

# FAR Practice Questions

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Twenty-five exam-style multiple-choice questions covering all three FAR content areas, with worked explanations. Give yourself about 1.5 minutes per question.

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## Area I: Financial Reporting

### Question 1 · Easy

Under the FASB Conceptual Framework, which is a **fundamental** qualitative characteristic of useful financial information?

- A. Comparability
- B. Timeliness
- C. Relevance
- D. Understandability

**Answer: C.** The fundamental characteristics are relevance and faithful representation. Comparability, verifiability, timeliness and understandability are enhancing characteristics.

### Question 2 · Hard

Equipment bought January 1, Year 1 for \$100,000 has a ten-year life and \$10,000 salvage value and is depreciated straight-line. On January 1, Year 6, undiscounted future cash flows are \$45,000 and fair value is \$40,000. What impairment loss is recognized?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$15,000

**Answer: D.** Annual depreciation is  $\$90,000 \div 10 = \$9,000$ , so after five years the carrying amount is  $\$100,000 - \$45,000 = \$55,000$ . Undiscounted cash flows of \$45,000 are below \$55,000, so the asset is impaired. The loss is

carrying amount minus fair value:  $\$55,000 - \$40,000 = \$15,000$ .

### Question 3 · Easy

Which item is reported as an investing activity on the statement of cash flows?

- A. Payment of dividends
- B. Issuance of common stock
- C. Purchase of equipment
- D. Payment of interest

**Answer: C.** Buying and selling PP&E and investments are investing activities. Dividends paid and stock issued are financing activities. Under U.S. GAAP, interest paid is an operating activity.

### Question 4 · Medium

Net income is \$500,000 and depreciation is \$80,000. Accounts receivable increased by \$30,000 and accounts payable decreased by \$20,000. What is cash flow from operating activities under the indirect method?

- A. \$530,000
- B. \$550,000
- C. \$570,000
- D. \$610,000

**Answer: A.**  $\$500,000 + \$80,000 - \$30,000 - \$20,000 = \$530,000$ . An increase in a current asset and a decrease in a current liability both use cash.

### Question 5 · Hard

A company had 100,000 common shares outstanding all year and net income of \$500,000. Its cumulative preferred stock carries \$50,000 of annual dividends, none declared this year. There are 20,000 options outstanding with a \$20 exercise price, and the average market price was \$30. What is diluted EPS?

- A. \$4.22
- B. \$4.33
- C. \$4.50
- D. \$5.00

**Answer: A.**

- Numerator:  $\$500,000 - \$50,000$  cumulative preferred dividends = \$450,000
- Treasury stock method: 20,000 shares issued, and proceeds of \$400,000 buy back  $\$400,000 \div \$30 = 13,333$  shares, adding 6,667 shares
- Diluted EPS:  $\$450,000 \div 106,667 = \$4.22$

Basic EPS is \$4.50, so the options are dilutive.

### Question 6 · Medium

Which of the following must a not-for-profit's statement of activities report?

- A. Net income attributable to owners
- B. The change in net assets with donor restrictions, the change in net assets without donor restrictions and the total change in net assets
- C. Only changes in net assets without donor restrictions
- D. Expenses classified by natural classification only

**Answer: B.** The statement of activities reports the change in each class of net assets and in total net assets. NFPs have no owners, and expenses must be analyzed by both function and nature.

### Question 7 · Hard

A city's proprietary (enterprise) fund receives a \$1 million federal grant restricted to buying equipment. How is it reported in the fund's statement of revenues, expenses and changes in fund net position?

- A. Operating revenue
- B. Capital contribution
- C. Other financing source
- D. Deferred inflow of resources

**Answer: B.** In proprietary funds, capital grants are reported as capital contributions, separately after nonoperating revenues and expenses. "Other financing sources" are used in governmental funds.

### Question 8 · Medium

Which statement about governmental funds is true?

- A. They use the full accrual basis of accounting.
- B. Depreciation expense is recorded.
- C. General long-term debt is reported on the fund balance sheet.
- D. Revenues are recognized when they are measurable and available.

**Answer: D.** Governmental funds use the modified accrual basis and the current financial resources focus. Capital outlays are expenditures, so there's no depreciation, and general long-term debt is reported only in the government-wide statements.

### Question 9 · Easy

On December 15, a city's general fund ordered \$50,000 of supplies. They were received and paid for on January 10. When is the expenditure recognized?

- A. December 15, when ordered
- B. December 31, at year-end
- C. January 10, when received
- D. Only when the supplies are used

**Answer: C.** Under modified accrual, an expenditure is recognized when the liability is incurred, which is when the supplies are received. The order creates only an encumbrance, if the government uses encumbrance accounting.

### Question 10 · Medium

A city's general fund transfers \$100,000 to its debt service fund for principal and interest payments. How does the general fund report the transfer?

- A. As an expenditure
- B. As an other financing use
- C. As an expense
- D. As a reduction of revenue

**Answer: B.** Interfund transfers are other financing sources and uses in governmental funds, not revenues, expenditures or expenses. The debt service fund reports an other financing source.

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## Area II: Select Balance Sheet Accounts

### Question 11 · Medium

A company uses periodic FIFO. Beginning inventory is 100 units at \$10, purchases are 200 units at \$12 and 250 units are sold. What is cost of goods sold?

- A. \$2,700
- B. \$2,800
- C. \$2,900
- D. \$3,000

**Answer: B.** The first 100 units cost \$10 each (\$1,000) and the next 150 cost \$12 each (\$1,800), for a total of **\$2,800**.

### Question 12 · Easy

Which entry increases the allowance for credit losses?

- A. Writing off a specific uncollectible account
- B. Recording credit loss expense
- C. Collecting a receivable that was never written off
- D. Recording a cash sale

**Answer: B.** Recording credit loss expense credits the allowance. A write-off debits it.

### Question 13 · Hard

On January 1, a company issued \$1,000,000 of five-year, 6% bonds with interest paid semiannually, when the market rate was 8%. The bonds sold for \$918,890. What is interest expense for the first six months under the effective interest method?

- A. \$30,000
- B. \$36,756
- C. \$40,000
- D. \$73,511

**Answer: B.** Interest expense =  $\$918,890 \times 4\% = \$36,756$ . Cash paid is  $\$1,000,000 \times 3\% = \$30,000$ , so the discount amortization is \$6,756.

### Question 14 · Medium

Equipment costing \$500,000 with a five-year life and \$50,000 salvage value is depreciated using double-declining balance. What is depreciation in year 2?

- A. \$90,000
- B. \$120,000
- C. \$150,000
- D. \$180,000

**Answer: B.** The rate is 40%. Year 1 is  $\$500,000 \times 40\% = \$200,000$ , leaving \$300,000. Year 2 is  $\$300,000 \times 40\% = \$120,000$ . Salvage value matters only when book value approaches it.

### Question 15 · Hard

On January 1, a company bought 30% of another company's voting stock for \$300,000 and has significant influence. The investee earned \$100,000 and paid \$40,000 of dividends during the year. What is the investment balance at year-end? Assume the price equaled 30% of the investee's book value.

- A. \$282,000
- B. \$300,000
- C. \$318,000
- D. \$330,000

**Answer: C.**  $\$300,000 + 30\% \times \$100,000 - 30\% \times \$40,000 = \$318,000$ . Under the equity method, dividends reduce the investment.

### Question 16 · Medium

A patent bought for \$100,000 has a 20-year legal life, but the company expects to benefit from it for only 10 years. What is annual amortization?

- A. \$5,000
- B. \$10,000
- C. \$20,000
- D. \$0, because patents are not amortized

**Answer: B.** Finite-lived intangibles are amortized over the shorter of legal life and useful life:  $\$100,000 \div 10 = \$10,000$ .

### Question 17 · Easy

Which is a current liability?

- A. Bonds payable due in five years
- B. Warranty obligations expected to be settled next year
- C. A pension obligation payable over many years
- D. Long-term debt refinanced on a long-term basis before the statements were issued

**Answer: B.** Current liabilities are expected to be settled within one year or the operating cycle, if longer.

### Question 18 · Medium

A company sells land with a carrying amount of \$100,000. It receives \$120,000 in cash, and the buyer also assumes the company's \$30,000 mortgage on the land. What gain is recognized?

- A. \$20,000
- B. \$50,000
- C. \$80,000
- D. \$150,000

**Answer: B.** The consideration is \$120,000 of cash plus \$30,000 of debt relief, or \$150,000. The gain is \$150,000 – \$100,000 = **\$50,000**.

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## Area III: Select Transactions

### Question 19 · Hard

A contractor signs a two-year, \$10 million contract to build a bridge and recognizes revenue over time using costs incurred. Year 1 costs are \$3 million, and estimated remaining costs are \$5 million. Year 1 billings are \$4 million and collections are \$3.5 million. What gross profit is recognized in year 1?

- A. \$750,000
- B. \$1,000,000
- C. \$2,000,000
- D. \$2,500,000

**Answer: A.** Progress is  $\$3 \text{ million} \div \$8 \text{ million} = 37.5\%$ . Revenue is  $\$10 \text{ million} \times 37.5\% = \$3.75 \text{ million}$ , less \$3 million of cost, for gross profit of **\$750,000**. Billings and collections don't drive revenue.

### Question 20 · Medium

A lessee signs a five-year equipment lease with annual payments of \$100,000, the first due immediately. The equipment has an eight-year economic life and a fair value of \$500,000. There's no ownership transfer, purchase option or specialized use. The present value of the payments at the lessee's 8% rate is \$431,213. How is the lease classified?

- A. Operating lease
- B. Finance lease
- C. Short-term lease
- D. Sales-type lease

**Answer: A.** None of the five criteria is met. The present value is 86% of fair value, below "substantially all," and the term is 62.5% of the economic life, below a "major part." Both types still put an ROU asset and lease liability on the balance sheet.

### Question 21 · Easy

Under ASC 606, revenue is recognized when:

- A. Cash is collected
- B. The contract is signed

- C. A performance obligation is satisfied
- D. Goods are shipped

**Answer: C.** Revenue is recognized when, or as, control of a good or service transfers and a performance obligation is satisfied. Shipment can be the point of transfer, but it isn't the rule itself.

### Question 22 · Medium

Current tax expense is \$100,000, and the deferred tax liability increased by \$20,000. There are no deferred tax assets. What is total income tax expense?

- A. \$80,000
- B. \$100,000
- C. \$120,000
- D. \$140,000

**Answer: C.** Total tax expense equals current tax expense plus deferred tax expense:  $\$100,000 + \$20,000 = \$120,000$ . Debit Income Tax Expense 120,000, credit Income Tax Payable 100,000 and Deferred Tax Liability 20,000.

### Question 23 · Hard

At year-end a company has a \$50,000 deferred tax asset. Based on available evidence, it is more likely than not that \$20,000 of it won't be realized. How is the DTA reported?

- A. \$50,000 with no allowance
- B. \$50,000 less a \$20,000 valuation allowance, for a net \$30,000
- C. \$20,000
- D. \$0, because realization is uncertain

**Answer: B.** A valuation allowance reduces the DTA by the portion more likely than not to go unrealized. The allowance increases income tax expense.

### Question 24 · Medium

A company exchanges land with a carrying amount of \$50,000 and a fair value of \$80,000 for another parcel worth \$70,000 plus \$10,000 cash. The exchange has commercial substance. What gain is recognized for financial reporting?

- A. \$0
- B. \$10,000
- C. \$20,000
- D. \$30,000

**Answer: D.** Nonmonetary exchanges with commercial substance are measured at fair value, so the full gain is recognized:  $\$80,000 - \$50,000 = \$30,000$ . The tax rules for like-kind exchanges, which defer most of the gain, are a REG topic, not a FAR one.

## Question 25 · Medium

In year 3, a company finds it failed to record \$100,000 of depreciation in year 1. Ignoring taxes, how is the error corrected in year 3's comparative statements?

- A.** Record \$100,000 of depreciation expense in year 3
- B.** Restate the prior periods presented and adjust the opening retained earnings of the earliest period presented
- C.** Treat it prospectively as a change in estimate
- D.** Disclose it only

**Answer: B.** Errors are corrected by restatement, with a prior period adjustment to opening retained earnings. They never go through current income.

## Answer Key

1. C

2. D

3. C

4. A

5. A

6. B

7. B

8. D

9. C

10. B

11. B

12. B

13. B

14. B

15. C

16. B

17. B

18. B

19. A

20. A

21. C

22. C

23. B

24. D

25. B

**Scoring:** 23–25 correct, you're ready. 20–22, review the ones you missed. 17–19, more study on weak areas. Below 17, work back through the FAR study guides first.