

Permanent Differences

They never reverse and create no deferred taxes. They cause the effective tax rate to differ from the statutory rate.

Book expenses that are never deductible

- Fines and penalties
- Life insurance premiums when the company is the beneficiary
- 50% of business meals, and all entertainment
- Federal income tax expense
- Compensation over \$1 million for covered employees of public companies

Book income that is never taxable, or special deductions

- Municipal bond interest
- Life insurance proceeds received by the company

- The **dividends-received deduction**: 50% if ownership is under 20%, 65% for 20% to under 80%, and 100% for 80% or more

Temporary Differences

Differences between the **book carrying amount and tax basis** of assets and liabilities that will reverse.

SITUATION	RESULT
Asset's book value greater than tax basis (example: tax depreciation faster than book)	Deferred tax liability
Liability's book value greater than tax basis (example: accrued warranties deductible when paid)	Deferred tax asset
Revenue taxed before it's earned for books (example: rent or subscriptions received in advance)	Deferred tax asset
Revenue earned for books before it's taxed (example: installment sales)	Deferred tax liability

Other common deferred tax assets: credit loss allowances, accrued expenses deductible when paid, unrealized losses and **net operating loss carryforwards**.

Current Tax

Pretax book income, plus nondeductible expenses, minus nontaxable income, plus or minus the current year's temporary differences, equals taxable income. Taxable income times the current rate equals the current tax payable.

Deferred Tax: the Balance Sheet Approach

1. Determine cumulative temporary differences at year-end.
2. Multiply by the **enacted** tax rate expected to apply when they reverse to get the required deferred tax balance.
3. The change from the beginning balance is the deferred tax expense or benefit.

Example: an asset costs \$100,000. Book depreciation is \$10,000 a year. Tax depreciation is \$15,000 in year 1 and \$12,000 in year 2. The tax rate is 21%.

- End of year 1: book value \$90,000, tax basis \$85,000. The \$5,000 difference requires a DTL of \$1,050. Debit Deferred Tax Expense 1,050, credit Deferred Tax Liability 1,050.
- End of year 2: book value \$80,000, tax basis \$73,000. The \$7,000 difference requires a DTL of \$1,470, an increase of **\$420**.

Total income tax expense = current tax expense + deferred tax expense (or – benefit).

Example presentation: income before taxes of \$100,000, current tax expense of \$25,000 and a deferred tax benefit of \$2,000 give total income tax expense of \$23,000 and net income of \$77,000.

Valuation Allowance

A deferred tax asset is reduced by a valuation allowance if it is **more likely than not** (over 50%) that some or all of it **won't** be realized.

- *Negative evidence:* cumulative recent losses, expected future losses and carryforwards about to expire unused.
- *Positive evidence:* existing contracts or backlog, a strong earnings history and taxable temporary differences that will reverse in time.

Example: a \$10,000 DTA with a \$3,000 allowance is reported at a net \$7,000. Increases in the allowance increase income tax expense.

Changes in Tax Rates

Remeasure deferred tax balances when a new rate is **enacted**, with the effect in income tax expense in the period of enactment. *Example:* a \$10,000 taxable temporary difference at 21% is a \$2,100 DTL. If 25% is enacted, the DTL becomes \$2,500, adding \$400 of deferred tax expense.

Net Operating Losses

For federal losses arising after 2020, NOLs generally **can't be carried back, carry forward indefinitely** and can offset **only 80% of taxable income** in a carryforward year. A deferred tax asset is recorded for the future benefit, subject to a valuation allowance.

Example at 21%:

- **Year 1:** taxable loss of \$100,000. Debit DTA 21,000, credit Income Tax Benefit 21,000.
- **Year 2:** taxable income of \$120,000 before the NOL. The deduction is limited to $80\% \times \$120,000 = \$96,000$, leaving taxable income of \$24,000 and current tax of \$5,040.
 - Debit Current Income Tax Expense 5,040, credit Income Tax Payable 5,040.
 - Debit Deferred Income Tax Expense 20,160, credit DTA 20,160 ($\$96,000 \times 21\%$).
 - Total tax expense is \$25,200, which is 21% of \$120,000. A \$840 DTA remains for the \$4,000 NOL still unused.

Uncertain Tax Positions

1. **Recognition:** recognize the benefit only if it is **more likely than not** that the position will be sustained on examination, based on its technical merits.
2. **Measurement:** measure the benefit at the **largest amount with a cumulative probability greater than 50%** of being realized on settlement.

Example: a \$100,000 deduction with these possible outcomes:

BENEFIT SUSTAINED	PROBABILITY	CUMULATIVE PROBABILITY
\$100,000	40%	40%
\$70,000	30%	70%
\$0	30%	100%

The largest amount with a cumulative probability over 50% is **\$70,000**. The unrecognized \$30,000 is a liability for unrecognized tax benefits.

Interest and penalties may be classified as income tax expense or as interest and other expense, applied consistently.

Intraperiod Tax Allocation

Income tax expense is allocated among continuing operations, discontinued operations, OCI and items charged directly to equity, so each is shown net of its own tax effect.

Accounting Changes and Error Corrections (ASC 250)

TYPE	EXAMPLES	TREATMENT
Change in accounting principle	FIFO to weighted average, or adopting a new standard	Retrospective: adjust opening retained earnings of the earliest period presented and restate prior periods
Change in accounting estimate	Useful lives, salvage values, credit loss rates, warranty rates	Prospective: current and future periods only
Change in estimate effected by a change in principle	Changing the depreciation method	Prospective
Change in reporting entity	Presenting consolidated instead of separate statements	Retrospective
Error correction	Math mistakes, misapplying GAAP, overlooked facts	Restatement: prior period adjustment to opening retained earnings

Change to LIFO: usually applied prospectively, because retrospective application is impracticable.

Change in principle example: switching from FIFO to weighted average at the start of year 3. Year 2 ending inventory was \$100,000 under FIFO and would have been \$90,000 under weighted average, and the tax rate is 30%. Debit Retained Earnings 7,000 and Deferred Tax Asset (or Taxes Payable) 3,000, credit Inventory 10,000. Restate prior years presented.

Change in estimate example: equipment cost \$100,000 with no salvage and a ten-year life. After four years and \$40,000 of depreciation, the total life is revised to twelve years. New annual depreciation = $\$60,000 \div 8$ remaining years = **\$7,500**.

Error correction example: in year 3, the company finds it never recorded \$100,000 of depreciation in year 1. The tax rate is 30%, and tax depreciation was claimed correctly. Debit Retained Earnings 70,000 and Deferred Tax Asset (or reduce the DTL) 30,000, credit Accumulated Depreciation 100,000. Restate any prior years presented, adjust opening retained earnings of the earliest year presented and disclose the error. Don't run the correction through year 3 income.

Topics Tested in BAR Under the Current Blueprints

The following topics used to be core FAR material. Under the 2026 blueprints they're tested in **BAR**. Review them here if you're taking BAR, or for context.

Business Combinations (ASC 805)

The **acquisition method** is required:

1. **Identify the acquirer:** the entity that obtains control. It usually transfers cash or other assets, or issues its equity. It is often the larger entity, and its owners and management usually dominate the combined entity.
2. **Determine the acquisition date:** when control is obtained, usually the closing date.
3. **Recognize and measure** identifiable assets acquired, liabilities assumed and any noncontrolling interest at **fair value**, including intangibles the acquiree never recorded, such as customer relationships, trademarks, patents, technology and in-process R&D.
4. **Recognize goodwill or a bargain purchase gain.**

Goodwill = consideration transferred + fair value of any noncontrolling interest – fair value of identifiable net assets.

Example: \$500,000 cash for 100% of an entity with assets at fair value of \$600,000 and liabilities of \$150,000. Net assets are \$450,000, so goodwill is **\$50,000**. If the price were \$400,000, after reassessing the measurements, a **\$50,000 bargain purchase gain** would be recognized in earnings.

Contingent consideration is measured at acquisition-date fair value. If classified as a liability, it's remeasured each period with changes in earnings. If classified as equity, it isn't remeasured.

Acquisition-related costs, such as legal and advisory fees, are expensed. Costs to issue debt or equity follow other GAAP.

Consolidations

Consolidate when the parent has a **controlling financial interest**: generally more than 50% of voting shares, or when it is the **primary beneficiary** of a variable interest entity.

Example, 100% acquisition: the parent pays \$400,000. The subsidiary's book equity is \$300,000 (common stock \$200,000 and retained earnings \$100,000). Its assets have a book value of \$400,000 and fair value of \$450,000, and liabilities are \$100,000 at both book and fair value.

- Fair value of net assets: $\$450,000 - \$100,000 = \$350,000$, so goodwill is $\$50,000$.
- Worksheet elimination: debit Common Stock 200,000, Retained Earnings 100,000, Assets 50,000 (the fair value step-up) and Goodwill 50,000. Credit Investment in Subsidiary 400,000.

Noncontrolling interest (NCI) is measured at fair value at acquisition and reported in equity, separately from the parent's equity. Goodwill is recognized for 100% of the subsidiary. Consolidated net income is split between the parent and the NCI.

Intercompany eliminations

- Receivables and payables between the companies
- Intercompany sales and purchases, plus unrealized profit in ending inventory. *Example:* goods costing the parent $\$150,000$ sold to the subsidiary for $\$200,000$ and still on hand. Debit Sales 200,000, credit COGS 150,000 and Inventory 50,000.
- Unrealized gains on intercompany sales of land or depreciable assets, realized when sold outside the group or through depreciation

Variable interest entities: an entity whose equity is insufficient to finance its activities, or whose equity holders lack the power, the obligation to absorb losses or the right to receive returns. The **primary beneficiary**, with both power over the most significant activities and significant exposure to losses or benefits, consolidates it.

Derivatives and Hedging (ASC 815)

A **derivative** has an underlying and a notional amount or payment provision, requires little or no initial net investment and can be net settled. Examples are forwards, futures, options and swaps. All derivatives are measured at **fair value**.

- **Fair value hedge** of a recognized asset, liability or firm commitment: changes in the fair value of both the derivative and the hedged item, for the hedged risk, go to **earnings**, largely offsetting.
- **Cash flow hedge** of a forecasted transaction or variable-rate item: the change in the derivative's fair value included in the effectiveness assessment goes to **OCI**. It is reclassified into earnings when the hedged transaction affects earnings, in the same income statement line. For a hedged inventory purchase, that's cost of goods sold when the inventory is sold.
- **Net investment hedge** of a foreign operation: gains and losses go to the cumulative translation adjustment in OCI.

Since ASU 2017-12, the separate measurement of hedge "ineffectiveness" is no longer required for cash flow hedges.

Share-Based Compensation (ASC 718)

Stock options for employees are measured at **grant-date fair value** using an option-pricing model, and recognized as expense over the requisite service period, usually the vesting period.

Example: 1,000 options with a \$10 fair value vest after three years. Total cost is \$10,000, so expense is about \$3,333 a year: debit Compensation Expense, credit APIC — Stock Options.

On exercise at a \$50 exercise price, with \$1 par stock: debit Cash 50,000 and APIC — Stock Options 10,000, credit Common Stock 1,000 and APIC 59,000. If options expire unexercised, the expense is not reversed.

- **Forfeitures:** an entity elects to estimate them or to account for them when they occur.
- **Performance conditions:** recognize expense only if achievement is probable, and true up for changes.
- **Market conditions,** such as a stock price target, are reflected in the grant-date fair value. The expense isn't reversed if the condition isn't met, provided the service is rendered.

Restricted stock and RSUs are measured at the grant-date share price and expensed over the vesting period.

Example: 1,000 shares at \$50 vesting over three years cost \$50,000, or about \$16,667 a year.

Employee stock purchase plans are noncompensatory if substantially all employees can participate, the discount is no more than 5% and there are no option features. Otherwise the discount is compensation cost.

Foreign Currency

Transactions denominated in a foreign currency are recorded at the spot rate, remeasured at each balance sheet date and settled at the spot rate then. Gains and losses go to income.

Example: a €10,000 purchase on account on December 1 at \$1.20, so the payable is \$12,000. On December 31 the rate is \$1.25, giving a \$500 loss and a \$12,500 payable. Payment on January 15 at \$1.22 costs \$12,200, giving a \$300 gain.

Translation is used when the foreign subsidiary's functional currency is not the U.S. dollar. Assets and liabilities use the current rate, revenues and expenses the average rate, and equity historical rates. The translation adjustment goes to **OCI**.

Remeasurement (temporal method) is used when the functional currency is the U.S. dollar. Monetary items use the current rate, and nonmonetary items such as inventory and PP&E use historical rates, as do their related expenses. The remeasurement gain or loss goes to **income**.

Pensions (ASC 715)

Defined contribution plans: expense equals the required contribution.

Defined benefit plans: the balance sheet shows the **funded status**, the projected benefit obligation (PBO) minus the fair value of plan assets. Unrecognized prior service cost and actuarial gains and losses sit in **AOCI**, not on the funded status line.

Net periodic pension cost

1. Service cost
2. + Interest cost (beginning PBO × discount rate)

3. – Expected return on plan assets
4. + Amortization of prior service cost
5. $\pm$ Amortization of net gains or losses that exceed the **corridor**, 10% of the greater of beginning PBO or plan assets

Service cost is reported with other compensation costs. The other components are reported outside operating income.

Quick Reference

- **Revenue:** identify the contract, the performance obligations and the price, allocate by SSP and recognize over time or at a point in time.
- **Lessees:** five criteria for a finance lease. Both types record an ROU asset and liability. Finance leases show interest plus amortization, while operating leases show a single straight-line cost.
- **Income taxes:** permanent differences create no deferred taxes. Temporary differences create DTAs or DTLs at enacted rates. A valuation allowance applies when realization isn't more likely than not.
- **Accounting changes:** principle and entity changes are retrospective, estimates are prospective and errors are restated.
- **Contingencies:** accrue if probable and estimable, disclose if reasonably possible.

Prioritize: revenue recognition, lessee accounting, income taxes and the not-for-profit and government concepts in Area I. Practice task-based simulations on each.