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CPA FAR Study Guide

Financial Accounting & Reporting — chapter-by-chapter review

2026 CPA Exam Blueprint · US GAAP, GASB & NFP

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How to Use This Guide and the FAR Exam Format

This guide is a chapter-by-chapter review of the **Financial Accounting and Reporting (FAR)** core section of the Uniform CPA Examination. It follows the same eighteen chapters as the FAR practice bank on UPractice.org, so you can read a chapter and then immediately drill the matching multiple-choice questions and simulations.

FAR is the "numbers" section of the core. Almost every chapter has a computational engine — present value, effective interest, depreciation, deferred taxes, lease schedules, earnings per share, consolidation eliminations — and the exam expects you to run that engine quickly and accurately. The rest of the section is classification: which account, which statement, which fund, which net asset class. If you can compute and classify, you can pass FAR.

The FAR section at a glance

The CPA Exam has three core sections that every candidate takes (AUD, FAR, REG) plus one discipline section of the candidate's choice (BAR, ISC or TCP).

Feature	FAR (2026 Blueprints)
Testing time	4 hours
Multiple-choice questions (MCQs)	50, in two testlets of 25
Task-based simulations (TBSs)	7, in three testlets (2, 3 and 2)
Total testlets	5
Score weighting	MCQs 50%, TBSs 50%
Score scale / passing score	0–99 / 75
Skill levels	Remembering and understanding 5–15%; Application 45–55%; Analysis 35–45%

The skill mix matters. Only a small slice of FAR rewards memorizing a definition. Most items ask you to **apply** a rule to numbers, and a large share ask you to **analyze** — reconcile, compare, find the error or pull the right figures out of several exhibits.

> **Exam tip:** FAR has fewer MCQs than AUD or REG (50 versus 72–78), so each multiple-choice item carries more weight. Do not rush the MCQ testlets to bank time for simulations; budget about 1.5 to 2 minutes per question.

Content areas and weights

Blueprint area	Weight	Main chapters in this guide
I. Financial Reporting (for-profit statements, NFPs, state and local government concepts, public company reporting, special purpose frameworks, ratios)	30–40%	1, 12, 15, 16, 17, 18
II. Select Balance Sheet Accounts (cash, receivables, inventory, PP&E, investments, intangibles, payables, debt, equity)	30–40%	3, 4, 5, 6, 7, 8, 11
III. Select Transactions (accounting changes and errors, contingencies, revenue, income taxes, fair value, lessee accounting, subsequent events)	25–35%	2, 7, 9, 10, 13, 14

The mapping is approximate: contingencies sit in Chapter 7 with payables, and topics such as consolidation and foreign currency are tested within the financial reporting and transaction areas.

What FAR covers — and what moved to BAR

Since the 2024 CPA Evolution redesign, several advanced topics are tested in the **Business Analysis and Reporting (BAR)** discipline section rather than FAR. The 2026 Blueprint keeps that split. This guide and the bank therefore do **not** drill:

Topic	Where it is tested now
Defined benefit pension and other postretirement plans	BAR
Share-based payment (stock options, restricted stock compensation)	BAR
Derivatives and hedge accounting	BAR
Lessor accounting (sales-type, direct financing, operating leases for lessors)	BAR
Goodwill and indefinite-lived intangible impairment testing in depth	BAR
Complex business combination issues (step acquisitions, contingent consideration remeasurement) and full consolidation beyond the basics	BAR

FAR still expects you to know the **basics** that touch these topics: a pension remeasurement can appear as an OCI item, goodwill is recognized in an acquisition, and a

lessee's side of a lease is fully tested.

> **Watch out:** Older review material is full of pension worksheets and lessor sales-type lease schedules. They are not FAR topics any more. Spend that time on lessee accounting, deferred taxes and governmental funds instead.

Which standards this guide uses

Entity	Standards	Issued by
Business entities (public and private)	FASB Accounting Standards Codification (ASC) — U.S. GAAP	Financial Accounting Standards Board
Public company filing rules (10-K, 10-Q, 8-K)	Securities Exchange Act reporting rules and Regulation S-X	Securities and Exchange Commission
State and local governments	GASB Statements and Codification	Governmental Accounting Standards Board
Nongovernmental not-for-profit entities	ASC 958 (part of U.S. GAAP)	FASB
Special purpose frameworks	Cash, modified cash, tax, regulatory and contractual bases	—

New pronouncements are generally eligible for testing in the exam window that begins **six months after the later of issuance or effective date**, and the old rule stays testable until then. Where a newly issued standard will change a rule later, this guide teaches the currently testable rule and flags the change (for example, ASU 2025-06 on internal-use software, effective for annual periods beginning after December 15, 2027).

Present value tables on the exam

FAR items give you present value factors in the stem or an exhibit; you do not need to memorize them. Know which factor to use:

Cash flow pattern	Factor
One amount received or paid at the end of n periods	PV of $1 = 1 ÷ (1 + i)^n
Equal payments at the **end** of each period	PV of an ordinary annuity
Equal payments at the **beginning** of each period (first payment today)	PV of an annuity due = ordinary annuity factor for (n − 1) periods + 1

All worked examples in this guide use factors rounded to four decimals and then multiply, the way exam items do. Small rounding differences of a dollar or two against a calculator

answer are normal.

How each chapter is organized

1. **Plain-language explanation** of each rule that the bank tests.
2. **Key-number tables** with thresholds, formulas and classifications.
3. **Worked examples** with every step shown. Each figure was computed and re-checked before it was printed.
4. **Journal entries** in table form (Account / Debit / Credit).
5. **Exam tips, traps and memory tricks** in colored boxes.
6. **Key takeaways** — a short summary to reread the night before the exam.

Callout boxes use four colors: green for exam tips, blue for worked examples, red for common traps and purple for memory tricks.

A study plan that works

1. **Master the engines early.** Present value, effective interest amortization, depreciation, deferred taxes and lease schedules show up in many chapters. Learn them in Chapters 5, 8, 9 and 10 until they are automatic.
2. **Work the chapters in order.** The framework and revenue chapters set up vocabulary; balance sheet accounts come next; then transactions; then the "other frameworks" (consolidation, special purpose frameworks, governments, NFPs).
3. **Read, then drill immediately.** After each chapter, do a timed set of 20–30 MCQs from the matching bank chapter, then its simulations.
4. **Keep an error log by chapter.** Rework every missed computation from a blank page a few days later.
5. **Study governments and NFPs as their own languages.** They use different measurement focuses, statements and terminology. Do not let business GAAP habits leak into fund accounting.
6. **Take full mock exams** under 4-hour timing in the last two to three weeks.

Test-day strategy

- **Budget your time.** About 1.5–2 minutes per MCQ (roughly 75–90 minutes for 50 questions) leaves well over two hours for seven simulations.
- **Read the simulation requirement first**, then the exhibits. Many exhibits contain data you will never use.
- **Answer every cell.** Each row of a simulation is scored separately; partial credit is real and a blank earns nothing.
- **Follow sign and rounding instructions** (negative numbers, nearest dollar, two decimals for EPS).

- **Use the standard break** after the third testlet; the exam clock stops during it.

> **Memory trick:** "Classify, then compute." Almost every FAR mistake comes from running the right formula on the wrong classification — a trading security treated as AFS, an operating lease treated as finance, a governmental fund treated like a business.

Key takeaways

- FAR: 4 hours, 50 MCQs and 7 TBSs in 5 testlets, 50/50 weighting, passing score 75.
- Areas: Financial Reporting 30–40%, Select Balance Sheet Accounts 30–40%, Select Transactions 25–35%.
- Pensions, share-based payment, derivatives and hedging, lessor accounting and goodwill impairment are BAR topics, not FAR.
- PV factors are given; know which one fits the cash flow pattern.
- Read a chapter, drill the matching bank chapter right away, and keep an error log.

1. Conceptual Framework and Financial Statements

Every rule in later chapters traces back to the FASB's conceptual framework: what makes information useful, what the elements of financial statements are, and when an item is recognized. This chapter also covers the general-purpose statements a business presents, the income statement format (including discontinued operations), other comprehensive income, interim and segment reporting, and the SEC filings that public companies make.

Who sets the rules

Body	Role
FASB	Sets U.S. GAAP for businesses and nongovernmental not-for-profit entities; publishes the Accounting Standards Codification (ASC) and Concepts Statements
GASB	Sets GAAP for state and local governments
SEC	Has legal authority over public company reporting; generally relies on the FASB for GAAP but issues its own disclosure and filing rules
Private Company Council (PCC)	Recommends private-company alternatives within GAAP (for example, amortizing goodwill)

Concepts Statements are **not** authoritative GAAP. They guide the Board when it writes standards and help preparers reason about issues the Codification does not address.

Qualitative characteristics of useful information

The objective of general-purpose financial reporting is to provide information that is useful to existing and potential **investors, lenders and other creditors** in making decisions about providing resources to the entity.

Level	Characteristic	Components / meaning
Fundamental	Relevance	Predictive value, confirmatory value, materiality (entity-specific)
Fundamental	Faithful representation	Complete, neutral, free from error
Enhancing	Comparability	Like things look alike across entities and periods (consistency helps achieve it)
Enhancing	Verifiability	Independent observers could reach consensus
Enhancing	Timeliness	Available in time to influence decisions
Enhancing	Understandability	Classified, characterized and presented clearly
Constraint	Cost	Benefits of reporting should justify the costs

Information must be **both** relevant and faithfully represented to be useful. Enhancing characteristics improve useful information but cannot make irrelevant or misleading information useful.

Memory trick: "Really Fine" — **R**elevance and **F**aithful representation are fundamental. The enhancing four are "CVTU": Comparability, Verifiability, Timeliness, Understandability.

Watch out: Conservatism (prudence) is **not** a qualitative characteristic; it would conflict with neutrality. Materiality has **no** FASB-set percentage threshold.

Elements of financial statements

Element	Plain-language meaning
Asset	A present right of the entity to an economic benefit
Liability	A present obligation of the entity to transfer an economic benefit (legal, equitable or constructive)
Equity	Residual interest: assets minus liabilities
Investments by owners / distributions to owners	Transactions with owners in their capacity as owners
Revenues and expenses	Inflows and outflows from the entity's ongoing major or central operations
Gains and losses	Increases and decreases from peripheral or incidental transactions
Comprehensive income	All changes in equity except those from owner transactions

Recognition requires that an item meets an element definition, can be measured with a relevant measurement attribute, and is faithfully represented at a cost that is justified. Common **measurement attributes** are historical cost, current cost, fair value, net realizable value and present value of future cash flows.

The general-purpose statements

Statement	Shows	Timing
Balance sheet (statement of financial position)	Assets, liabilities and equity	At a point in time
Income statement	Revenues, expenses, gains, losses, net income	For a period
Statement of comprehensive income	Net income + OCI = comprehensive income (one continuous statement or two consecutive statements)	For a period
Statement of changes in equity	Reconciles each equity component	For a period
Statement of cash flows	Operating, investing and financing cash flows	For a period
Notes	Accounting policies, details, commitments, contingencies, subsequent events	—

The first note is normally the **summary of significant accounting policies**: basis of consolidation, revenue recognition, inventory method, depreciation methods and similar choices.

Going concern

Management must evaluate whether there is **substantial doubt** about the entity's ability to continue as a going concern **within one year after the date the financial statements are issued** (or available to be issued). If substantial doubt exists, management discloses it and its plans; if the plans alleviate the doubt, it discloses that the doubt was alleviated.

Income statement format

A multiple-step income statement flows in this order:

Line	
Net sales (gross sales − returns, allowances, discounts)	
− Cost of goods sold	= Gross profit
− Selling, general and administrative expenses	= Operating income
± Other income and expense (interest, gains and losses on sales of assets, unusual or infrequent items)	= Income from continuing operations before income taxes
− Income tax expense on continuing operations	= Income from continuing operations
± Discontinued operations, **net of tax**	= Net income
Then: net income attributable to noncontrolling interest and to the parent; EPS for public entities	

Discontinued operations. A disposal (or held-for-sale classification) of a component or group of components is reported as discontinued operations only if it represents a **strategic shift that has (or will have) a major effect** on operations and results — for example, a major geographic area, a major line of business or a major equity method investment. The line includes the component's operating results for the period plus any gain or loss on disposal or impairment write-down, all **net of tax**.

Unusual or infrequent items stay in continuing operations, shown pretax as a separate line or disclosed. The old "extraordinary items" category no longer exists.

Example: Harbor Lane Co. has a 25% tax rate. For 2026: net sales $900,000; cost of goods sold $540,000; selling and administrative expenses $180,000; gain on sale of a warehouse $20,000; interest expense $15,000. During the year it sold a division that qualifies as discontinued operations: the division's operating loss was $60,000 and the gain on its sale was $20,000.

1. Income from continuing operations before tax = 900,000 − 540,000 − 180,000 + 20,000 − 15,000 = **$185,000**.
2. Tax on continuing operations = 25% × 185,000 = $46,250; income from continuing operations = **$138,750**.
3. Discontinued operations pretax = −60,000 + 20,000 = −$40,000; net of tax = −40,000 × (1 − 0.25) = **−$30,000**.
4. Net income = 138,750 − 30,000 = **$108,750**.

Other comprehensive income

OCI collects certain gains and losses that bypass net income until they are realized or "recycled."

Common OCI items (FAR level)	Recycled to net income?
Unrealized holding gains and losses on available-for-sale debt securities	Yes, when sold
Foreign currency translation adjustments	Yes, on sale or liquidation of the foreign entity
Effective portion of cash flow hedges (mechanics are BAR)	Yes, when the hedged item affects earnings
Pension and postretirement remeasurements (mechanics are BAR)	Yes, through amortization
Changes in instrument-specific credit risk on liabilities measured under the fair value option	Yes, on settlement

Items **not** in OCI: unrealized gains on equity securities (they go to net income), dividends, stock issuances and treasury stock (owner transactions), and prior-period adjustments (retained earnings).

Accumulated other comprehensive income (AOCI) is a separate component of equity. OCI items are shown net of tax, or before tax with one tax line.

Example: Continuing the Harbor Lane facts, during 2026 the company also had an unrealized gain on AFS debt securities of $12,000 (net of tax) and a foreign currency translation loss of $5,000 (net of tax). It declared dividends of $40,000.

Comprehensive income = 108,750 + 12,000 − 5,000 = **$115,750**. The dividends reduce retained earnings but are not part of comprehensive income.

Memory trick: OCI is "PAFE" — **P**ension (BAR mechanics), **A**FS debt, **F**oreign currency translation, **E**ffective cash flow hedge — plus own-credit changes on fair-value-option debt.

Interim reporting

Interim (quarterly) reports use the **integral view**: each quarter is a part of the annual period.

Item	Interim rule
Revenues	Recognized as earned, same as annual
Costs directly associated with revenue (COGS)	Same as annual; a LIFO layer liquidation expected to be restored by year-end is not charged to the quarter
Inventory write-downs	Recognized in the quarter unless the decline is temporary and expected to recover within the year
Costs that benefit several quarters (annual repairs, property taxes, advertising)	May be allocated across quarters
Income taxes	Apply the **estimated annual effective tax rate** to year-to-date income, then subtract tax recognized in earlier quarters

Example: A company estimates its annual effective tax rate at 24% in Q1 and Q2, then revises it to 26% in Q3. Year-to-date pretax income is $100,000 at Q2 and $180,000 at Q3. Tax through Q2 = 24% × 100,000 = $24,000. Tax through Q3 = 26% × 180,000 = $46,800. **Q3 tax expense** = 46,800 − 24,000 = **$22,800**.

Segment reporting (public entities)

Public business entities report information about **operating segments** — components whose operating results are regularly reviewed by the **chief operating decision maker (CODM)**. A segment is **reportable** if it meets any one of three 10% tests:

Test	Threshold
Revenue	Segment revenue (external **and** intersegment) ≥ 10% of combined revenue of all operating segments
Profit or loss	Absolute profit or loss ≥ 10% of the **greater** of (a) combined profit of profitable segments or (b) combined loss of loss segments
Assets	Segment assets ≥ 10% of combined assets of all operating segments

Reportable segments together must cover at least **75% of consolidated external revenue**; if not, add segments until they do. Under ASU 2023-07, public entities also disclose **significant segment expenses** regularly provided to the CODM, and segment disclosures are required in interim periods too.

> **Example:** Segment profits and losses: A $90,000, B $40,000, C ($30,000), D $8,000, E ($12,000). Combined profits = 138,000; combined losses = 42,000. The test base is the greater, $138,000; 10% = $13,800. A, B and C (absolute $30,000) pass; D ($8,000) and E ($12,000) fail the profit test (they may still pass the revenue or asset test).

SEC reporting

Form	Contents	Assurance
Form 10-K	Annual report: audited financial statements, MD&A, risk factors, internal control reports	Audited
Form 10-Q	Quarterly report for the first three quarters	Reviewed (not audited)
Form 8-K	Current report of significant events (change in auditor, acquisition, bankruptcy, officer departures)	None

Filer status (based on public float)	10-K due	10-Q due
Large accelerated filer (≥ $700 million)	60 days after year-end	40 days after quarter-end
Accelerated filer ($75 million to < $700 million)	75 days	40 days
Non-accelerated filer (< $75 million)	90 days	45 days

A Form 8-K is generally due within **four business days** of the triggering event. Regulation S-X governs the form and content of financial statements in SEC filings (for example,

balance sheets for two years and income statements for three years for most registrants); Regulation S-K governs the non-financial disclosures.

> **Memory trick:** "60-75-90" for the 10-K; "40-40-45" for the 10-Q.

> **Exam tip:** In SEC questions, identify the filer status first. The deadline follows automatically.

Common traps

- Subtracting the **pretax** discontinued operations loss instead of the net-of-tax amount.
- Putting unrealized gains on **equity** securities in OCI — they are already in net income.
- Treating dividends or treasury stock purchases as reductions of comprehensive income.
- Describing 10-Q statements as audited — they are only reviewed.
- Using combined **net** profit instead of the greater of total profits or total losses in the segment profit test.

Key takeaways

- Useful information is relevant and faithfully represented; enhancing characteristics are CVTU; cost is the constraint.
- Income statement: continuing operations pretax → tax → continuing → discontinued (net of tax) → net income.
- Discontinued operations require a strategic shift with a major effect.
- Comprehensive income = net income + OCI; owner transactions are never part of it.
- Interim taxes use the estimated annual effective rate on year-to-date income.
- Segments: three 10% tests and the 75% external revenue test.
- 10-K: 60/75/90 days; 10-Q: 40/40/45 days; 8-K: four business days.

2. Revenue Recognition (ASC 606)

ASC 606 applies one model to almost every contract with customers (leases, insurance, financial instruments and guarantees are the main exclusions). The core principle: recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity **expects to be entitled to** in exchange. The model is applied in five steps, and the concept that ties the steps together is **control**.

The five steps

Step	Question to answer
1. Identify the contract	Is there an enforceable agreement with commercial substance, approved by the parties, with identifiable rights and payment terms, and is collection of the consideration **probable**?
2. Identify the performance obligations	Which promised goods or services are **distinct**?
3. Determine the transaction price	How much does the entity expect to receive, including variable consideration, financing effects and noncash consideration, less consideration payable to the customer?
4. Allocate the transaction price	Split the price among performance obligations using **relative standalone selling prices**
5. Recognize revenue	When (at a point in time) or as (over time) each obligation is satisfied by transferring control

> **Memory trick:** "**C**an **P**igs **P**lay **A**ll **R**ounds?" — Contract, Performance obligations, Price, Allocate, Recognize.

Step 1 — the contract

If collection is not probable, no contract exists yet; any cash received is a **liability** until the contract criteria are met, the entity has no remaining obligations and has received substantially all consideration, or the contract is terminated.

Contract modifications that add distinct goods at their standalone selling price are treated as a **separate contract**. Other modifications are either accounted for prospectively (remaining goods are distinct) or by a cumulative catch-up (remaining goods are part of a single partially satisfied obligation).

Step 2 — distinct performance obligations

A good or service is distinct only if **both** conditions hold:

1. It is **capable of being distinct** — the customer can benefit from it on its own or with readily available resources; and
2. It is **distinct within the context of the contract** — it is separately identifiable, not an input to a combined output, not significantly modifying another promise, and not highly interdependent with other promises.

Typical separate obligations: equipment and an extended (service-type) warranty, software license and post-contract support, goods and a material right (such as a significant discount on future purchases). Installation that any third party could perform is usually distinct; significant customization that transforms the product usually is not.

Warranties. An **assurance-type** warranty (the product works as promised) is not a performance obligation — accrue its expected cost (Chapter 7). A **service-type** warranty (extra coverage, often sold separately) is a separate obligation that receives part of the transaction price.

Step 3 — the transaction price

Component	Rule
Variable consideration (bonuses, penalties, rebates, price concessions, returns)	Estimate using **expected value** (many similar contracts) or **most likely amount** (binary outcomes)
Constraint	Include variable consideration only to the extent it is **probable** that a significant revenue reversal will not occur
Significant financing component	Adjust for the time value of money when timing gives a significant financing benefit; practical expedient — ignore if the period between payment and transfer is **one year or less**
Noncash consideration	Measure at fair value at contract inception
Consideration payable to the customer	Reduce the transaction price (unless it pays for a distinct good or service from the customer)
Sales taxes collected	May be excluded from revenue by policy election

Example: A contractor earns a $40,000 bonus if it finishes early (estimated 60% likely), $20,000 if it finishes on time (30% likely) and nothing if late (10% likely). Expected value = 0.6 × 40,000 + 0.3 × 20,000 + 0.1 × 0 = **$30,000**. Expected value fits when there is a range of outcomes; for a single all-or-nothing bonus, the most likely amount is usually better. Either estimate is then tested against the constraint.

Step 4 — allocation

Allocate the transaction price in proportion to **standalone selling prices** (SSP). If an SSP is not observable, estimate it by the adjusted market assessment, expected cost plus margin, or (in limited cases) the residual approach. A discount is spread proportionally over all obligations unless observable evidence shows it relates to only some of them.

Example: Ridgeway Systems sells a bundle of equipment, installation and two years of support for $90,000. Standalone prices: equipment $60,000, installation $15,000, support $25,000 (total $100,000).

Obligation	SSP	Allocation	Allocated price
Equipment	$60,000	60%	$54,000
Installation	$15,000	15%	$13,500
Support	$25,000	25%	$22,500
Total	$100,000		$90,000

Equipment revenue is recognized on delivery, installation when complete, and support evenly over 24 months.

Step 5 — point in time or over time

An obligation is satisfied **over time** if any one criterion is met:

1. The customer **simultaneously receives and consumes** the benefits as the entity performs (cleaning, payroll processing);
2. The entity's performance creates or enhances an asset the **customer controls** as it is created (building on the customer's land); or
3. The asset has **no alternative use** to the entity **and** the entity has an **enforceable right to payment** for performance completed to date.

Otherwise revenue is recognized at the **point in time** control transfers. Indicators of control transfer: present right to payment, legal title, physical possession, risks and rewards of ownership, and customer acceptance.

Memory trick: Over-time test "SCAN" — **S**imultaneous consumption, **C**ustomer controls, **A**lternative use = **N**o plus right to payment.

Measuring progress on over-time contracts

Use an **output method** (units delivered, milestones, surveys) or an **input method** (cost incurred to date ÷ total estimated cost, labor hours). Each period recognize **cumulative**

revenue to date minus revenue already recognized. If total estimated costs exceed the contract price, the **entire expected loss** is recognized immediately.

Example: Tidewater Builders has a $5,000,000 fixed-price contract measured with the cost-to-cost method.

	Year 1	Year 2	Year 3
Costs incurred this year	$1,200,000	$2,100,000	$1,100,000
Cumulative costs	$1,200,000	$3,300,000	$4,400,000
Estimated costs to complete	$2,800,000	$1,100,000	$0
Total estimated cost	$4,000,000	$4,400,000	$4,400,000
Percent complete	30%	75%	100%
Cumulative revenue	$1,500,000	$3,750,000	$5,000,000
Revenue this year	**$1,500,000**	**$2,250,000**	**$1,250,000**
Cumulative gross profit	$300,000	$450,000	$600,000
Gross profit this year	**$300,000**	**$150,000**	**$150,000**

Example: Change the facts: at the end of Year 2 total estimated cost rises to $5,200,000. The contract now shows an overall loss of 5,000,000 − 5,200,000 = $200,000. Year 1 recognized $300,000 of profit, so Year 2 must recognize a loss of 300,000 + 200,000 = **$500,000**, bringing the cumulative result to −$200,000.

Special situations

Situation	Treatment
Principal vs. agent	Principal controls the good before transfer → gross revenue. Agent arranges for another party to provide it → net fee or commission
Consignment	Consignor keeps control; revenue when the consignee sells to the end customer. Goods stay in the consignor's inventory
Bill-and-hold	Revenue before delivery only if there is a substantive reason, the goods are identified as the customer's, ready for transfer, and cannot be redirected
Right of return	Revenue for the amount expected to be kept; **refund liability** for expected refunds; **return asset** (at former cost less recovery costs) with a reduction of COGS
Customer options (loyalty points, discount vouchers)	A material right is a separate obligation; allocate part of the price and defer it
Licenses of IP	Right to **access** (symbolic IP, brand names) → over time; right to **use** (functional IP, software, films) → point in time
Breakage (unused gift cards)	If breakage is expected, recognize it in proportion to the pattern of rights exercised; otherwise when redemption becomes remote
Sales-based royalties	Recognize at the later of the subsequent sale or satisfaction of the obligation

Example: Cobalt Gear sells 1,000 units at $50 each (cost $30) and expects 6% to be returned.

Account	Debit	Credit
Cash / Accounts receivable	50,000	
Sales revenue		47,000
Refund liability		3,000
Cost of goods sold	28,200	
Estimated returns inventory (return asset)	1,800	
Inventory		30,000

Revenue = 1,000 × 50 × 94% = $47,000; refund liability = 1,000 × 50 × 6% = $3,000; return asset = 1,000 × 30 × 6% = $1,800; COGS = 30,000 − 1,800 = $28,200.

Contract balances and costs

- **Contract asset**: the entity has performed but its right to payment is **conditional** on something other than time. **Receivable**: the right is unconditional (only time must pass).
- **Contract liability** (deferred or unearned revenue): the customer has paid, or payment is due, before the entity performs.
- **Incremental costs of obtaining a contract** (sales commissions) are capitalized and amortized on a basis consistent with the transfer of goods; practical expedient — expense if the amortization period is **one year or less**.
- **Costs to fulfill a contract** not covered by another standard are capitalized if they relate directly to a contract, generate or enhance resources used to satisfy future obligations, and are expected to be recovered.

Common traps

- Allocating standalone prices without spreading the bundle discount.
- Reporting cumulative contract revenue as current-year revenue.
- Recording gross revenue when the entity is only an agent.
- Recognizing revenue when goods are shipped to a consignee.
- Deferring only the current-year portion of a loss on a loss-making contract instead of recognizing the whole loss.
- Treating an assurance-type warranty as a performance obligation.

Key takeaways

- Five steps: contract, performance obligations, price, allocate, recognize — driven by transfer of **control**.
- Distinct = capable of being distinct **and** separately identifiable.
- Variable consideration: expected value or most likely amount, subject to the "probable no significant reversal" constraint.
- Allocate by relative standalone selling prices; spread discounts proportionally.
- Over time if SCAN applies; otherwise at a point in time.
- Over-time revenue each year = cumulative revenue to date − revenue previously recognized; recognize full expected losses immediately.
- Right of return: revenue net of expected returns, refund liability, return asset at cost.

3. Cash, Receivables and Credit Losses

This chapter covers what counts as cash and cash equivalents, bank reconciliations, accounts and notes receivable, the current expected credit loss (CECL) model for the allowance, and transfers of receivables (factoring, pledging and discounting notes).

Cash and cash equivalents

Cash includes currency and coins, checking and savings deposits, petty cash, and checks received but not yet deposited. **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and so near maturity that interest rate risk is insignificant — in practice, investments with an **original maturity to the holder of three months or less** (Treasury bills, commercial paper, money market funds).

Item	Classification
Treasury bill bought with 2 months to maturity	Cash equivalent
Treasury bill bought with 6 months to maturity, now 2 months from maturity	**Not** a cash equivalent (original maturity to the holder > 3 months) — short-term investment
Certificate of deposit with 6-month term	Short-term investment
Postdated check received from a customer	Receivable
Employee IOU in petty cash; postage stamps	Receivable; prepaid expense
Compensating balance legally restricted under a loan agreement	Restricted cash (current or noncurrent, depending on the loan) — disclosed
Cash set aside in a sinking fund to retire bonds	Restricted cash / investment, usually noncurrent
Bank overdraft	Current liability (offset only against other accounts at the same bank)

The statement of cash flows reconciles **cash, cash equivalents and restricted cash** together (ASU 2016-18), so restricted cash is part of the beginning and ending totals.

Bank reconciliations

Reconcile the bank balance and the book balance to the same **adjusted (true) cash balance**.

Bank side (no journal entries)	Book side (journal entries required)
+ Deposits in transit	+ Collections by the bank (notes collected, interest)
− Outstanding checks	− NSF (bounced) customer checks
± Bank errors	− Bank service charges and fees
	± Book errors (transposed amounts)

Memory trick: "Bank DOE" — **D**eposits in transit, **O**utstanding checks and **E**rrors by the bank go on the bank side. Everything the company did not know about goes on the book side — and only book-side items need entries.

Example: Lakeview Supply's June 30 bank statement shows $24,600. Deposits in transit are $3,200 and outstanding checks total $5,150. The bank collected a $1,500 note for Lakeview, returned a $400 NSF customer check and charged a $30 fee. Lakeview recorded check #512 for supplies, written for $860, as $680. The general ledger shows $21,760.

Bank side		Book side	
Balance per bank	$24,600	Balance per books	$21,760
+ Deposits in transit	3,200	+ Note collected	1,500
− Outstanding checks	(5,150)	− NSF check	(400)
		− Service charge	(30)
		− Error on check #512 (860 − 680)	(180)
Adjusted balance	**$22,650**	**Adjusted balance**	**$22,650**

Lakeview records entries only for the four book-side items.

A **four-column proof of cash** extends the reconciliation to receipts and disbursements for the month: beginning balance, receipts, disbursements and ending balance, reconciled for both bank and books. It catches unrecorded receipts or disbursements that a single-date reconciliation would miss.

Accounts receivable

Receivables are recorded at the transaction price under ASC 606. Two pricing points:

- **Trade discounts** are not recorded; the invoice is net of them.
- **Cash (sales) discounts** such as 2/10, n/30 are a form of variable consideration: if customers are expected to take the discount, revenue and the receivable reflect the

amount expected to be collected.

Credit losses — the CECL model

ASC 326 requires an allowance for **lifetime expected credit losses** on financial assets measured at amortized cost (trade receivables, loans, held-to-maturity debt securities, net investments in leases). The estimate uses past events, current conditions and **reasonable and supportable forecasts**. There is no "probable" threshold — an allowance is recorded on day one, even when the risk of loss is low.

Common estimation methods: aging schedule (loss rates by age bucket), loss-rate method, roll-rate method, discounted cash flows and probability of default.

The allowance T-account

Allowance for credit losses	
Beginning balance	Credit
+ Credit loss expense (provision)	Credit
+ Recoveries of amounts written off	Credit
− Write-offs	Debit
= Ending (required) balance	Credit

Balance sheet approach: compute the required ending allowance first, then the expense is the plug.

Example: Northpoint Distributors' aging schedule at December 31:

Age bucket	Balance	Expected loss rate	Required allowance
Current	$300,000	1%	$3,000
31–60 days	80,000	5%	4,000
61–90 days	30,000	20%	6,000
Over 90 days	10,000	50%	5,000
Total	$420,000		**$18,000**

The allowance began the year at $8,000 (credit). Write-offs were $11,000 and recoveries $1,500. Unadjusted balance = 8,000 − 11,000 + 1,500 = **$1,500 debit**. Credit loss expense = 18,000 + 1,500 = **$19,500**. Net receivables = 420,000 − 18,000 = $402,000.

Journal entries in the allowance method:

Transaction	Account	Debit	Credit
Record expense	Credit loss expense	19,500	
	Allowance for credit losses		19,500
Write off $2,000	Allowance for credit losses	2,000	
	Accounts receivable		2,000
Recover $500 previously written off	Accounts receivable	500	
	Allowance for credit losses		500
	Cash	500	
	Accounts receivable		500

A write-off changes neither net receivables nor expense — the asset and the contra-asset fall by the same amount. The **direct write-off method** (expense when an account is deemed uncollectible) is not GAAP unless the effect is immaterial; it is the method used for tax.

> **Watch out:** The required allowance is **not** the expense. Expense = required ending balance − unadjusted balance (add a debit balance, subtract a credit balance).

An income statement approach (credit loss expense = a percentage of credit sales) can still appear in questions as a quick estimate, but under CECL the allowance at the balance sheet date must reflect lifetime expected losses.

Notes receivable

Notes are recorded at present value. A note with a stated rate equal to the market rate is recorded at face. A non-interest-bearing note (or one with an unreasonably low rate) is recorded at the present value of its cash flows, and the discount is amortized to interest income with the effective interest method. Short-term trade notes (maturity of one year or less) may be recorded at face.

Discounting a note at a bank

1. **Maturity value** = face + interest for the full term.
2. **Discount** = maturity value × bank's discount rate × time remaining to maturity.
3. **Proceeds** = maturity value − discount.
4. **Gain or loss** = proceeds − carrying amount (face + interest accrued to the discount date).

Example: On March 1 Pine Valley Co. receives a $60,000, 6-month, 9% note from a customer. On May 1 (2 months later) it discounts the note at its bank at 12%.

1. Maturity value = 60,000 + 60,000 × 9% × 6/12 = **$62,700**.
2. Discount = 62,700 × 12% × 4/12 = **$2,508**.
3. Proceeds = 62,700 − 2,508 = **$60,192**.
4. Carrying amount = 60,000 + 60,000 × 9% × 2/12 = $60,900. Loss = 60,192 − 60,900 = **$708**.

If the transfer meets the sale conditions below, the note is derecognized; otherwise the proceeds are a secured borrowing.

Transfers of receivables (ASC 860)

A transfer of financial assets is a **sale** only if the transferor surrenders **control**: (1) the assets are legally isolated from the transferor, even in bankruptcy; (2) the transferee can pledge or exchange them; and (3) the transferor does not keep effective control (for example, through an agreement to repurchase). If any condition fails, the transfer is a **secured borrowing**: the receivables stay on the books and the cash received is a liability.

Arrangement	Typical treatment
Pledging (assigning) receivables as collateral	Borrowing; disclose the pledge
Factoring **without** recourse that meets the control conditions	Sale; factor bears credit risk
Factoring **with** recourse that meets the control conditions	Sale; record the recourse obligation at fair value, which increases the loss
Transfer failing any control condition	Secured borrowing

Example: Brightwater Inc. factors $200,000 of receivables without recourse. The factor charges a 3% fee and holds back 5% to cover sales returns and allowances.

Account	Debit	Credit
Cash	184,000	
Receivable from factor (holdback)	10,000	
Loss on sale of receivables	6,000	
Accounts receivable		200,000

Cash = 200,000 − 6,000 fee − 10,000 holdback = $184,000; loss = carrying amount − cash − holdback = **$6,000**.

Common traps

- Classifying a 6-month CD or a T-bill bought with more than three months to maturity as a cash equivalent.
- Recording journal entries for deposits in transit or outstanding checks.
- Reporting the required allowance as the period's expense.
- Discounting the face of a note instead of its maturity value.
- Forgetting accrued interest in the carrying amount when computing the gain or loss on discounting.
- Treating the factor's holdback as part of the loss.

Key takeaways

- Cash equivalents: original maturity to the holder of three months or less.
- Bank reconciliation: bank side = deposits in transit, outstanding checks, bank errors; only book-side items are journalized.
- CECL: lifetime expected losses on amortized-cost assets; compute the required allowance, plug the expense.
- Write-offs do not change net receivables or expense.
- Note discounting: maturity value → discount → proceeds → compare to carrying amount with accrued interest.
- Transfers are sales only when control is surrendered; otherwise secured borrowings.

4. Inventory

Inventory questions on FAR test four things: what belongs in inventory (ownership and cost), how cost flows to cost of goods sold (specific identification, FIFO, LIFO, average), how inventory is written down (LCNRV or LCM), and how inventory is estimated (gross profit and retail methods, dollar-value LIFO). Inventory errors and their two-year effects are a favorite.

What belongs in inventory

Cost includes the purchase price plus all costs to bring the goods to their saleable condition and location: freight-in, insurance in transit, import duties and handling. Purchase discounts reduce cost. Selling costs, freight-out, abnormal waste and general administrative overhead are period expenses. For manufacturers, inventory includes direct materials, direct labor and **fixed production overhead allocated on normal capacity** (unallocated overhead from abnormally low production is expensed).

Who owns the goods?

Situation	Included in the inventory of
Goods in transit, **FOB shipping point**	Buyer (title passes at shipment)
Goods in transit, **FOB destination**	Seller (title passes on delivery)
Goods out on **consignment**	Consignor (owner), not the consignee
Goods sold with a right of return	Seller removes them; a return asset is recorded for expected returns (Chapter 2)
Bill-and-hold goods meeting the ASC 606 criteria	Buyer
Goods sold under a product financing arrangement (seller must repurchase)	Seller — it is a borrowing

> **Memory trick:** "**S**hipping point — **S**hip it, it's yours (buyer). **D**estination — **D**on't own it till it **D**ocks."

Example: Year-end physical count: $410,000. Not included: goods shipped to a customer FOB destination on December 30 and still in transit (cost $12,000); goods received on consignment from a supplier ($18,000, already excluded correctly); goods purchased FOB shipping point, shipped December 29 and received January 3 ($9,000). Correct inventory = 410,000 + 12,000 + 9,000 = **$431,000**. The consigned goods belong to the supplier.

Periodic and perpetual systems

- **Periodic:** COGS = beginning inventory + net purchases − ending inventory (counted).
- **Perpetual:** inventory and COGS are updated at every sale. FIFO gives the same result under both systems; LIFO and average cost can differ.

Cost flow assumptions

Method	Ending inventory consists of	In rising prices
Specific identification	Actual cost of the items on hand	—
FIFO	Most recent costs	Highest ending inventory and net income; lowest COGS
LIFO	Oldest costs	Lowest ending inventory and net income; highest COGS; lower taxes
Weighted average (periodic)	Average cost of all goods available	Between FIFO and LIFO
Moving average (perpetual)	Average recomputed after each purchase	Between FIFO and LIFO

LIFO conformity rule: a company that uses LIFO for tax must use it for financial reporting. A **LIFO liquidation** (selling more units than purchased) charges old, low costs to COGS and inflates profit.

Example: Maple Ridge Co. (periodic system):

Layer	Units	Unit cost	Total
Beginning inventory	200	$10	$2,000
Purchase 1	300	$12	$3,600
Purchase 2	500	$13	$6,500
Goods available	1,000		$12,100

It sold 650 units, leaving 350.

Method	Ending inventory	COGS
FIFO	350 × $13 = **$4,550**	12,100 − 4,550 = **$7,550**
LIFO	200 × $10 + 150 × $12 = **$3,800**	**$8,300**
Weighted average ($12,100 ÷ 1,000 = $12.10)	350 × $12.10 = **$4,235**	**$7,865**

Lower of cost and NRV / lower of cost or market

Inventory measured with	Subsequent measurement
FIFO, average cost, specific identification	**Lower of cost and net realizable value (LCNRV)**
LIFO or the retail inventory method	**Lower of cost or market (LCM)**

- **NRV** = estimated selling price − reasonably predictable costs of completion, disposal and transportation.
- **Market** (LCM only) = replacement cost, but not more than the **ceiling** (NRV) and not less than the **floor** (NRV − normal profit margin). In practice, market is the **middle** of the three values.

Write-downs are recognized in income (usually in COGS). A written-down amount becomes the new cost; it is **not written back up** in a later annual period. (Interim write-downs that are recovered within the same year may be reversed.)

Example: An item has cost $50, replacement cost $44, selling price $60, costs to sell $8 and a normal profit margin of $10.

- NRV (ceiling) = 60 − 8 = $52; floor = 52 − 10 = $42; replacement cost = $44.
- **LCM** (LIFO company): market is the middle value, $44; LCM = lower of $50 and $44 = **$44**.
- **LCNRV** (FIFO company): lower of $50 and $52 = **$50** — no write-down.

Memory trick: LCM "market" is the **middle child** of replacement cost, ceiling and floor.

Dollar-value LIFO

Dollar-value LIFO measures layers in dollars rather than units, using a price index.

1. Deflate ending inventory at current prices to **base-year dollars** (divide by the current index).
2. Compare with the prior year's base-year total to find any **new layer** (or a decrease, which removes the most recent layers first).
3. Price each layer at the **index of the year it was added**.
4. Add the layers.

Example:

Year	EI at current prices	Index	EI in base-year $	Layers (base $ × layer index)	DV LIFO inventory
1 (base)	$100,000	1.00	$100,000	100,000 × 1.00	**$100,000**
2	$132,000	1.10	$120,000	+ 20,000 × 1.10 = 22,000	**$122,000**
3	$150,000	1.20	$125,000	+ 5,000 × 1.20 = 6,000	**$128,000**

Estimating inventory

Gross profit method

Used for interim statements and for casualty losses (fire, theft); **not** acceptable for annual GAAP statements.

COGS = net sales × (1 − gross profit %). If the profit is quoted as a **markup on cost**, convert it: gross profit % of sales = markup ÷ (1 + markup).

> **Example:** A fire destroys a warehouse. Beginning inventory $80,000; purchases $420,000; sales $600,000; the company's normal markup is 25% on cost.
>
> 1. Gross profit % of sales = 0.25 ÷ 1.25 = **20%**.
> 2. Estimated COGS = 600,000 × 80% = $480,000.
> 3. Estimated ending inventory = 80,000 + 420,000 − 480,000 = **$20,000** (less any undamaged goods recovered).

Retail inventory method

Apply a cost-to-retail ratio to ending inventory at retail.

Variant	Cost-to-retail ratio includes
Conventional (LCM) retail	Beginning inventory + purchases + net **markups**; **excludes** markdowns
Average cost retail	Beginning inventory + purchases + markups − markdowns
FIFO retail	Purchases only (beginning inventory excluded), with markups and markdowns

Ending inventory at retail = goods available at retail + markups − markdowns − sales (net of returns) − normal shrinkage and employee discounts. Freight-in adds to cost; purchase returns reduce both cost and retail; abnormal shortage is removed from both.

Example:

	Cost	Retail
Beginning inventory	$30,000	$50,000
Purchases	162,000	250,000
Net markups		20,000
Available for LCM ratio	$192,000	$320,000
Net markdowns		(15,000)
Sales		(230,000)
Ending inventory at retail		**$75,000**

Conventional (LCM) ratio = 192,000 ÷ 320,000 = 60%; ending inventory = 75,000 × 60% = **$45,000**. The average cost ratio would be 192,000 ÷ 305,000, giving about **$47,213** — higher, because excluding markdowns makes the LCM ratio smaller.

Inventory errors

COGS = beginning inventory + purchases − ending inventory, so an ending inventory error flows into two years.

Error	Current-year COGS	Current-year net income	Next-year net income	Retained earnings end of next year
Ending inventory **overstated**	Understated	**Overstated**	Understated	Correct (self-correcting)
Ending inventory **understated**	Overstated	Understated	Overstated	Correct
Purchases and ending inventory both understated (goods omitted)	No effect	No effect	No effect	— (but assets and A/P understated)

Purchase commitments

A loss on a firm, noncancelable purchase commitment is recognized when the market price falls below the contract price: debit loss, credit estimated liability on purchase commitments. Disclose significant commitments even without a loss.

Common traps

- Using NRV for a LIFO or retail company (they use LCM), or LCM for a FIFO company.
- Including goods held on consignment for someone else.
- Confusing a markup on cost with a margin on sales.
- Re-pricing the base layer or old layers at the current index in dollar-value LIFO.
- Including markdowns in the conventional retail ratio.
- Writing inventory back up after an annual write-down.

Key takeaways

- Ownership follows title: FOB shipping point → buyer at shipment; FOB destination → seller until delivery; consigned goods → consignor.
- Rising prices: FIFO highest income and ending inventory; LIFO highest COGS.
- LCNRV for FIFO/average; LCM (middle of replacement cost, ceiling, floor) for LIFO and retail; no write-ups.
- Dollar-value LIFO: deflate, find layers, re-inflate each layer at its own index.
- Gross profit %: markup ÷ (1 + markup). Conventional retail ratio includes markups and excludes markdowns.
- Ending inventory errors reverse in the following year.

5. PP&E, Intangibles and Software

Long-lived assets are recorded at cost, allocated to expense over their useful lives, tested for impairment when something goes wrong, and removed with a gain or loss when sold. This chapter covers what to capitalize (including interest during construction and asset retirement obligations), depreciation methods, nonmonetary exchanges, impairment, intangible assets, research and development, software costs and crypto assets.

What to capitalize

Capitalize every cost **necessary to acquire the asset and get it ready for its intended use**.

Asset	Capitalized costs
Land (not depreciated)	Purchase price, closing costs, title and legal fees, back taxes assumed, surveying, clearing and grading, **demolition of an old building less salvage proceeds**, special assessments for permanent improvements (streets, sewers)
Land improvements (depreciated)	Parking lots, driveways, fences, landscaping, outdoor lighting
Building	Purchase price or construction costs, architect fees, permits, excavation for the foundation, capitalized interest during construction
Equipment	Invoice price less discounts, freight-in, insurance in transit, installation, testing and trial runs

Expensed instead: repairs and maintenance that only keep the asset working, training, relocation of staff, abnormal costs (damage from careless installation), and interest on assets that are not being constructed.

Basket purchases (land and building for one price) are allocated by **relative fair values**. **Donated assets** received by a business are recorded at fair value with contribution revenue (a gain). Assets acquired with stock are recorded at the fair value of the stock or of the asset, whichever is more clearly evident.

After acquisition

Expenditure	Treatment
Additions (a new wing)	Capitalize
Improvements and replacements that extend life or increase capacity or efficiency	Capitalize; remove the old component's cost and accumulated depreciation if known
Rearrangement or reinstallation with future benefit	Capitalize if material
Ordinary repairs and maintenance	Expense

Capitalized interest

Interest is capitalized on assets **constructed for a company's own use** (or built as discrete projects for sale or lease, such as ships or real estate developments) during the period of construction. It is **not** capitalized on inventory routinely produced, on assets already in use or ready for use, or on land held without development.

1. Compute **weighted-average accumulated expenditures (WAAE)** for the period.
2. Apply the rate on any **specific construction borrowing** to WAAE up to that loan; apply the **weighted-average rate on other debt** to any excess. The result is **avoidable interest**.
3. Capitalize the **lesser** of avoidable interest and **actual interest** incurred.

> **Example:** Crestline Corp. builds its own headquarters during the year: expenditures of $600,000 on January 1, $400,000 on July 1 and $800,000 on October 1. It has a $500,000 construction loan at 8% and other debt of $2,000,000 at 10%.
>
> 1. WAAE = 600,000 × 12/12 + 400,000 × 6/12 + 800,000 × 3/12 = **$1,000,000**.
> 2. Avoidable interest = 500,000 × 8% + (1,000,000 − 500,000) × 10% = 40,000 + 50,000 = **$90,000**.
> 3. Actual interest = 40,000 + 200,000 = $240,000.
> 4. Capitalize **$90,000** (the lesser); expense the remaining $150,000.

Asset retirement obligations (AROs)

When a company has a legal obligation to dismantle or restore an asset (an oil platform, a leased site, a mine), it records the **fair value of the ARO** — normally the present value of the expected retirement cost at a credit-adjusted risk-free rate — as a liability and adds the same amount to the asset's cost.

- Each year: **accretion expense** = beginning ARO × discount rate (an operating expense, not interest).

- The capitalized ARO cost is depreciated with the asset.
- At settlement, any difference between the liability and the actual cost is a gain or loss.

Example: On January 1 Granite Mining builds a facility costing $400,000 and must restore the site in 10 years at an expected cost of $100,000. The credit-adjusted risk-free rate is 6% (PV of $1, 10 periods, 6% = 0.5584).

Account	Debit	Credit
Facility	455,840	
Cash		400,000
Asset retirement obligation		55,840

ARO = 100,000 × 0.5584 = $55,840. Year 1 accretion expense = 55,840 × 6% = **$3,350**; depreciation of the ARO portion (straight-line, 10 years, no salvage) = **$5,584**.

Depreciation methods

Method	Formula	Salvage value
Straight-line	(Cost − salvage) ÷ useful life	Subtracted
Units of production	(Cost − salvage) ÷ total estimated units × units this year	Subtracted
Sum-of-the-years'-digits	(Cost − salvage) × remaining life ÷ SYD, where SYD = n(n + 1) ÷ 2	Subtracted
Double-declining balance	Beginning book value × (2 ÷ life)	**Ignored** in the formula, but book value cannot fall below salvage

Example: Equipment costs $50,000, salvage value $5,000, life 5 years. SYD = 5 × 6 ÷ 2 = 15.

Year	Straight-line	SYD	DDB (40%)
1	$9,000	45,000 × 5/15 = $15,000	50,000 × 40% = $20,000
2	$9,000	45,000 × 4/15 = $12,000	30,000 × 40% = $12,000
3	$9,000	45,000 × 3/15 = $9,000	18,000 × 40% = $7,200

DDB book value after Year 3 = 50,000 − 39,200 = $10,800; later years stop when book value reaches $5,000.

> **Memory trick:** DDB — "double the rate, ignore salvage until the end."

Partial years: compute a full year's depreciation and multiply by the months held (unless the question gives a convention such as half-year). **Group and composite** methods depreciate a pool at one rate; retirements are charged to accumulated depreciation with no gain or loss. **Changes in useful life, salvage or method** are changes in estimate handled prospectively (Chapter 13).

Disposals and nonmonetary exchanges

On a sale, first bring depreciation up to the disposal date, then: gain or loss = proceeds − book value.

For **nonmonetary exchanges** of assets:

Exchange	Measurement of new asset	Gain or loss
Has **commercial substance** (future cash flows change significantly)	Fair value of asset given up + cash paid (or fair value received, if more evident)	Recognize gain or loss in full
Lacks commercial substance	Book value of asset given up + cash paid	Losses recognized; gains generally deferred (if cash is **received**, a proportionate gain is recognized; if cash received is 25% or more of total consideration the exchange is treated as monetary)

Example: Shoreline Co. trades a truck (cost $30,000, accumulated depreciation $12,000, book value $18,000, fair value $25,000) plus $5,000 cash for a new truck.

- **With commercial substance:** new truck = 25,000 + 5,000 = **$30,000**; gain = 25,000 − 18,000 = **$7,000**.
- **Without commercial substance:** new truck = 18,000 + 5,000 = **$23,000**; the $7,000 gain is deferred through the lower basis.

Account (with commercial substance)	Debit	Credit
Truck (new)	30,000	
Accumulated depreciation	12,000	
Truck (old)		30,000
Cash		5,000
Gain on exchange		7,000

Involuntary conversions (fire, condemnation) are recognized as gains or losses in full, even if the proceeds are reinvested.

Impairment of long-lived assets

Asset status	Test	Measurement	Reversal
Held and used (PP&E, finite-lived intangibles)	Only when indicators exist. Step 1 recoverability: carrying amount > **undiscounted** future cash flows?	Loss = carrying amount − **fair value**; fair value becomes new cost basis, depreciate it	**Not allowed**
Held for sale	—	Lower of carrying amount or **fair value less costs to sell**; stop depreciating	Recoveries allowed up to cumulative losses recognized
Indefinite-lived intangibles (not goodwill)	At least annually, one step	Carrying amount − fair value	Not allowed
Goodwill	Annual test; details are BAR	—	Not allowed

Example: A plant has a carrying amount of $900,000. Expected undiscounted future cash flows are $850,000 and fair value is $700,000.

1. Recoverability: 900,000 > 850,000 → not recoverable, so the asset is impaired.
2. Loss = 900,000 − 700,000 = **$200,000**. New cost basis $700,000, depreciated over the remaining life.

If undiscounted cash flows had been $950,000, there would be **no** impairment, even though fair value is below carrying amount.

Memory trick: "**U**ndiscounted to **T**est, **F**air value to **M**easure."

Intangible assets

Type	Accounting
Purchased intangibles (patents, copyrights, customer lists, franchises)	Capitalize cost; amortize over the shorter of legal life and useful life if finite
Internally developed intangibles	Generally expensed (R&D, advertising, start-up costs); capitalize only direct costs such as legal registration fees
Indefinite-lived intangibles (perpetual trademarks, broadcast licenses with expected renewal)	Not amortized; tested for impairment annually
Goodwill (from business combinations)	Not amortized for public companies; private companies may elect to amortize over 10 years or less
Successful legal defense of a patent	Capitalize the legal costs; an unsuccessful defense is expensed and the patent is likely impaired
Organization and start-up costs	Expense as incurred

Research and development

R&D costs are **expensed as incurred**, including materials, salaries, and depreciation of R&D equipment. Exceptions: equipment and facilities with **alternative future uses** are capitalized and depreciated (the depreciation is R&D expense); R&D performed **for others** under contract is a cost of the contract; and in-process R&D acquired in a business combination is capitalized as an indefinite-lived intangible until completed or abandoned.

Software costs

Software	Expense	Capitalize	After capitalization
To be sold, leased or marketed	All costs until **technological feasibility** (detailed program design or working model)	From technological feasibility until the product is available for **general release**	Amortize at the greater of (a) revenue ratio or (b) straight-line over remaining life; inventory costs after release
Internal use (current stage model)	Preliminary project stage; post-implementation and operation stage, **training** and **data conversion** (unless needed to make the software operational)	**Application development stage**: coding, installation, testing, and related payroll and interest	Amortize straight-line once ready for use
Cloud computing (hosting) arrangement that is a service	Same stage rules for implementation costs	Implementation costs during development	Present as a **prepaid asset**, amortized over the hosting term in the same line as hosting fees

Memory trick: Internal-use stages "Prelim–Develop–Post" = **E–C–E** (Expense–Capitalize–Expense).

Watch out: ASU 2025-06 (issued 2025) replaces the stage model for internal-use software with a "probable to complete" threshold — capitalization begins once management authorizes and commits to funding the project and completion is probable. It is effective for annual periods beginning after December 15, 2027 (early adoption allowed). Until it becomes testable, expect the stage model on the exam.

Crypto assets

Under ASU 2023-08, in-scope crypto assets (fungible, secured by blockchain, not issued by the reporting entity and not giving rights to underlying goods or services) are measured at **fair value**, with changes recognized in **net income** each period. They are presented separately from other intangibles. Before the ASU, crypto was an indefinite-lived intangible carried at cost less impairment.

Common traps

- Deducting salvage value in the double-declining balance formula.
- Measuring an impairment loss against undiscounted cash flows instead of fair value.
- Reversing a write-down on an asset held and used.

- Recording a gain on an exchange that lacks commercial substance (when no cash is received).
- Capitalizing training or data conversion costs for internal-use software.
- Capitalizing interest above actual interest incurred, or on inventory produced routinely.
- Calling accretion of an ARO "interest expense."

Key takeaways

- Capitalize all costs to get the asset ready for use; demolition goes to land; land improvements are depreciated.
- Capitalized interest = lesser of avoidable interest (on WAAE) and actual interest.
- ARO at present value; add it to the asset; accretion expense each year.
- SL, SYD and units subtract salvage; DDB ignores salvage until book value hits salvage.
- Exchanges with commercial substance use fair value and recognize gains; without, gains are deferred.
- Impairment of held-and-used assets: undiscounted test, fair value measurement, no reversal.
- R&D expensed; software for sale capitalized from technological feasibility to release; internal-use software capitalized in development.
- Crypto assets in scope of ASU 2023-08: fair value through net income.

6. Investments

Accounting for an investment depends on two questions: is it **debt or equity**, and how much **influence or intent** does the investor have? The answer decides whether the investment is carried at fair value, amortized cost or under the equity method, and whether changes in value go to net income or to other comprehensive income.

Classification map

Investment	Measurement	Unrealized gains and losses
Debt — **trading**	Fair value	Net income
Debt — **available-for-sale (AFS)**	Fair value	**OCI** (except credit losses, which go to net income)
Debt — **held-to-maturity (HTM)** (positive intent and ability to hold)	Amortized cost, less CECL allowance	Not recognized
Equity — with readily determinable fair value (generally < 20%)	Fair value	**Net income**
Equity — without readily determinable fair value	Fair value, or the **measurement alternative**: cost − impairment ± observable price changes in orderly transactions for identical or similar securities	Net income
Equity — significant influence (generally 20%–50%)	**Equity method** (or fair value option)	Not recognized (share of investee income instead)
Equity — control (generally > 50%)	Consolidate (Chapter 15)	—

Memory trick: "THE" classes — **T**rading hits income; **H**TM holds at cost; **E**quity securities go through income. AFS = "**A**way **F**rom the **S**tatement of income" until sold.

Watch out: There is no AFS category for **equity** securities any more. Unrealized gains and losses on equity securities always go through net income (unless the equity method or consolidation applies).

Debt securities and the effective interest method

Bonds bought at a discount or premium are amortized with the effective interest method:

- **Interest income** = beginning carrying amount (amortized cost) × market (effective) rate at purchase.
- **Cash received** = face × stated (coupon) rate.
- **Amortization** = difference; a discount increases amortized cost, a premium decreases it.

Example: On January 1, Year 1, Summit Partners buys a $100,000, 5-year bond with a 6% annual coupon (paid December 31) when the market rate is 8%. PV of $1 (5, 8%) = 0.6806; PV of an ordinary annuity (5, 8%) = 3.9927.

Price = 100,000 × 0.6806 + 6,000 × 3.9927 = 68,060 + 23,956 = **$92,016**.

Year	Beginning amortized cost	Interest income (8%)	Cash (6%)	Discount amortization	Ending amortized cost
1	$92,016	$7,361	$6,000	$1,361	$93,377
2	$93,377	$7,470	$6,000	$1,470	$94,847

HTM: report $93,377 at the end of Year 1.

AFS: fair value at the end of Year 1 is $96,000. Unrealized holding gain = 96,000 − 93,377 = **$2,623**, reported in OCI. Interest income is still $7,361 — the effective interest method runs on amortized cost, not on fair value.

Trading: the same $2,623 gain goes to net income.

AFS journal entry at the end of Year 1:

Account	Debit	Credit
Fair value adjustment — AFS	2,623	
Unrealized holding gain — OCI		2,623

When an AFS security is sold, the **realized gain or loss = proceeds − amortized cost**, and the accumulated OCI amount is **reclassified** (recycled) out of AOCI so it is not counted twice. If the Summit bond were sold at the start of Year 2 for $97,000, the realized gain would be 97,000 − 93,377 = **$3,623**, and the $2,623 in AOCI would be reversed.

Transfers between categories

Transfer	Treatment at the transfer date
Into trading	Unrealized gain or loss recognized in net income immediately
AFS → HTM	Unrealized amount stays in AOCI and is amortized over the remaining life
HTM → AFS	Unrealized gain or loss recognized in OCI

Selling or transferring more than an insignificant amount of HTM securities can "taint" the HTM portfolio and call the intent to hold into question.

Credit losses on debt securities

Category	Model
HTM	CECL: allowance for lifetime expected credit losses (Chapter 3)
AFS	Impairment exists when fair value < amortized cost. If the investor **intends to sell** (or more likely than not will be required to sell) → write the amortized cost down to fair value through earnings. Otherwise, record an **allowance** for the credit-loss portion only, **limited to the amount by which fair value is below amortized cost**; the non-credit portion goes to OCI. Allowances can be reversed if credit improves.

Example: An AFS bond has amortized cost of $100,000 and fair value of $85,000. The present value of expected cash flows is $92,000, and the investor does not intend to sell.

- Credit loss = 100,000 − 92,000 = $8,000; fair value shortfall = 100,000 − 85,000 = $15,000.
- Allowance = lesser = **$8,000** (credit loss expense in net income).
- Remaining decline = 15,000 − 8,000 = **$7,000** in OCI.

The equity method

Use the equity method when the investor has **significant influence** over the investee's operating and financial policies — presumed at **20% to 50%** of voting stock, but evidenced also by board representation, policy participation, material intercompany transactions or interchange of managers. Influence can be absent at 25% (for example, if the investee opposes the investor) or present below 20%.

Event	Effect on investment account
Purchase	Debit at cost
Investor's share of investee net income	**Increase**; equity in earnings (income)
Investor's share of investee net loss	Decrease (stop at zero unless the investor guaranteed obligations)
Dividends received	**Decrease** (a return of investment, not income)
Amortization of excess of cost over book value attributed to depreciable or amortizable assets	Decrease; reduces equity in earnings
Excess attributed to land or goodwill	Not amortized
Investee OCI	Investor's share recorded in its own OCI

> **Memory trick:** "**I**ncome **I**n, **D**ividends **D**own."

Example: On January 1, Brookfield Corp. pays $500,000 for 30% of Delta Inc. Delta's net assets have a book value of $1,400,000. Delta's building (10-year remaining life) is undervalued by $100,000; any remaining excess is goodwill. During the year Delta earns $200,000 and pays dividends of $50,000.

Step	Amount
Cost	$500,000
Share of book value: 30% × 1,400,000	(420,000)
Excess	$80,000
Attributed to building: 30% × 100,000	(30,000)
Goodwill (not amortized)	$50,000

Investment account	Amount
Cost	$500,000
+ Share of income: 30% × 200,000	60,000
− Building excess amortization: 30,000 ÷ 10	(3,000)
− Dividends: 30% × 50,000	(15,000)
Ending balance	**$542,000**

Equity in earnings reported in Brookfield's income statement = 60,000 − 3,000 = **$57,000**.

Journal entries:

Account	Debit	Credit
Investment in Delta	500,000	
Cash		500,000
Investment in Delta	57,000	
Equity in earnings of Delta		57,000
Cash	15,000	
Investment in Delta		15,000

Changing to the equity method (for example, increasing from 10% to 25%): under ASU 2016-07, apply the equity method **prospectively** — add the cost of the new shares to the

carrying amount of the existing interest, with no retroactive restatement. For an AFS debt-like holding, any unrealized amount in AOCI is recognized in earnings at that date.

Changing from the equity method (selling down below significant influence): stop applying the equity method; the carrying amount becomes the starting basis, and the investment is then measured at fair value through net income.

Intercompany profits between investor and investee: the investor eliminates its **percentage share** of unrealized profit on inventory still held, until it is sold to outsiders.

Fair value option

An entity may irrevocably elect fair value for eligible financial assets and liabilities (instrument by instrument, at initial recognition). Changes go to net income — except changes in a liability's value caused by the entity's own credit risk, which go to OCI.

Other investment items

- **Cash surrender value of life insurance** owned by the company: a noncurrent asset; premiums paid minus the increase in cash surrender value is expense.
- **Funds** set aside for specific purposes (sinking funds, plant expansion funds) are noncurrent investments.

Common traps

- Recording equity-method dividends as dividend income.
- Putting unrealized gains on equity securities in OCI.
- Using the cash coupon instead of carrying amount × market rate as interest income.
- Computing the realized gain on an AFS sale from last year's fair value instead of amortized cost.
- Amortizing the excess attributed to land or goodwill.
- Recording the full AFS fair value decline as a credit loss when the credit loss is smaller.

Key takeaways

- Debt: trading (FV-NI), AFS (FV-OCI), HTM (amortized cost). Equity securities: FV-NI or the measurement alternative.
- Interest income always = amortized cost × effective rate.
- AFS credit loss allowance = lesser of credit loss and fair value shortfall.
- Equity method: cost + share of income − dividends − excess amortization on depreciable assets.
- Changes to the equity method are prospective.
- Realized AFS gain = proceeds − amortized cost; recycle the AOCI amount.

7. Payables, Contingencies and Exit Costs

Current liabilities look easy until the exam asks whether a lawsuit should be accrued, how much warranty expense belongs in the year of sale, whether short-term debt can be shown as long-term, or when a restructuring cost becomes a liability. This chapter covers payables and accruals, loss and gain contingencies (ASC 450), guarantees, exit and disposal costs (ASC 420) and the classification of debt.

Current liabilities

A liability is **current** if it is expected to be settled within one year of the balance sheet date or the operating cycle, whichever is longer, using current assets or by creating other current liabilities.

Liability	Key point
Accounts payable	Recorded at invoice amount (gross method) or net of expected discounts (net method; lost discounts are a finance expense)
Notes payable	Short-term trade notes at face; accrue interest at year-end
Current maturities of long-term debt	Portion due within one year (unless refinanced as described below)
Dividends payable	Cash dividends once declared; stock dividends distributable are **equity**, not a liability
Unearned (deferred) revenue / contract liabilities	Customer paid before the entity performed
Accrued expenses	Wages, interest, taxes, utilities incurred but unpaid
Customer deposits and refundable deposits	Liability until returned or applied
Sales taxes collected	Liability owed to the government — not revenue

Sales tax included in total receipts

If cash register receipts include sales tax, back the tax out: sales = total ÷ (1 + rate).

> **Example:** Total receipts including 7% sales tax are $53,500. Sales = 53,500 ÷ 1.07 = **$50,000**; sales tax payable = 53,500 − 50,000 = **$3,500**.

Payroll

The employer withholds the employee's income tax and FICA (both are liabilities, not expenses of the employer) and separately incurs its own payroll taxes: the employer's matching FICA plus federal and state unemployment taxes.

Example: Gross wages are $100,000. Employee FICA is 7.65% ($7,650), federal income tax withheld is $15,000, the employer matches FICA ($7,650) and owes $2,000 of unemployment taxes.

Account	Debit	Credit
Salaries and wages expense	100,000	
FICA taxes payable		7,650
Income taxes withheld payable		15,000
Cash (net pay)		77,350
Payroll tax expense	9,650	
FICA taxes payable		7,650
Unemployment taxes payable		2,000

Employer payroll tax expense = 7,650 + 2,000 = **$9,650**. The employee's withholdings are not employer expenses.

Bonuses

Write the bonus formula as an equation. If the bonus is a percentage of income **after** the bonus, the bonus appears on both sides.

Example: Income before bonus and taxes is $440,000. The manager's bonus is 10% of income **after** deducting the bonus (but before taxes). $B = 0.10 \times (440{,}000 - B) \rightarrow 1.10B = 44{,}000 \rightarrow$ **$B = \$40{,}000$**. Check: $10\% \times (440{,}000 - 40{,}000) = 40{,}000$.

Compensated absences

Accrue a liability for future paid absences when **all four** conditions are met: the obligation relates to services already rendered, the rights **vest or accumulate**, payment is **probable** and the amount is **estimable**. Vacation that vests or carries over is accrued. **Sick pay** must be accrued only if it **vests** (paid even if the employee is never sick); accumulating but nonvesting sick pay may be accrued but is not required.

Memory trick: Sick pay accrual only if it **V**ests — "V for Vital."

Warranties

Warranty type	Accounting
Assurance-type (product works as promised)	Accrue estimated warranty cost as an expense in the **year of sale** (debit warranty expense, credit warranty liability); actual repairs reduce the liability
Service-type (extended warranty)	Separate performance obligation under ASC 606: defer the allocated revenue and recognize it over the coverage period; costs expensed as incurred

Example: Halcyon Appliances sells 2,000 units with a one-year assurance warranty. It expects 4% to need repair at $150 each. Repairs paid during the year cost $4,500.

- Warranty expense = 2,000 × 4% × $150 = **$12,000** (recognized in the year of sale, regardless of payments).
- Year-end warranty liability = 12,000 − 4,500 = **$7,500**.

Coupons, premiums and rebates offered to customers are generally consideration payable to the customer or a material right under ASC 606; questions may also ask for the liability for expected redemptions: units expected to be redeemed × cost, less redemptions to date.

Loss contingencies (ASC 450)

A contingency is an existing condition with an uncertain outcome that will be resolved by a future event: litigation, guarantees, environmental cleanups, product defects.

Likelihood of loss	Reasonably estimable	Not estimable
Probable (likely to occur)	**Accrue** and disclose	Disclose
Reasonably possible (more than remote, less than probable)	Disclose	Disclose
Remote (slight)	Generally nothing (but **guarantees** are disclosed)	Nothing

Ranges: accrue the **best estimate** within the range. If no amount is better than any other, accrue the **minimum** and disclose the possible additional loss up to the maximum. (IFRS uses the midpoint — a classic distractor.)

Example: At year-end, counsel says it is probable that Kingsford Co. will lose a lawsuit, with damages between $200,000 and $600,000 and no amount more likely than another. Kingsford accrues **$200,000** and discloses that an additional loss of up to **$400,000** is reasonably possible. If counsel had said $350,000 was the most likely amount, Kingsford would accrue $350,000.

Memory trick: "P-E-A" — **P**robable + **E**stimable = **A**ccrue. "Minimum in the U.S., middle in IFRS."

Other points:

- **Unasserted claims:** accrue or disclose only if it is probable a claim will be asserted **and** the loss is probable or reasonably possible.
- **General or unspecified business risks** and self-insurance for future events are **not** accrued.
- **Events after the balance sheet date** that provide evidence about conditions existing at year-end (a settlement in January of a December lawsuit) adjust the accrual (Chapter 14).
- **Gain contingencies are never accrued**; they are recognized only when realized and are disclosed carefully to avoid misleading implications.

Guarantees

A guarantor recognizes at inception a liability for the **fair value of the stand-ready obligation**, even if loss is not probable. If a loss later becomes probable and estimable, an ASC 450 contingent loss is also measured. Guarantees are disclosed even when remote.

Commitments

Unconditional purchase obligations, long-term contracts and similar commitments are **disclosed**. A firm purchase commitment with an expected loss (market price below the contract price) is accrued (Chapter 4).

Exit and disposal costs (ASC 420)

Costs associated with exit or disposal activities (restructurings, plant closings) are recognized at **fair value when the liability is incurred** — not when management merely commits to a plan.

Cost	Recognize when
One-time termination benefits — no future service required beyond the minimum retention period	At the **communication date** to employees
One-time termination benefits — employees must work beyond the minimum retention period	**Ratably** over the future service period
Contract termination costs (cancelling a contract before its end)	When the contract is terminated in accordance with its terms
Costs that continue under a contract without economic benefit	When the entity ceases using the right
Other costs (relocating employees, consolidating facilities)	When incurred

Ongoing benefit arrangements (severance under an existing written plan or past practice) are accounted for under the benefits standards when probable and estimable, not ASC 420.

Example: On November 1 Ridgeline Corp. communicates a plant closure. Employees who stay until the closing date of February 28 (four months, longer than the 60-day minimum retention period) will receive a total of $120,000 of one-time termination benefits. The liability is recognized ratably: 120,000 × 2/4 = **$60,000** by December 31, and the remaining $60,000 in January and February. If no further service were required, the full $120,000 would be recognized on November 1.

Classifying debt as current or noncurrent

Situation	Classification at the balance sheet date
Short-term obligation **refinanced on a long-term basis** after year-end but **before the statements are issued** (or available to be issued)	Noncurrent, up to the amount refinanced
Entity has a **noncancelable financing agreement** for long-term refinancing in place before issuance, with no violation	Noncurrent, limited to the amount available under the agreement
Debt paid off after year-end with current assets and then replaced with new long-term debt	**Current** (current assets were used)
Long-term debt **callable** at the balance sheet date because of a covenant violation	Current, unless the creditor waives the right for more than one year, or a grace period cure is probable

Example: A $1,000,000 note is due on March 31 of next year. On February 10, before the statements are issued, the company issues $700,000 of 5-year bonds and uses the proceeds to repay the note. At year-end, **$700,000** is reported as noncurrent and **$300,000** as current.

Common traps

- Accruing the midpoint of a range when no best estimate exists.
- Recognizing a gain contingency.
- Expensing assurance warranty costs as paid instead of in the year of sale.
- Including employee withholdings in the employer's payroll tax expense.
- Recognizing restructuring costs when management commits to a plan rather than when the liability is incurred.
- Classifying refinanced debt as noncurrent when the refinancing came after the statements were issued.
- Treating a stock dividend distributable as a liability.

Key takeaways

- Accrue when probable and estimable; disclose when reasonably possible; remote → nothing (except guarantees).
- Range without a best estimate: accrue the minimum, disclose the rest.
- Assurance warranties: accrue expected cost in the year of sale; service warranties defer revenue.
- Compensated absences: accrue if vested or accumulated, probable and estimable; sick pay only if it vests.
- ASC 420: exit costs at fair value when incurred; one-time termination benefits at communication or over the retention period.
- Short-term debt refinanced long-term before issuance can be noncurrent, limited to the amount refinanced.

8. Bonds and Notes Payable

Long-term debt is the purest present value chapter on FAR. A bond is recorded at the present value of its cash flows at the market rate, the discount or premium is amortized with the effective interest method, and gains or losses arise only when the debt is extinguished early or restructured. Get the per-period rate and number of periods right and the rest follows.

Pricing a bond

Issue price = PV of the face amount + PV of the interest payments, both discounted at the **market (effective) rate** for the period.

Relationship	Bond sells at	Carrying amount over time
Market rate > stated (coupon) rate	**Discount** (below face)	Rises toward face
Market rate < stated rate	**Premium** (above face)	Falls toward face
Market rate = stated rate	Face (par)	Stays at face

For semiannual bonds, **halve the rates and double the periods**. Cash interest always uses the stated rate on the face amount.

Memory trick: "**M**arket **M**ightier = **M**inus" — when the market rate is higher, the bond sells at a discount.

Example: On January 1, Year 1, Cascade Energy issues $1,000,000 of 5-year, 8% bonds paying interest semiannually (June 30 and December 31) when the market rate is 10%. Use 5% for 10 periods: PV of $1 = 0.6139; PV of an ordinary annuity = 7.7217.

Component	Computation	Present value
Face	1,000,000 × 0.6139	$613,900
Interest	40,000 × 7.7217	308,868
Issue price		**$922,768**
Discount	1,000,000 − 922,768	$77,232

Effective interest amortization

- **Interest expense** = beginning carrying amount × market rate per period.

- **Cash paid** = face × stated rate per period.
- **Amortization** = interest expense − cash (discount), or cash − interest expense (premium).

Example (continued): Amortization table for Cascade's bonds.

Period	Beginning carrying amount	Interest expense (5%)	Cash paid (4%)	Discount amortization	Ending carrying amount
1	$922,768	$46,138	$40,000	$6,138	$928,906
2	$928,906	$46,445	$40,000	$6,445	$935,351
3	$935,351	$46,768	$40,000	$6,768	$942,119
4	$942,119	$47,106	$40,000	$7,106	$949,225

Year 1 interest expense = 46,138 + 46,445 = **$92,583**.

Journal entries for issuance and the first payment:

Account	Debit	Credit
Cash	922,768	
Bonds payable (net of discount)		922,768
Interest expense	46,138	
Bonds payable (discount amortization)		6,138
Cash		40,000

(Many textbooks credit Bonds payable for the face and debit a separate Discount on bonds payable; the net carrying amount is the same.)

Example (premium): If $1,000,000 of 5-year, 10% semiannual bonds were issued when the market rate was 8% (4% for 10 periods; PV of $1 = 0.6756; annuity = 8.1109), the price would be 1,000,000 × 0.6756 + 50,000 × 8.1109 = **$1,081,145**. First-period interest expense = 1,081,145 × 4% = $43,246; premium amortization = 50,000 − 43,246 = **$6,754**.

Memory trick: Effective interest is "CAR" — **C**arrying **A**mount × **R**ate.

Straight-line amortization (discount ÷ number of periods) is allowed only if the result is not materially different from the effective interest method. With effective interest, expense

is a constant **rate**; with straight-line, expense is a constant **amount**.

Bonds issued between interest dates

The buyer pays the issue price **plus accrued interest** since the last interest date; on the next interest date the issuer pays a full period's interest, so the net expense covers only the time outstanding. Accrued interest is not part of the bond's price.

Debt issue costs

Legal, underwriting and printing costs to issue debt are reported as a **direct deduction from the carrying amount** of the debt (like a discount), not as an asset, and are amortized into interest expense with the effective interest method. (Issue costs for a revolving line of credit with no outstanding balance may be shown as an asset.)

Early extinguishment

Gain or loss = **net carrying amount** (including unamortized discount, premium and issue costs, updated to the extinguishment date) − **reacquisition price** (including call premium). It is reported in income from continuing operations — it is not an extraordinary item.

Example: At the end of Year 2 (after period 4), Cascade calls all its bonds at 102. Carrying amount = $949,225; reacquisition price = 1,000,000 × 1.02 = $1,020,000.

Loss on extinguishment = 949,225 − 1,020,000 = **$(70,775)**.

Account	Debit	Credit
Bonds payable (net)	949,225	
Loss on extinguishment of debt	70,775	
Cash		1,020,000

Notes payable with no or low stated interest

A note exchanged for cash, property or services with a stated rate that is zero or unreasonable is recorded at the **present value** of its cash flows at the market rate (or at the fair value of the property received, if more clearly determinable). The discount is amortized to interest expense.

Example: Linden Corp. buys equipment by signing a $100,000 non-interest-bearing note due in 3 years. Its borrowing rate is 9% (PV of $1, 3 periods = 0.7722).

- Equipment and note recorded at 100,000 × 0.7722 = **$77,220**.
- Year 1 interest expense = 77,220 × 9% = **$6,950**; carrying amount of the note at year-end = $84,170.

Installment notes with equal payments: each payment includes interest (carrying amount × rate) and principal (payment − interest).

Debt with conversion features and warrants

Instrument	Accounting at issuance
Bonds with **detachable** warrants	Allocate proceeds between bonds and warrants by **relative fair values** (or to the warrants at fair value and the rest to bonds if only one value is known); warrants go to APIC — warrants. Any reduction of the bond amount is a discount
Bonds with **nondetachable** warrants	Treated like convertible debt — all proceeds to debt
Convertible bonds (ASU 2020-06)	Generally recorded entirely as a **single liability**; the old cash-conversion and beneficial-conversion separation models were removed. (Separation still applies if the conversion option is a derivative or the bond was issued at a substantial premium.)
Conversion of convertible bonds	**Book value method**: carrying amount of the bonds → common stock and APIC; **no gain or loss**

Example: Bonds with detachable warrants are issued for $1,030,000. Without the warrants, the bonds would sell for $990,000; the warrants have a fair value of $60,000 (total $1,050,000).

- Bonds: 1,030,000 × 990/1,050 = **$971,143** (a discount of $28,857 on $1,000,000 face).
- Warrants (APIC): 1,030,000 × 60/1,050 = **$58,857**.

Induced conversions (a sweetener offered to encourage conversion) produce an expense equal to the fair value of the extra consideration.

Troubled debt restructurings — debtor (ASC 470-60)

A restructuring is troubled when the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession it would not otherwise consider.

Form	Debtor accounting
Settlement by transferring an asset	First, gain or loss on the asset = fair value − book value. Then **restructuring gain** = carrying amount of the debt (incl. accrued interest) − fair value of the asset
Settlement by issuing equity	Restructuring gain = carrying amount of debt − fair value of equity issued
Modification of terms	Compare carrying amount with **total undiscounted future cash payments**. If future payments < carrying amount: reduce the debt to the future payments, recognize a gain, and record **no interest expense** thereafter. If future payments ≥ carrying amount: no gain; compute a new effective rate prospectively

Example: Lark Industries owes $500,000 principal plus $50,000 accrued interest (carrying amount $550,000).

- **Modification:** the bank reduces the debt so that total future payments (principal and interest) are $520,000. Gain = 550,000 − 520,000 = **$30,000**; all future payments reduce the liability, with no interest expense.
- **Asset settlement instead:** Lark transfers land with book value $300,000 and fair value $360,000. Gain on land = 360,000 − 300,000 = **$60,000**; restructuring gain = 550,000 − 360,000 = **$190,000**.

Disclosures

Disclose maturities and sinking fund requirements for each of the **five years** after the balance sheet date, the fair value of debt, assets pledged as collateral and covenant terms.

Common traps

- Discounting the cash flows at the coupon rate instead of the market rate.
- Mixing annual coupons with semiannual factors (or the reverse).
- Treating debt issue costs as an asset.
- Computing an extinguishment gain against face value instead of net carrying amount.
- Including accrued interest from a between-dates issue in the bond's price.
- Recognizing a gain on conversion of convertible bonds.
- Recording a TDR gain when undiscounted future payments exceed the carrying amount.

Key takeaways

- Issue price = PV of face + PV of interest at the market rate per period.
- Discount if market rate > coupon; premium if market rate < coupon; carrying amount moves toward face.
- Interest expense = carrying amount × market rate; amortization = expense − cash.
- Debt issue costs reduce the carrying amount.
- Extinguishment gain or loss = net carrying amount − reacquisition price.
- Zero-interest notes at present value; detachable warrants by relative fair values; convertibles generally one liability under ASU 2020-06.
- Debtor TDR modification: gain only if undiscounted future payments < carrying amount.

9. Leases — Lessee (ASC 842)

Under ASC 842, lessees put almost every lease on the balance sheet: a **right-of-use (ROU) asset** and a **lease liability**. The classification as a **finance** or **operating** lease then decides how the cost shows up in the income statement. FAR tests the lessee side in depth; lessor accounting is a BAR topic.

Is it a lease?

A contract contains a lease if it conveys the right to **control the use of an identified asset** for a period of time in exchange for consideration. Control means the customer has the right to obtain substantially all the economic benefits from use **and** the right to direct how and for what purpose the asset is used. If the supplier has a substantive right to substitute the asset, there is no identified asset.

Short-term lease election: a lessee may elect (by asset class) not to recognize an ROU asset and liability for leases with a term of **12 months or less** that do **not** include a purchase option the lessee is reasonably certain to exercise. Payments are expensed straight-line.

Lease term and discount rate

Lease term = noncancelable period + periods covered by renewal options the lessee is **reasonably certain** to exercise + periods after termination options the lessee is reasonably certain **not** to exercise + periods controlled by the lessor.

Discount rate: the rate implicit in the lease if **readily determinable**; otherwise the lessee's **incremental borrowing rate**. Lessees that are not public business entities may elect a **risk-free rate** by asset class.

Classification — the five finance lease criteria

A lease is a **finance lease** if **any one** criterion is met; otherwise it is an **operating lease**.

Criterion	Test
Ownership transfer	Title transfers to the lessee by the end of the term
Written purchase option	Lessee is **reasonably certain** to exercise a purchase option
Net present value	PV of lease payments + any residual value guaranteed by the lessee ≥ **substantially all** of the asset's fair value (a common benchmark is 90%)
Economic life	Lease term is a **major part** of the remaining economic life (common benchmark 75%); not used if the lease starts near the end of the asset's life
Specialized asset	Asset is so specialized that it has no alternative use to the lessor at the end of the term

> **Memory trick:** "**OWNES**" — Ownership, Written option, Net PV 90%, Economic life 75%, Specialized.

Initial measurement

Lease liability = PV of	ROU asset =
Fixed payments (less lease incentives receivable)	Lease liability
Variable payments based on an **index or rate** (measured using the index at commencement)	+ Lease payments made at or before commencement (prepaid rent)
Exercise price of a purchase option **reasonably certain** to be exercised	+ **Initial direct costs** (incremental costs that would not have been incurred without the lease, such as commissions)
Termination penalties if the term reflects termination	− Lease incentives received
Amounts **probable** of being owed under **residual value guarantees** (expected shortfall only)	

Excluded from the liability: variable payments based on **usage or performance** (sales-based rent, mileage) — expense them as incurred.

When payments are made **at the beginning** of each period, use the **annuity due** factor, and remember that the first payment immediately reduces the liability with no interest.

> **Memory trick:** "**Due** = **Do** it now" — first payment at commencement → annuity due.

Worked example — finance lease

Example: On January 1, Year 1, Harborview Logistics leases a machine for 5 years with annual payments of $50,000 due **each January 1**, starting at commencement. The machine's fair value is $240,000 and economic life is 8 years. Harborview's incremental borrowing rate is 7% (the implicit rate is not known). It pays initial direct costs of $5,000. There is no transfer of ownership or purchase option. PV of an annuity due (5 periods, 7%) = 4.3872.

Classification:

- Lease liability = 50,000 × 4.3872 = **$219,360**.
- PV test: 219,360 ÷ 240,000 = 91.4% ≥ 90% → **finance lease**. (Term test: 5 ÷ 8 = 62.5% — not met, but one criterion is enough.)

Initial entries:

Account	Debit	Credit
Right-of-use asset	224,360	
Lease liability		219,360
Cash (initial direct costs)		5,000
Lease liability	50,000	
Cash (first payment)		50,000

Year 1:

1. Liability after the first payment = 219,360 − 50,000 = $169,360.
2. Interest expense = 169,360 × 7% = **$11,855**; liability at December 31 = 169,360 + 11,855 = **$181,215** (the next $50,000 payment is due the following day).
3. ROU amortization = 224,360 ÷ 5 = **$44,872** (shorter of lease term and useful life; useful life if ownership transfers or a purchase option is reasonably certain).
4. Total Year 1 expense = 11,855 + 44,872 = **$56,727** — front-loaded, because interest is highest early.

Account	Debit	Credit
Interest expense	11,855	
Lease liability (accrued interest)		11,855
Amortization expense	44,872	
Right-of-use asset (or accumulated amortization)		44,872

Worked example — operating lease

Example: Same facts, but the machine's fair value is $260,000. PV test: 219,360 ÷ 260,000 = 84.4% < 90%, term test 62.5% < 75%, no other criterion → **operating lease**. Initial measurement is identical (ROU $224,360; liability $219,360).

1. **Single straight-line lease cost** = (total payments + initial direct costs) ÷ term = (5 × 50,000 + 5,000) ÷ 5 = **$51,000** per year.
2. The liability is still measured with the effective interest method: Year 1 accretion = **$11,855**; liability at December 31 = **$181,215**.
3. ROU amortization is the **plug**: 51,000 − 11,855 = **$39,145**; ROU asset at December 31 = 224,360 − 39,145 = **$185,215** (= liability 181,215 + unamortized IDC 4,000).

Account	Debit	Credit
Lease cost (operating expense)	51,000	
Lease liability		11,855
Right-of-use asset		39,145

Memory trick: "**O**perating = **O**ne straight line; **F**inance = **F**ront-loaded."

Comparing the two classifications

Item	Finance lease	Operating lease
Balance sheet	ROU asset and lease liability	ROU asset and lease liability (presented separately from finance leases)
Income statement	Interest expense + amortization expense (separately)	Single lease cost, straight-line, in operating expenses
Cash flow statement	Principal → **financing**; interest → operating	All payments → **operating**
ROU amortization	Straight-line	Plug (lease cost − liability accretion)

Residual value guarantees and purchase options

> **Example:** A lessee guarantees that the asset will be worth $20,000 at the end of the lease; it expects the asset to be worth $15,000. Only the **expected shortfall of $5,000** is a lease payment included in the liability. The full $20,000 would be used in the lessor's computations, but not the lessee's.

A purchase option the lessee is reasonably certain to exercise is included at its exercise price, the lease is a finance lease, and the ROU asset is amortized over the asset's **useful life**.

Subsequent changes

- **Remeasure** the liability (with an offsetting ROU adjustment) when the lease term changes, the assessment of a purchase option changes, the amount probable under a residual guarantee changes, or a contingency on variable payments is resolved. A change in an index alone does not trigger remeasurement.
- **Modifications** that grant an additional right of use at a standalone price are separate contracts; others remeasure the existing lease.
- **Impairment:** ROU assets are tested under the long-lived asset impairment model (Chapter 5). After an operating lease ROU asset is impaired, the remaining asset is amortized straight-line and the single-cost pattern no longer applies.

Sale-leaseback (seller-lessee)

If the transfer of the asset qualifies as a **sale** under ASC 606 (and the leaseback is not a finance lease, and there is no repurchase option except at fair value for an asset readily available), the seller-lessee derecognizes the asset, recognizes the gain or loss, and accounts for the leaseback as a lease. If it does not qualify, the seller keeps the asset and records the cash received as a **financing liability**.

Common traps

- Charging Year 1 interest on the full liability when the first payment was made at commencement.
- Including usage- or sales-based variable rent in the liability.
- Including the full residual value guarantee instead of the expected shortfall.
- Amortizing an operating lease ROU asset straight-line.
- Forgetting initial direct costs in the ROU asset (and in operating lease cost).
- Using the implicit rate when it is not readily determinable to the lessee.
- Classifying finance lease principal payments as operating cash flows.

Key takeaways

- Recognize an ROU asset and lease liability for all leases over 12 months (short-term election otherwise).
- Finance lease if any OWNES criterion is met.
- Liability = PV of fixed and index-based payments, reasonably certain purchase options and probable RVG shortfalls.
- ROU = liability + IDC + prepaid rent − incentives.
- Finance: interest + straight-line amortization (front-loaded). Operating: single straight-line cost, ROU amortization is the plug.
- Cash flows: finance principal is financing; operating payments are operating.

10. Income Taxes (ASC 740)

Financial statement income and taxable income differ. ASC 740 handles the difference with an **asset-and-liability approach**: compute the taxes payable for this year (current tax), then measure the future tax effects of today's differences (deferred tax assets and liabilities). Income tax expense is whatever is needed to move the balance sheet from last year's tax position to this year's.

Permanent vs. temporary differences

Type	What happens	Deferred taxes?
Permanent	Item is in book income or taxable income but **never** in the other	**No** — affects current tax and the effective rate only
Temporary	Item is in both, but in **different periods**; the difference between the tax basis and book carrying amount of an asset or liability will reverse	**Yes**

Common permanent differences

Item	Book	Tax
Interest on municipal (state and local) bonds	Income	Never taxable
Fines and penalties for violating the law	Expense	Never deductible
Premiums on key-person life insurance (company is beneficiary)	Expense	Not deductible
Life insurance proceeds on a key person	Gain	Not taxable
Dividends received deduction (DRD)	—	Deduction with no book counterpart
50% of business meals	Expense	Not deductible

Common temporary differences

Item	Effect now	Creates
Accelerated depreciation for tax (book SL)	Taxable income < book income now; more tax later	**Deferred tax liability (DTL)**
Installment sales (book now, tax when collected)	Taxable income < book now	DTL
Prepaid expenses deducted for tax when paid	Taxable income < book now	DTL
Equity-method income in excess of dividends	Taxable later	DTL
Warranty or litigation accruals (book now, tax when paid)	Taxable income > book now	**Deferred tax asset (DTA)**
Allowance for credit losses (tax uses direct write-off)	Taxable income > book now	DTA
Unearned revenue taxed when received (book when earned)	Taxable income > book now	DTA
Net operating loss and tax credit carryforwards	Future deductions or credits	DTA

Memory trick: "Pay later → **L**iability (DTL); pay now → **A**sset later (DTA)." Permanent differences are "forever friends": **F**ines and **F**ree (muni) interest.

The computation

1. Start with pretax financial income.
2. Remove permanent differences → book income subject to tax.
3. Adjust for this year's originating and reversing temporary differences → **taxable income**.
4. **Current tax expense** = taxable income × current rate (minus credits).
5. Measure **ending DTA and DTL** = cumulative temporary differences × **enacted rate for the years they reverse**.
6. **Deferred tax expense (benefit)** = change in DTL − change in DTA (and change in any valuation allowance).
7. **Total income tax expense** = current + deferred.

Example: Fairmont Corp.'s first year of operations. Pretax book income is $500,000, including $20,000 of municipal bond interest and $10,000 of fines. Tax depreciation exceeds book depreciation by $60,000, and book expense includes a $15,000 warranty accrual not yet paid. The enacted tax rate is 25% for all years.

	Amount
Pretax book income	$500,000
− Municipal interest (permanent)	(20,000)
+ Fines (permanent)	10,000
− Excess tax depreciation (temporary)	(60,000)
+ Warranty accrual (temporary)	15,000
Taxable income	**$445,000**

- Current tax expense = 445,000 × 25% = **$111,250**.
- DTL = 60,000 × 25% = **$15,000**; DTA = 15,000 × 25% = **$3,750**.
- Deferred tax expense = 15,000 − 3,750 = **$11,250**.
- Total tax expense = 111,250 + 11,250 = **$122,500**.
- Check: (500,000 − 20,000 + 10,000) × 25% = 490,000 × 25% = $122,500. Temporary differences change only the split between current and deferred; permanent differences change the total.

Account	Debit	Credit
Income tax expense — current	111,250	
Income taxes payable		111,250
Income tax expense — deferred	11,250	
Deferred tax asset	3,750	
Deferred tax liability		15,000

Exam tip: When the rate is flat, check your answer with total tax expense = (pretax income ± permanent differences) × rate. If it does not match, a temporary difference was mishandled.

Enacted rates and rate changes

Measure deferred taxes using the **enacted** rate expected to apply in the year each difference reverses. Do not anticipate future rate changes that are not yet law.

> **Example:** A $90,000 taxable temporary difference will reverse evenly over the next three years. Enacted rates are 25% for Years 2 and 3 and 30% for Year 4. DTL = 30,000 × 25% + 30,000 × 25% + 30,000 × 30% = 7,500 + 7,500 + 9,000 = **$24,000**.

When a new rate is enacted, adjust existing DTA and DTL balances immediately; the effect goes to **income tax expense from continuing operations** in the period of enactment (even if the original deferred tax related to OCI).

> **Example:** A company has a $100,000 taxable temporary difference with a DTL of $20,000 at 20%. A law enacted this year raises the future rate to 25%. DTL becomes $25,000; the **$5,000** increase is deferred tax expense in continuing operations this year.

Valuation allowance

Reduce a DTA with a **valuation allowance** if it is **more likely than not** (a likelihood of more than 50%) that some or all of the DTA will **not** be realized. Evidence includes future reversals of DTLs, projected future taxable income, tax-planning strategies, carryback potential (positive) and cumulative recent losses or expiring carryforwards (negative).

> **Example:** A company has a $40,000 DTA. It concludes that 30% of the related deductions will more likely than not go unused. Valuation allowance = 40,000 × 30% = **$12,000**; net DTA = **$28,000**. The $12,000 increases deferred tax expense.

Net operating losses

Under current federal law, NOLs arising after 2020 are **carried forward indefinitely** (no carryback for most businesses) and can offset only **80%** of taxable income in a later year. The tax benefit of a carryforward is recognized as a **DTA** in the loss year, subject to a valuation allowance.

> **Example:** A company has a $200,000 NOL, an enacted rate of 25% and expects ample future income. DTA = 200,000 × 25% = **$50,000**; the deferred tax benefit reduces the loss-year net loss to $150,000.

Uncertain tax positions

ASC 740 uses a **two-step** approach for positions taken on a tax return:

1. **Recognition:** is it **more likely than not** that the position will be sustained on examination by the taxing authority (assuming the authority has full knowledge)? If not, recognize **no** benefit.
2. **Measurement:** recognize the **largest amount of benefit that is greater than 50% likely** to be realized on settlement (use cumulative probabilities).

The difference between the benefit claimed on the return and the benefit recognized is a **liability for unrecognized tax benefits** (plus interest and penalties, classified per policy).

Example: A company claims a $100,000 deduction benefit that is more likely than not to be sustained. Possible outcomes:

Benefit realized	Probability	Cumulative probability
$100,000	40%	40%
$70,000	25%	**65%**
$50,000	20%	85%
$0	15%	100%

The largest amount whose cumulative probability exceeds 50% is **$70,000**. Recognize a $70,000 benefit and a **$30,000** liability for unrecognized tax benefits. An expected-value calculation is **not** used.

Presentation and allocation

- All DTAs and DTLs are classified as **noncurrent** (ASU 2015-17).
- Within each tax-paying component and jurisdiction, DTAs and DTLs are **netted** to one noncurrent amount; balances from different jurisdictions are not offset.
- **Intraperiod tax allocation:** tax is allocated to continuing operations, discontinued operations, OCI and items charged directly to equity (such as prior-period adjustments). Each item below continuing operations is shown **net of its own tax**.
- Disclosures include the components of tax expense, the types of temporary differences and carryforwards, and a reconciliation of the statutory rate to the effective rate (expanded for public entities by ASU 2023-09).

Common traps

- Recording deferred taxes on permanent differences.
- Using today's rate when a different future rate has been enacted.
- Using expected value (or the most likely outcome) for an uncertain tax position.

- Treating an increase in a DTA as deferred tax **expense** — it is a benefit.
- Classifying any part of a DTA or DTL as current.
- Netting deferred taxes across different tax jurisdictions.

Key takeaways

- Temporary differences create DTAs and DTLs; permanent differences never do.
- Total tax expense = current tax + change in DTL − change in DTA (± valuation allowance changes).
- Use enacted rates for reversal years; rate changes hit continuing operations when enacted.
- Valuation allowance when realization is not more likely than not.
- UTPs: recognize if more likely than not; measure the largest amount > 50% cumulatively likely.
- All deferred taxes are noncurrent and netted by jurisdiction.

11. Equity and Earnings per Share

Equity questions test one principle again and again: **transactions with owners never create income statement gains or losses**. Issuing stock, buying it back, reissuing it and declaring dividends all move amounts among equity accounts. Earnings per share (EPS) then measures income available to common shareholders per common share, basic and diluted. FAR also tests partnership capital accounts.

Components of stockholders' equity

Component	Includes
Contributed capital	Preferred and common stock at par (or stated value); additional paid-in capital (APIC) from issuance above par, treasury stock transactions, warrants, stock dividends
Retained earnings	Cumulative net income − dividends ± prior-period adjustments; may be appropriated (restricted) by the board
Accumulated other comprehensive income	Unrealized AFS gains and losses, translation adjustments and other OCI items
Treasury stock	Contra-equity (cost method)
Noncontrolling interest	In consolidated statements, shown in equity separately from parent equity

Issuing stock

Situation	Accounting
Cash issuance	Cash; common stock at par; excess to APIC
No-par stock with a stated value	Treat stated value like par
No-par stock without a stated value	Entire proceeds to common stock
Stock issued for property or services	Fair value of the stock or of what is received, whichever is more clearly evident
Lump-sum issuance of two classes	Allocate by relative fair values (or incremental method if only one is known)
Stock issue costs	Reduce APIC (not expensed)
Stock subscriptions	Subscriptions receivable is generally shown as a **reduction of equity** (contra-equity), not an asset

Example: A company issues 10,000 shares of $1 par common stock at $15 per share, paying $4,000 of issue costs. Debit cash $146,000; credit common stock $10,000 and APIC $136,000 (150,000 − 10,000 − 4,000).

Treasury stock (cost method)

1. **Purchase:** debit treasury stock at cost.
2. **Reissue above cost:** credit the excess to **APIC — treasury stock**.
3. **Reissue below cost:** debit APIC — treasury stock to the extent of its balance, then **retained earnings**.
4. **Retirement:** remove par and the original APIC for those shares; any excess cost reduces APIC — treasury stock and then retained earnings.

Example: Wexford Inc. buys 1,000 of its shares at $30. It later reissues 400 shares at $35 and then 300 shares at $26.

Transaction	Account	Debit	Credit
Buy 1,000 at $30	Treasury stock	30,000	
	Cash		30,000
Reissue 400 at $35	Cash	14,000	
	Treasury stock		12,000
	APIC — treasury stock		2,000
Reissue 300 at $26	Cash	7,800	
	APIC — treasury stock	1,200	
	Treasury stock		9,000

The $1,200 "loss" is absorbed by the $2,000 APIC — treasury stock balance; none of it touches net income. Treasury stock remaining: 300 shares × $30 = $9,000.

Treasury shares are issued but **not outstanding**: they get no dividends, no votes and are excluded from EPS.

Dividends

Dividend	Measured at	Entry at declaration
Cash	Amount declared	Dr retained earnings, Cr dividends payable
Property	**Fair value** of the property; first remeasure the asset and recognize a gain or loss in income	Dr retained earnings, Cr property dividends payable
Scrip (note)	Face of the note; interest on the note is expense	Dr retained earnings, Cr notes payable
Liquidating (return of capital)	Amount beyond retained earnings	Dr APIC
Small stock dividend (< 20–25% of shares)	**Fair value** of shares	Dr retained earnings, Cr common stock dividend distributable (par), Cr APIC
Large stock dividend (> 20–25%)	**Par value**	Dr retained earnings, Cr common stock dividend distributable
Stock split	No entry (memo); par per share changes	—

Key dates: **declaration** (liability arises for cash or property dividends), **record** (no entry) and **payment**. Stock dividend distributable is equity, not a liability.

Example: A company with 100,000 shares of $1 par stock outstanding declares a 10% stock dividend when the market price is $18. Small dividend → fair value: retained earnings debit = 10,000 × $18 = **$180,000**; common stock distributable $10,000; APIC $170,000. A 30% dividend would instead be recorded at par: 30,000 × $1 = **$30,000**.

Example: A company distributes land with a carrying amount of $40,000 and a fair value of $55,000 as a property dividend. It first recognizes a **$15,000 gain** in income, then debits retained earnings for **$55,000**.

Memory trick: "**S**mall at **F**air, **L**arge at **P**ar."

Preferred stock features

- **Cumulative:** unpaid dividends (dividends in arrears) must be paid before common gets anything. Arrears are **disclosed**, not a liability, until declared.
- **Participating:** shares in dividends beyond the stated rate with common.

- **Convertible**, **callable** and **mandatorily redeemable**: mandatorily redeemable preferred stock is a **liability**.

Earnings per share

Public entities present basic and diluted EPS on the face of the income statement for income from continuing operations and net income (and discontinued operations, on the face or in the notes).

Basic EPS

Basic EPS = (net income − preferred dividends) ÷ weighted-average common shares outstanding.

- **Preferred dividends:** subtract the current year's dividend on **cumulative** preferred **whether or not declared**; on noncumulative preferred, subtract only dividends declared.
- **Weighted-average shares:** time-weight issuances and repurchases; apply **stock dividends and splits retroactively** to the beginning of the year (and to all periods presented) — including shares issued before the dividend.

Example: Tremont Corp. reports net income of $1,200,000. It has 5,000 shares of $100 par, 6% cumulative nonconvertible preferred stock (no dividends declared this year). Common share activity:

Date	Event	Shares	Restated for stock dividend	Months	Weighted
Jan 1	Outstanding	400,000	× 1.10	12/12	440,000
Apr 1	Issued for cash	60,000	× 1.10	9/12	49,500
Jul 1	10% stock dividend	—	(applied above)	—	—
Oct 1	Treasury purchase	(40,000)	—	3/12	(10,000)
	Weighted average				**479,500**

1. Preferred dividends = 5,000 × $100 × 6% = $30,000 (deducted although undeclared — the stock is cumulative).
2. Basic EPS = (1,200,000 − 30,000) ÷ 479,500 = **$2.44**.

Diluted EPS

Add potential common shares that would **reduce** EPS:

Security	Method	Numerator	Denominator
Options and warrants	**Treasury stock method** — assume exercise and buyback at the **average market price** for the period	No change	+ shares issued − shares repurchased (only if in the money)
Convertible bonds	**If-converted method**	+ interest expense **net of tax**	+ shares on conversion (from the start of the year or the issue date)
Convertible preferred	If-converted method	+ preferred dividends previously subtracted	+ shares on conversion
Contingently issuable shares	Include if conditions are currently met	—	+ shares

Rank securities by **incremental EPS** (numerator effect ÷ share effect), add them one at a time starting with the most dilutive, and stop when adding one would increase EPS (it is **antidilutive**). The "control number" for dilution is **income from continuing operations**. If there is a loss from continuing operations, all potential shares are antidilutive.

Example (continued): Tremont also has (a) 50,000 options exercisable at $20, with an average market price of $25 for the year, and (b) $1,000,000 of 6% convertible bonds outstanding all year, convertible into 40,000 shares. The tax rate is 25%.

1. **Options:** proceeds = 50,000 × 20 = $1,000,000; shares repurchased = 1,000,000 ÷ 25 = 40,000; incremental shares = 50,000 − 40,000 = **10,000** (incremental EPS = $0 — most dilutive).
2. **Bonds:** after-tax interest = 1,000,000 × 6% × (1 − 0.25) = **$45,000**; incremental EPS = 45,000 ÷ 40,000 = $1.125.
3. With options: 1,170,000 ÷ (479,500 + 10,000) = **$2.39**.
4. Add bonds ($1.125 < $2.39, so dilutive): (1,170,000 + 45,000) ÷ (489,500 + 40,000) = 1,215,000 ÷ 529,500 = **$2.29**.

Diluted EPS = **$2.29**; basic EPS = $2.44.

Memory trick: Treasury stock method — "**Average** is the answer." If-converted — add back **after-tax** interest.

Partnerships

Formation and income allocation

Partners' noncash contributions are recorded at **fair value** (net of any liabilities assumed by the partnership). Income is allocated according to the partnership agreement; if the agreement is silent, **equally**. A typical agreement allocates in this order: **salaries**, **interest on capital**, then the **residual** in the profit-and-loss ratio (even if the residual is negative).

Example: Partners Avery and Blake have beginning capital of $60,000 and $40,000. The agreement gives salaries of $30,000 (Avery) and $20,000 (Blake), 10% interest on beginning capital, and the residual 60:40. Net income is $90,000.

	Avery	Blake	Total
Salaries	$30,000	$20,000	$50,000
Interest (10%)	6,000	4,000	10,000
Residual 60:40 (90,000 − 60,000 = 30,000)	18,000	12,000	30,000
Total	**$54,000**	**$36,000**	**$90,000**

Admission of a new partner

Method	Treatment
Purchase of an existing partner's interest	Transfer capital between partners; partnership assets unchanged
Investment — **bonus method**	New total capital = old capital + investment; new partner's capital = ownership % × new total; difference is a bonus credited (or charged) to old partners in their P&L ratio (or to the new partner)
Investment — **goodwill method**	Implied total value from the price paid; record goodwill to the old (or new) partners

Example: Cole invests $65,000 for a one-fourth interest in the Avery-Blake partnership (capital $60,000 + $40,000). Using the bonus method: total capital = 100,000 + 65,000 = $165,000; Cole's capital = 165,000 × 1/4 = **$41,250**; bonus to old partners = 65,000 − 41,250 = **$23,750**, shared 60:40 — Avery $14,250 and Blake $9,500.

On **withdrawal**, a payment above the withdrawing partner's capital is a bonus charged to the remaining partners (bonus method). On **liquidation**, sell assets, allocate gains and

losses, pay creditors, then pay partners according to their capital balances; a partner with a deficit must contribute or the deficit is absorbed by the others.

Common traps

- Time-weighting a stock split or stock dividend instead of applying it retroactively.
- Using the year-end price in the treasury stock method.
- Recording treasury stock gains or losses in net income.
- Adding back pretax interest under the if-converted method.
- Forgetting to subtract undeclared cumulative preferred dividends — or subtracting undeclared noncumulative ones.
- Recording a property dividend at book value without remeasuring the property.
- Allocating partnership income only by the P&L ratio when salaries and interest are specified.

Key takeaways

- Owner transactions never create gains or losses; treasury reissue differences go to APIC — TS and then retained earnings.
- Small stock dividends at fair value, large at par; splits need no entry.
- Property dividends: remeasure to fair value, recognize the gain or loss, then declare.
- Basic EPS = (NI − preferred dividends) ÷ weighted shares; splits and stock dividends are retroactive.
- Diluted EPS: treasury stock method (average price) and if-converted method (after-tax interest); exclude antidilutive securities; test against continuing operations.
- Partnerships: salaries, interest, then residual; bonus method keeps total capital equal to contributions.

12. Statement of Cash Flows

The statement of cash flows (ASC 230) explains the change in **cash, cash equivalents and restricted cash** during the period by sorting every cash receipt and payment into operating, investing or financing activities. FAR tests classification constantly and computations heavily: the indirect-method reconciliation, direct-method line items and reconstructions of PP&E, debt and dividends.

The three categories (U.S. GAAP)

Operating	Investing	Financing
Cash from customers	Purchase and sale of PP&E and intangibles	Issuing stock; buying treasury stock
Cash paid to suppliers and employees	Purchase and sale of debt and equity securities of other entities (**not** trading or cash equivalents)	Borrowing and repaying principal on bonds, notes and loans
Interest paid and **interest received**	Making loans and collecting their principal	**Dividends paid**
Dividends received	Purchase of a business (net of cash acquired)	**Finance lease principal** payments
Income taxes paid	Insurance proceeds for damaged PP&E	Debt issue costs; debt prepayment and extinguishment costs
Operating lease payments; short-term and variable lease payments		Contingent consideration paid soon after an acquisition (up to the acquisition-date liability)
Purchases and sales of **trading** securities		
Insurance proceeds for inventory or business interruption		

Memory trick: U.S. GAAP interest — "**In or out, it's operating.**" Dividends — "**Received = Operating, Paid = Financing.**"

Watch out: IFRS allows choices for interest and dividends (for example, interest paid as financing). On FAR, the U.S. GAAP classification is the expected answer unless the question says IFRS.

Noncash investing and financing activities

Transactions that affect assets, liabilities or equity but involve **no cash** are **disclosed** separately (in a schedule or note), not in the body of the statement:

- Converting bonds or preferred stock into common stock
- Acquiring land or equipment by issuing a note or stock
- Obtaining an ROU asset in exchange for a new lease liability
- Exchanging one noncash asset for another

If part of a purchase is paid in cash, only the cash part goes in investing; the financed part is disclosed.

Operating activities — indirect method

Start with net income and remove everything that did not involve operating cash:

Adjustment	Direction
Depreciation, amortization, depletion, impairment losses	**Add** back
Losses on sales of PP&E or investments; loss on extinguishment of debt	**Add** back (the full proceeds go to investing/financing)
Gains on sales; gain on extinguishment	**Subtract**
Amortization of bond **discount** (payable)	Add (interest expense exceeds cash paid)
Amortization of bond **premium** (payable)	Subtract
Equity-method income in excess of dividends received	Subtract
Deferred tax expense (increase in net DTL)	Add
Increase in operating **current assets** (receivables, inventory, prepaids)	**Subtract**
Decrease in operating current assets	Add
Increase in operating **current liabilities** (payables, accruals, unearned revenue)	**Add**
Decrease in operating current liabilities	Subtract

> **Memory trick:** "**A**ssets **U**p, **C**ash **D**own." "**G**ains **G**o away, **L**osses **L**ift."

Example: Westbrook Corp. reports net income of $150,000, including depreciation of $40,000 and an $8,000 gain on the sale of equipment. Working capital changes: accounts receivable +$12,000; inventory −$5,000; accounts payable +$7,000; prepaid expenses +$2,000; accrued liabilities −$3,000.

Item	Amount
Net income	$150,000
+ Depreciation	40,000
− Gain on sale of equipment	(8,000)
− Increase in accounts receivable	(12,000)
+ Decrease in inventory	5,000
+ Increase in accounts payable	7,000
− Increase in prepaid expenses	(2,000)
− Decrease in accrued liabilities	(3,000)
Net cash from operating activities	**$177,000**

Operating activities — direct method

The direct method lists major classes of operating receipts and payments. The FASB encourages it, but a business using it must **also** present the indirect reconciliation of net income to operating cash flow.

Line	Formula
Cash from customers	Sales − increase in A/R (+ decrease) + increase in unearned revenue (− decrease)
Cash paid to suppliers	COGS + increase in inventory (− decrease) − increase in A/P (+ decrease)
Cash paid for operating expenses	Expense + increase in prepaids − increase in accrued liabilities − noncash expenses
Cash paid for interest	Interest expense − discount amortization (+ premium amortization) + decrease in interest payable (− increase)
Cash paid for income taxes	Tax expense − increase in taxes payable (+ decrease) − increase in net DTL (+ decrease)

Example: Westbrook's sales were $800,000, accounts receivable rose $12,000 and unearned revenue rose $4,000. COGS was $500,000, inventory fell $5,000 and accounts payable rose $7,000.

- Cash from customers = 800,000 − 12,000 + 4,000 = **$792,000**.
- Purchases = 500,000 − 5,000 = $495,000; cash paid to suppliers = 495,000 − 7,000 = **$488,000**.

Example: Interest expense is $30,000, including $1,000 of bond discount amortization, and interest payable fell by $2,000. Cash paid for interest = 30,000 − 1,000 + 2,000 = **$31,000**. Income tax expense is $40,000; taxes payable rose $5,000 and the DTL rose $3,000. Cash paid for taxes = 40,000 − 5,000 − 3,000 = **$32,000**.

Investing and financing — reconstructions

Exam items often give beginning and ending balances and ask for the cash amount. Reconstruct the T-account.

Example: Westbrook sold equipment that cost $60,000 and had accumulated depreciation of $45,000, at an $8,000 gain. Proceeds = book value + gain = (60,000 − 45,000) + 8,000 = **$23,000** (investing inflow). It also bought new equipment for $120,000 cash.

Example: Westbrook declared dividends of $50,000. Dividends payable were $6,000 at the beginning of the year and $9,000 at the end. Dividends paid = 6,000 + 50,000 − 9,000 = **$47,000** (financing outflow).

Putting the pieces together (Westbrook also issued $100,000 of bonds for cash):

Section	Amount
Net cash from operating activities	$177,000
Investing: proceeds from sale of equipment	23,000
Investing: purchase of equipment	(120,000)
Net cash used in investing activities	(97,000)
Financing: issuance of bonds	100,000
Financing: dividends paid	(47,000)
Net cash from financing activities	53,000
Net increase in cash, cash equivalents and restricted cash	**$133,000**

Specific classification rules worth memorizing

Item	Classification
Distributions from equity-method investees	Operating up to cumulative equity income (cumulative earnings approach); excess is investing (return of investment)
Proceeds from corporate-owned life insurance settlements	Investing; premiums paid may be investing, operating or a combination
Debt prepayment or extinguishment costs (call premiums)	Financing
Settlement of zero-coupon bonds	Interest portion (accreted) → operating; principal → financing
Contingent consideration paid **soon after** an acquisition	Investing; paid later: financing up to the acquisition-date fair value, excess operating
Cash overdrafts (book)	Usually financing when the change is reported
Purchases of securities classified by nature (trading)	Operating
Cash flows from hedging (BAR detail)	Generally same category as the hedged item
Restricted cash transfers	Not cash flows — restricted cash is part of the totals

Required disclosures: interest paid (net of amounts capitalized) and income taxes paid (if using the indirect method), noncash investing and financing activities, and the policy for cash equivalents. A **cash flow per share** figure may **not** be reported.

Common traps

- Reversing the sign on working capital changes.
- Classifying interest paid as financing under U.S. GAAP.
- Including noncash transactions (bonds converted to stock, assets bought with a note) in the investing or financing totals.
- Putting the gain on sale, rather than the full proceeds, in investing.
- Using dividends declared instead of dividends paid.
- Forgetting that a direct-method statement still needs the indirect reconciliation.
- Adding premium amortization back instead of subtracting it.

Key takeaways

- Statement explains the change in cash, cash equivalents **and restricted cash**.
- U.S. GAAP: interest paid/received and dividends received are operating; dividends paid are financing.
- Indirect method: add noncash expenses and losses, subtract gains, adjust for working capital (assets up → cash down; liabilities up → cash up).
- Direct method lines adjust each income statement item for related balance sheet changes.
- Reconstruct PP&E, debt and dividend accounts to find cash amounts.
- Noncash investing and financing activities are disclosed, not shown in the body.

13. Accounting Changes and Error Corrections

ASC 250 sorts every change into one of four boxes, and each box has its own treatment. Classify first; the accounting follows automatically.

The four categories

Category	Examples	Treatment
Change in accounting principle	Average cost → FIFO; full-cost → successful-efforts; adopting a new ASU (per its transition rules)	**Retrospective**: restate all prior periods presented; cumulative effect on earlier periods adjusts **opening retained earnings** of the earliest period presented
Change in accounting estimate	Useful life, salvage value, credit loss rates, warranty costs, inventory obsolescence	**Prospective**: current and future periods only; no restatement
Change in estimate effected by a change in principle	Change in **depreciation method** (SL → DDB)	Prospective, like an estimate change, but must be **preferable**
Change in reporting entity	Consolidating a subsidiary not previously consolidated; changing which subsidiaries are included	Retrospective
Error correction	Math mistakes, misapplying GAAP, oversight, using a non-GAAP method (cash basis → accrual)	**Restatement**: prior-period adjustment to opening retained earnings, **net of tax**

Memory trick: "**P**rinciple = **P**ast (retrospective); **E**stimate = **E**xpected future (prospective); **E**rror = **E**rase and restate." "Depreciation method = an estimate in disguise."

Watch out: Moving from a method that is **not** GAAP (cash basis, direct write-off of material bad debts) to GAAP is an **error correction**, not a change in principle.

Change in accounting principle

- A voluntary change must be justified as **preferable**; a change required by a new ASU follows the ASU's transition method.
- Only **direct effects** (for example, the inventory balance and related deferred taxes) are restated; **indirect effects** (such as profit-sharing bonuses computed on restated income) are recognized in the period of the change.
- If retrospective application is **impracticable** for all prior periods, apply the new principle prospectively from the earliest date practicable. The classic example is a change **to LIFO**: base-year layers cannot be reconstructed, so the beginning inventory of the change year becomes the first LIFO layer.

Example: At the start of 2026, Ellison Co. changes from average cost to FIFO. Prior-year income would have been $50,000 higher (pretax) under FIFO. The tax rate is 25%, and the change is also made for tax purposes.

- Cumulative effect, net of tax = 50,000 × (1 − 0.25) = **$37,500** credited to opening retained earnings of the earliest period presented.
- Comparative statements for 2025 are restated to FIFO.

Account	Debit	Credit
Inventory	50,000	
Income taxes payable (or DTL)		12,500
Retained earnings		37,500

Change in accounting estimate

No catch-up adjustment. Take the **book value at the date of the change**, subtract the new salvage value and spread it over the **remaining** life.

Example: Equipment bought January 1, 2023 for $100,000 (salvage $10,000, 10-year life, straight-line). At the beginning of 2026 the company revises the total life to 8 years (5 years remaining) and salvage to $4,000.

1. Accumulated depreciation through 2025 = (100,000 − 10,000) ÷ 10 × 3 = $27,000; book value = **$73,000**.
2. New annual depreciation = (73,000 − 4,000) ÷ 5 = **$13,800** for 2026 through 2030.
3. Prior years are not touched.

The same approach applies when the depreciation method changes: compute book value at the change date and apply the new method over the remaining life. Disclose the effect

on income from continuing operations, net income and EPS if material.

Error corrections

1. Determine the effect of the error on prior periods' income (pretax).
2. Apply the tax effect → net-of-tax prior-period adjustment.
3. Adjust **opening retained earnings** of the earliest period presented, and restate any comparative periods shown.
4. Disclose the nature of the error and its effect on each line item and per-share amount.

Example: In 2026 Pryor Corp. discovers that 2025 depreciation of $20,000 was never recorded (for books or taxes). The tax rate is 25%. The 2025 statements are presented for comparison.

- Restate 2025: depreciation +$20,000; net income −$15,000.
- Opening 2026 retained earnings decreases by 20,000 × 75% = **$15,000**.

Account	Debit	Credit
Retained earnings (prior-period adjustment)	15,000	
Income tax refund receivable	5,000	
Accumulated depreciation		20,000

Counterbalancing and non-counterbalancing errors

Error type	Examples	Behavior
Counterbalancing	Inventory errors; failure to accrue wages, interest or revenue at year-end; prepaid expenses expensed	Self-correct over two years; if found after the second year's books are closed, retained earnings is already correct (but comparative statements are still restated)
Non-counterbalancing	Capitalizing an expense; omitting depreciation; recording a capital expenditure as repairs	Do not self-correct until the asset is fully depreciated or sold

Example: Ending inventory for 2025 was overstated by $30,000 (ignore taxes).

	2025	2026
Cost of goods sold	Understated $30,000	Overstated $30,000
Net income	**Overstated** $30,000	**Understated** $30,000
Retained earnings, end of year	Overstated $30,000	**Correct**

If discovered during 2026 before the books are closed, record: debit retained earnings $30,000, credit inventory (beginning) $30,000.

Working backward from multiple errors

For a schedule of several errors, set up columns for each year's net income and the ending retained earnings effect, then add each error's effect. Remember that an **accrual omitted at the end of Year 1** affects Year 1 income one way and Year 2 income the opposite way.

Disclosures and presentation

Change	Key disclosures
Principle	Nature and reason (why preferable), method of applying it, effect on income, EPS and retained earnings, indirect effects
Estimate	Effect on income from continuing operations, net income and EPS if material (not needed for routine estimates like credit losses unless material)
Error	Nature of the error, effect on each line item and EPS, cumulative effect on retained earnings
Reporting entity	Nature and reason, effect on income and EPS for all periods presented

Interim periods: a change in principle made in an interim period is applied retrospectively to the earlier interim periods of the year.

Common traps

- Restating prior years for a change in useful life or salvage value.
- Treating a depreciation method change as retrospective.
- Forgetting the tax effect on prior-period adjustments.
- Calling a change from cash basis to accrual a change in principle.
- Running the prior-period adjustment through current-year income.
- Spreading the revised depreciable base over the **original** total life instead of the remaining life.

Key takeaways

- Principle and reporting entity changes: retrospective; adjust opening retained earnings of the earliest period presented.
- Estimates (including depreciation method changes): prospective; book value − new salvage over remaining life.
- Change to LIFO: usually prospective (impracticable to apply retrospectively).
- Errors: restate prior periods; prior-period adjustment net of tax.
- Inventory and accrual errors counterbalance after two years; depreciation and capitalization errors do not.

14. Fair Value, Foreign Currency and Subsequent Events

Three short but heavily tested topics: how fair value is measured (ASC 820), how foreign currency transactions and statements are handled (ASC 830), and what to do with events after the balance sheet date (ASC 855).

Fair value measurement (ASC 820)

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date — an **exit price**, from the perspective of market participants, not the entity's own intentions.

Concept	Rule
Which market	The **principal market** (greatest volume and level of activity for the asset). Only if there is no principal market, the **most advantageous market** (best net amount after transaction and transport costs)
Transaction costs	**Not** part of fair value; used only to identify the most advantageous market
Transportation costs	**Deducted** from the price to get fair value (location is a characteristic of the asset)
Nonfinancial assets	Measured at **highest and best use** — physically possible, legally permissible and financially feasible — even if the entity uses the asset differently
Liabilities	Assume the liability is **transferred** (not settled); include nonperformance risk (own credit)
Blockage factors	Not applied to Level 1 instruments (price × quantity)

Example: An asset trades in two markets, and the entity can access both.

	Market A	Market B
Price	$48	$50
Transaction costs	(3)	(6)
Transport costs	(2)	(3)
Net received	**$43**	$41
Fair value (price − transport)	$46	$47

- **No principal market:** Market A is most advantageous (net $43 > $41), so fair value = 48 − 2 = **$46**.
- **If Market B is the principal market:** fair value = 50 − 3 = **$47**, even though Market A nets more.

Memory trick: Fair value "leaves out the **transaction toll** but keeps the **transport truck**."

Valuation techniques and the hierarchy

Techniques: **market approach** (prices of identical or comparable items), **income approach** (present value, option pricing models) and **cost approach** (current replacement cost).

Level	Inputs	Examples
Level 1	Quoted prices for **identical** items in **active** markets, unadjusted	Exchange-traded stock
Level 2	Other **observable** inputs	Quoted prices for similar items; quoted prices in inactive markets; interest rate yield curves; credit spreads
Level 3	**Unobservable** inputs reflecting the entity's own assumptions	Discounted cash flow forecasts for a private company; a model using internal estimates

The whole measurement is categorized at the **lowest level of any significant input**. Level 3 measurements need the most disclosure (including a rollforward for recurring measurements, for public entities).

Foreign currency transactions

A **transaction** denominated in a foreign currency (buying or selling on credit in euros) is recorded in dollars at the **spot rate on the transaction date**. Monetary items (receivables, payables) are **remeasured at each balance sheet date** and at settlement; the change is a **transaction gain or loss in net income** — never deferred and never in OCI.

Position	Foreign currency strengthens (more $ per unit)	Weakens
Receivable in foreign currency	Gain	Loss
Payable in foreign currency	**Loss**	Gain

Example: On November 1, Coastal Imports buys inventory for €100,000, payable February 1. Exchange rates ($ per €): November 1, 1.08; December 31, 1.11; February 1, 1.09.

Date	Account	Debit	Credit
Nov 1	Inventory	108,000	
	Accounts payable (€)		108,000
Dec 31	Foreign currency transaction loss	3,000	
	Accounts payable (€)		3,000
Feb 1	Accounts payable (€)	111,000	
	Foreign currency transaction gain		2,000
	Cash		109,000

Year 1 loss = 100,000 × (1.11 − 1.08) = **$3,000**; Year 2 gain = 100,000 × (1.11 − 1.09) = **$2,000**. Inventory stays at $108,000 — the rate change affects only the payable.

Memory trick: "**Owe** more = **lose**" — a payable in a currency that rises costs more dollars.

Foreign currency financial statements

A foreign subsidiary's statements must be converted to the parent's reporting currency. The method depends on the subsidiary's **functional currency** (the currency of its primary economic environment).

Situation	Method	Rates	Difference goes to
Functional currency = local currency	**Translation** (current rate method)	Assets and liabilities at the **current** (year-end) rate; income items at the rate when recognized (weighted average allowed); equity at historical rates	**Cumulative translation adjustment in OCI**
Functional currency = U.S. dollar (books kept in local currency)	**Remeasurement** (temporal method)	Monetary items at current rate; nonmonetary items (inventory at cost, PP&E, equity) at **historical** rates; related expenses (COGS, depreciation) at historical	**Net income**
Highly inflationary economy (cumulative 3-year inflation ≈ 100% or more)	Remeasure as if the functional currency were the reporting currency	Temporal	Net income

If books are kept in a currency that is neither the functional nor the reporting currency, **remeasure** into the functional currency first, then **translate** into the reporting currency. The cumulative translation adjustment is recycled to net income when the foreign entity is sold or substantially liquidated.

Subsequent events (ASC 855)

Events after the balance sheet date but before the statements are issued (or available to be issued) fall into two types:

Type	Test	Treatment	Examples
Recognized (Type I)	The **condition existed** at the balance sheet date	**Adjust** the financial statements	Settlement of a lawsuit filed before year-end; customer bankruptcy that reveals a year-end receivable was uncollectible due to a deteriorating condition; sale of inventory below year-end carrying amount confirming NRV
Nonrecognized (Type II)	The condition **arose after** the balance sheet date	**Disclose** if needed to keep the statements from being misleading; no adjustment	Fire, flood or casualty loss after year-end; issuing stock or bonds; business combination; lawsuit for an event after year-end; changes in market prices of investments; a customer's bankruptcy caused by a post-year-end disaster

Evaluation period: SEC filers (and conduit bond obligors) evaluate subsequent events through the date the statements are **issued** and do not disclose that date. Other entities evaluate through the date the statements are **available to be issued** and **disclose** that date.

Stock dividends or splits after year-end but before issuance are applied **retroactively** to EPS for all periods presented, with disclosure. Revised statements reissued later disclose the date through which subsequent events were evaluated in both the original and revised statements.

> **Memory trick:** "**Before** = **Book** it; **After** = **Announce** it." Ask when the underlying **condition** arose, not when the news arrived.

> **Example:** A customer owing $80,000 at December 31 files for bankruptcy on February 5, before the statements are issued, because of losses it had been suffering all year → **adjust** the allowance for credit losses. If the bankruptcy had been caused by a warehouse fire on January 20 → **disclose** only.

Common traps

- Deducting transaction costs from fair value.
- Using the most advantageous market when a principal market exists.
- Classifying a measurement by its most significant observable input instead of the lowest-level significant input.
- Deferring foreign currency transaction gains or losses until settlement, or putting them in OCI.
- Restating the inventory cost for later exchange rate changes.

- Adjusting the statements for a post-year-end fire, stock issuance or market decline.

Key takeaways

- Fair value = exit price in the principal (else most advantageous) market; subtract transport, not transaction costs.
- Hierarchy: Level 1 identical/active, Level 2 observable, Level 3 unobservable; categorize by the lowest significant input.
- FX transactions: remeasure monetary items at each balance sheet date; gains and losses in net income.
- Translation (local functional currency) → CTA in OCI; remeasurement (dollar functional currency) → net income.
- Subsequent events: condition at year-end → adjust; condition after → disclose. SEC filers evaluate through issuance; others through available-to-be-issued and disclose the date.

15. Consolidated Financial Statements

Consolidated statements present a parent and its subsidiaries as **one economic entity**. FAR tests the acquisition-date analysis (fair values, goodwill and noncontrolling interest), the core eliminations (investment, intercompany balances, intercompany sales and unrealized profit) and the split of consolidated net income between the parent and the noncontrolling interest (NCI). Complex combination issues are BAR topics.

When to consolidate

Model	Consolidate when
Voting interest model	The parent has a **controlling financial interest**, usually ownership of **more than 50%** of the voting shares (directly or indirectly)
Variable interest entity (VIE) model	The reporting entity is the **primary beneficiary**: it has the power to direct the activities that most significantly affect the VIE's performance **and** the obligation to absorb losses or right to receive benefits that could be significant

Do **not** consolidate when control does not rest with the majority owner (the subsidiary is in legal reorganization or bankruptcy, or under severe foreign government restrictions). **Combined statements** (no parent-subsidiary relationship, such as companies under common control by one individual) add the entities together and eliminate intercompany items the same way.

The acquisition method

1. **Identify the acquirer** and the **acquisition date** (when control is obtained).
2. Measure **consideration transferred** at fair value (cash, shares issued, contingent consideration at fair value).
3. Recognize **identifiable assets and liabilities** at **fair value** — including intangibles the acquiree never recorded (customer lists, trademarks, in-process R&D).
4. Measure the **NCI** at fair value.
5. Compute goodwill or a bargain purchase gain.

Goodwill = consideration transferred + fair value of NCI (+ fair value of any previously held interest) − fair value of identifiable net assets.

If the result is negative, reassess the measurements; any remaining excess is a **bargain purchase gain** recognized in the acquirer's **net income**.

Cost	Treatment
Legal, accounting, valuation and finder's fees	**Expense** in the period incurred
Stock registration and issue costs	Reduce APIC
Debt issue costs	Reduce the carrying amount of the debt

Memory trick: Goodwill = "**C + N − F**": Consideration + NCI − Fair value of net assets.

Example: On January 1, Pinnacle Corp. pays $800,000 cash for 80% of Summit Co. The fair value of the 20% NCI is $200,000. Summit's identifiable net assets have a book value of $800,000; the only difference from fair value is a building undervalued by $100,000 (10-year remaining life). Pinnacle also pays $25,000 of legal fees.

Item	Amount
Consideration transferred	$800,000
+ Fair value of NCI	200,000
= Fair value of the subsidiary as a whole	$1,000,000
− Fair value of identifiable net assets (800,000 + 100,000)	(900,000)
Goodwill	**$100,000**

The $25,000 legal fees are expensed. On the consolidated balance sheet at acquisition: Summit's assets and liabilities at fair value, goodwill $100,000 and NCI $200,000 in equity.

The elimination process

The parent keeps an investment account (often at cost or under the equity method) in its own books. On the consolidation worksheet:

Elimination	Purpose
Investment in subsidiary vs. subsidiary's equity; record fair value adjustments, goodwill and NCI	Avoid double counting the subsidiary's net assets
Amortize fair value adjustments (extra depreciation on stepped-up assets)	Adjust the subsidiary's income to an acquisition-date fair value basis
Intercompany receivables and payables, loans, interest income and expense	One entity cannot owe itself
Intercompany dividends	Dividends paid to the parent are not income to the group
Intercompany sales and purchases	Remove 100% of the intercompany revenue and cost
Unrealized profit in ending inventory	Defer profit until goods are sold to outsiders
Intercompany gains on sales of PP&E	Eliminate the gain; restore the asset to original cost; realize the gain through reduced depreciation

> **Memory trick:** "**Eliminate 100%, attribute by %.**" Intercompany items are eliminated in full regardless of ownership; only the NCI's **share** of adjusted subsidiary income depends on the percentage.

Intercompany inventory

Unrealized profit = intercompany goods still on hand at year-end × gross profit % (on the selling price).

- **Downstream** (parent sells to subsidiary): the parent's profit is deferred; the NCI is not affected.
- **Upstream** (subsidiary sells to parent): the subsidiary's profit is deferred; the deferral reduces the subsidiary's income that is shared with the NCI.

Consolidated COGS = combined COGS − intercompany sales + unrealized profit in ending inventory (− unrealized profit in beginning inventory realized this year).

> **Memory trick:** "**Up** the stream, **share** the dream" — upstream adjustments are shared with the NCI.

Consolidated net income and the NCI

Example (continued): During the first year, Pinnacle's own income (excluding any income from Summit) is $400,000, and Summit reports net income of $150,000. Summit sold goods to Pinnacle for $100,000 at a 30% gross profit; 40% of these goods are still in Pinnacle's inventory at year-end. Combined COGS before eliminations: Pinnacle $600,000, Summit $300,000.

1. Extra depreciation on the building step-up = 100,000 ÷ 10 = $10,000.
2. Unrealized profit (upstream) = 100,000 × 40% × 30% = **$12,000**.
3. Adjusted subsidiary income = 150,000 − 10,000 − 12,000 = **$128,000**.
4. **NCI in net income** = 128,000 × 20% = **$25,600**.
5. Consolidated net income = 400,000 + 128,000 = **$528,000**.
6. Attributable to Pinnacle = 528,000 − 25,600 = **$502,400** (check: 400,000 + 80% × 128,000 = 502,400).
7. Consolidated COGS = 600,000 + 300,000 − 100,000 + 12,000 = **$812,000**.

Elimination entries for the intercompany sales:

Account	Debit	Credit
Sales	100,000	
Cost of goods sold		100,000
Cost of goods sold	12,000	
Inventory		12,000

NCI on the balance sheet = beginning NCI + NCI share of adjusted income − dividends paid to NCI. In the example, if Summit paid no dividends, year-end NCI = 200,000 + 25,600 = **$225,600**.

Intercompany sale of equipment

Example: At the beginning of the year, a parent sells equipment with a book value of $40,000 to its subsidiary for $60,000 (downstream). The remaining life is 5 years. The $20,000 gain is eliminated in consolidation, the equipment is restated to the parent's original basis, and consolidated depreciation is reduced by 20,000 ÷ 5 = **$4,000** per year — so the gain is realized $4,000 a year as the asset is used.

Presentation

Item	Consolidated presentation
NCI	In **equity**, separate from the parent's equity
Net income	Full consolidated net income, then attributed to NCI and to the parent
Comprehensive income	Also attributed to NCI and parent
Changes in ownership **without loss of control**	Equity transactions — no gain or loss; adjust APIC
Loss of control (deconsolidation)	Gain or loss in net income; any retained interest remeasured to fair value
Subsidiary losses	Allocated to the NCI even if this makes the NCI negative

Pushdown accounting (an option for the acquiree's own separate statements) records the acquirer's new basis in the subsidiary's books.

Common traps

- Eliminating only the parent's percentage of intercompany sales, receivables or profits.
- Computing goodwill with book values instead of fair values, or forgetting the NCI's fair value.
- Capitalizing acquisition-related legal and advisory fees.
- Leaving an intercompany gain in consolidated income.
- Applying the NCI percentage to the subsidiary's unadjusted net income.
- Charging downstream unrealized profit against the NCI.

Key takeaways

- Consolidate when controlling financial interest (> 50% voting) or primary beneficiary of a VIE.
- Acquisition method: everything at fair value; goodwill = consideration + NCI − FV of net assets; bargain purchase gain in income; acquisition costs expensed.
- Eliminate 100% of intercompany balances, sales, dividends and unrealized profits.
- Unrealized inventory profit = goods on hand × GP % on selling price; upstream adjustments are shared with NCI.
- NCI income = (sub NI − fair value amortization − upstream unrealized profit) × NCI %; NCI is reported in equity.

16. Special Purpose Frameworks and Ratios

Not every set of financial statements follows GAAP. Small businesses, lenders and regulators often accept statements on a **special purpose framework** (SPF). FAR tests what those frameworks are, how their statements are titled and disclosed, and how to convert cash-basis records to accrual. The second half of this chapter covers the financial ratios and simple variance analysis FAR expects you to compute and interpret.

The special purpose frameworks

Framework	Description
Cash basis	Revenues when cash is received, expenses when cash is paid
Modified cash basis	Cash basis with modifications that have **substantial support** — for example, capitalizing and depreciating fixed assets, recording payroll withholdings or accruing income taxes
Tax basis	The basis used to file the entity's federal income tax return
Regulatory basis	Required by a regulatory agency (for example, an insurance commission)
Contractual basis	Agreed in a contract, such as a loan or purchase agreement
Other basis	A definite set of logical, reasonable criteria applied to all material items, such as the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)

Cash, modified cash, tax and other bases are sometimes called "other comprehensive bases of accounting."

Statement titles

GAAP titles should **not** be used for SPF statements without modification.

GAAP title	Cash / modified cash basis	Tax basis
Balance sheet	Statement of assets and liabilities arising from cash transactions (or statement of assets, liabilities and equity — modified cash basis)	Statement of assets, liabilities and equity — income tax basis
Income statement	Statement of revenues collected and expenses paid (or statement of revenues and expenses — modified cash basis)	Statement of revenues and expenses — income tax basis
Statement of cash flows	Generally not required	Generally not required

Disclosures

SPF statements must include:

- A **summary of significant accounting policies** describing the basis, and a description of how it **differs from GAAP** (the effects need not be quantified).
- Informative disclosures similar to GAAP for items that appear in the statements (related parties, contingencies, subsequent events, going concern considerations) when the item is relevant to that basis.
- For a contractual or regulatory basis, a description of the contract or regulation.

> **Exam tip:** Questions on SPF focus on three things: whether a modification has **substantial support** (depreciation of fixed assets does; recording accounts receivable for revenue usually moves the statements toward accrual and is not an acceptable modification of the cash basis), the **titles**, and the **"differs from GAAP"** disclosure without quantification.

Converting cash basis to accrual

Accrual amount	= Cash amount	Adjustments
Revenue	Cash collected from customers	+ increase in receivables (− decrease) + decrease in unearned revenue (− increase)
Expense	Cash paid	+ increase in accrued liabilities/payables (− decrease) + decrease in prepaid expenses (− increase) + noncash expenses (depreciation)

Example: Linwood Consulting uses the cash basis. Cash collected from clients is $410,000. Receivables rose from $30,000 to $45,000; unearned fees fell from $8,000 to $5,000.

Accrual revenue = 410,000 + (45,000 − 30,000) + (8,000 − 5,000) = **$428,000**.

Cash paid for operating expenses is $150,000. Accrued expenses payable rose from $12,000 to $18,000; prepaid expenses fell from $4,000 to $1,000.

Accrual expense = 150,000 + (18,000 − 12,000) + (4,000 − 1,000) = **$159,000**.

Exam tip: A T-account solves almost every conversion: beginning receivable + revenue − collections = ending receivable.

Financial ratios

Liquidity

Ratio	Formula
Current ratio	Current assets ÷ current liabilities
Quick (acid-test) ratio	(Cash + marketable securities + net receivables) ÷ current liabilities
Cash ratio	(Cash + marketable securities) ÷ current liabilities
Working capital	Current assets − current liabilities

Activity

Ratio	Formula
Receivables turnover	Net credit sales ÷ **average** net receivables
Days sales outstanding	365 ÷ receivables turnover
Inventory turnover	COGS ÷ **average** inventory
Days in inventory	365 ÷ inventory turnover
Payables turnover	Purchases (or COGS) ÷ average payables
Operating cycle	Days in inventory + days sales outstanding
Cash conversion cycle	Operating cycle − days payable outstanding
Asset turnover	Net sales ÷ average total assets

Solvency and profitability

Ratio	Formula
Debt to equity	Total liabilities ÷ total equity
Debt ratio	Total liabilities ÷ total assets
Times interest earned	**EBIT** (income before interest and taxes) ÷ interest expense
Profit margin	Net income ÷ net sales
Return on assets	Net income ÷ average total assets
Return on equity	(Net income − preferred dividends) ÷ average common equity
DuPont ROE	Profit margin × asset turnover × equity multiplier (average assets ÷ average equity)
Price-earnings	Market price per share ÷ EPS
Dividend payout	Dividends per share ÷ EPS

Memory trick: DuPont is "**P-A-L**": **P**rofit margin × **A**sset turnover × **L**everage. "The quick ratio skips the slow stuff" — inventory and prepaids.

Example: Brightline Co. data:

Item	Amount
Current assets (incl. inventory $90,000 and prepaids $10,000)	$250,000
Current liabilities	$125,000
Net sales (all credit)	$1,200,000
COGS	$720,000
Inventory: beginning / ending	$80,000 / $100,000
Receivables: beginning / ending	$90,000 / $110,000
Net income	$96,000
Average total assets / average equity	$800,000 / $400,000
EBIT / interest expense	$150,000 / $30,000

- Current ratio = 250,000 ÷ 125,000 = **2.0**; quick ratio = (250,000 − 90,000 − 10,000) ÷ 125,000 = **1.2**.
- Inventory turnover = 720,000 ÷ 90,000 = **8.0** (about 45.6 days).
- Receivables turnover = 1,200,000 ÷ 100,000 = **12.0** (about 30.4 days).
- Times interest earned = 150,000 ÷ 30,000 = **5.0**.
- DuPont: margin 96,000 ÷ 1,200,000 = 8%; asset turnover 1,200,000 ÷ 800,000 = 1.5; equity multiplier 800,000 ÷ 400,000 = 2.0. ROE = 8% × 1.5 × 2.0 = **24%** (= 96,000 ÷ 400,000).

How transactions move ratios

When a ratio is **greater than 1**, an equal decrease in the numerator and denominator **raises** it; an equal increase **lowers** it. (The reverse holds for a ratio below 1.)

Example: Brightline pays $25,000 of accounts payable in cash. Current ratio = (250,000 − 25,000) ÷ (125,000 − 25,000) = 225,000 ÷ 100,000 = **2.25** — up from 2.0. Working capital is unchanged at $125,000.

Transaction	Current ratio (starting > 1)	Working capital
Pay a current liability with cash	Increases	No change
Buy inventory on account	Decreases	No change
Collect a receivable	No change	No change
Write off a receivable against the allowance	No change	No change
Sell inventory at a profit for cash	Increases	Increases
Borrow long-term cash	Increases	Increases
Declare a cash dividend	Decreases	Decreases

Budget and variance analysis

FAR may ask for simple comparisons of budget and actual results. Compare actual results with a **flexible budget** (budget adjusted to the actual activity level) to separate volume effects from price or efficiency effects.

Example: Budgeted sales were 10,000 units at $20 ($200,000); actual sales were 11,000 units at $19 ($209,000).

- Sales price variance = (19 − 20) × 11,000 = **$11,000 unfavorable**.
- Sales volume variance = (11,000 − 10,000) × $20 = **$20,000 favorable**.
- Total = $9,000 favorable (209,000 − 200,000).

Common traps

- Using year-end instead of average balances in turnover ratios.
- Using net income instead of EBIT in times interest earned.
- Assuming a write-off against the allowance changes the current ratio.
- Including inventory or prepaids in the quick ratio.
- Using GAAP statement titles for cash-basis or tax-basis statements.
- Requiring quantification of differences from GAAP in SPF disclosures.

Key takeaways

- SPFs: cash, modified cash, tax, regulatory, contractual and other bases; modifications need substantial support.
- Use basis-specific titles and describe how the basis differs from GAAP (no quantification needed).

- Accrual revenue = cash collected + Δ receivables − Δ unearned revenue; accrual expense = cash paid + Δ accrued liabilities − Δ prepaids.
- Know each ratio's formula, whether it uses averages, and the DuPont split.
- For a ratio above 1, equal decreases raise it and equal increases lower it.

17. State and Local Governments (GASB)

State and local governments follow standards issued by the **Governmental Accounting Standards Board (GASB)**. Their reporting differs from business GAAP in one basic way: a government reports at **two levels** — **fund** financial statements, which show how specific resources were raised and spent, and **government-wide** statements, which show the government as a whole on a full accrual basis. Learn the fund types, the measurement focus of each, and the reconciling items between the two levels.

The reporting model

Statement set	Measurement focus	Basis of accounting
Government-wide (statement of net position, statement of activities)	Economic resources	Full accrual
Governmental funds	**Current financial resources**	**Modified accrual**
Proprietary funds (enterprise, internal service)	Economic resources	Full accrual
Fiduciary funds	Economic resources	Full accrual

The annual comprehensive financial report also includes **management's discussion and analysis (MD&A)** and other **required supplementary information** (RSI) such as budgetary comparison schedules for the general fund and major special revenue funds, and pension and OPEB schedules.

The eleven fund types

Category	Fund	Used for
Governmental	**General**	Everything not required to be reported elsewhere; always a major fund; only one
	Special revenue	Proceeds of specific revenue sources **restricted or committed** to purposes other than debt service or capital projects (a gas tax for road maintenance)
	Capital projects	Resources for acquiring or constructing major capital facilities (excluding those of proprietary and fiduciary funds)
	Debt service	Resources for paying principal and interest on general long-term debt
	Permanent	Resources legally restricted so that only **earnings**, not principal, may be used to support the **government's own programs** (a cemetery perpetual-care fund)
Proprietary	**Enterprise**	Goods or services sold to the **public** for a fee (water utility, airport, toll road); required if debt is backed solely by fees, laws require cost recovery through fees, or pricing policy is set to recover costs
	Internal service	Goods or services provided to **other departments** of the government on a cost-reimbursement basis (motor pool, central IT)
Fiduciary	**Pension (and OPEB) trust**	Resources held in trust for employees' benefit plans
	Investment trust	External portion of an investment pool for other governments
	Private-purpose trust	Trust arrangements benefiting individuals, private organizations or other governments (scholarships for private individuals)
	Custodial	Fiduciary resources not held in a trust (taxes collected for other governments)

Memory trick: Governmental funds "**GRCDP**": General, special Revenue, Capital projects, Debt service, Permanent. Ask **who pays**: taxpayers → governmental; outside users → enterprise; other departments → internal service; resources belonging to others → fiduciary.

Major funds

The general fund is always major. Another governmental or enterprise fund is **major** if its total assets (+ deferred outflows), liabilities (+ deferred inflows), revenues or expenditures/expenses are at least **10%** of the corresponding total for its category (all governmental or all enterprise funds) **and** at least **5%** of the corresponding total for governmental and enterprise funds combined. A government may also designate any fund as major. Nonmajor funds are aggregated in one column.

Modified accrual basis (governmental funds)

Element	Recognition
Revenues	When **measurable and available** — collected within the period or soon enough after to pay current-period liabilities
Property taxes	Available if collected during the year or within **60 days** after year-end; the rest is a **deferred inflow of resources**
Sales and income taxes (derived tax revenues)	When the underlying transaction occurs and resources are available
Grants (government-mandated and voluntary nonexchange)	When all eligibility requirements, including time requirements, are met and resources are available
Expenditures	When the fund liability is incurred
Debt service (principal and interest) on general long-term debt	When **due** (not accrued at year-end)
Compensated absences, claims and judgments	When due and payable from current resources
Capital outlay	**Expenditure** when acquired — no capital assets or depreciation in the fund
Long-term debt proceeds	**Other financing source** (not revenue)
Transfers to and from other funds	Other financing sources and uses
Inventories and prepaids	Purchases method (expenditure when bought) or consumption method

Example: Lakeside County levies property taxes of $2,000,000 for the current year and expects 2% to be uncollectible. It collects $1,700,000 during the year and $150,000 within 60 days after year-end; the remaining $110,000 of the net levy is expected to be collected later.

- Net levy = 2,000,000 × 98% = $1,960,000.
- **General fund revenue** = 1,700,000 + 150,000 = **$1,850,000**; deferred inflow of resources = **$110,000**.
- **Government-wide revenue** = **$1,960,000** (full accrual: recognized in the period for which levied, net of uncollectibles).

General fund entries	Account	Debit	Credit
Levy	Property taxes receivable	2,000,000	
	Allowance for uncollectible taxes		40,000
	Revenues — property taxes		1,960,000
Year-end	Revenues — property taxes	110,000	
	Deferred inflows — unavailable property taxes		110,000

Nonexchange revenue categories (GASB 33)

Category	Example	Asset recognized when	Revenue recognized when
Derived tax	Sales tax, income tax	Underlying transaction occurs	Underlying transaction occurs (and available, in funds)
Imposed nonexchange	Property tax, fines	Enforceable legal claim (lien date) or receipt	Period for which levied (and available, in funds)
Government-mandated	State-required program funded by the state	Eligibility requirements met	Eligibility requirements met
Voluntary	Grants, donations	Eligibility requirements met	Eligibility requirements met

Resources received before time requirements are met are deferred inflows; resources received before other eligibility requirements are met are liabilities (unearned revenue).

Budgetary accounting

The general fund and special revenue funds usually record the **budget** in the accounts:

Entry	Account	Debit	Credit
Adopt budget (estimated revenues $5,000,000; appropriations $4,800,000)	Estimated revenues	5,000,000	
	Appropriations		4,800,000
	Budgetary fund balance		200,000
Issue a purchase order for $30,000	Encumbrances	30,000	
	Budgetary fund balance — reserved for encumbrances		30,000
Goods arrive; invoice $29,500 — reverse the encumbrance	Budgetary fund balance — reserved for encumbrances	30,000	
	Encumbrances		30,000
Record the actual expenditure	Expenditures	29,500	
	Vouchers payable		29,500

Budgetary accounts are closed at year-end. Encumbrances are **not** expenditures or liabilities; outstanding encumbrances at year-end are reported within restricted, committed or assigned fund balance.

Fund balance and net position

Governmental fund balance (GASB 54), from most to least constrained:

Class	Constraint
Nonspendable	Not in spendable form (inventory, prepaids) or legally required to be kept intact (permanent fund principal)
Restricted	Externally imposed (creditors, grantors, laws of other governments) or by enabling legislation
Committed	Imposed by the government's **highest decision-making authority** by formal action (ordinance); removable only the same way
Assigned	Intended use by a body or official delegated authority; includes all residual positive balances in governmental funds other than the general fund
Unassigned	Residual; positive unassigned balance only in the **general fund** (other funds can have a negative unassigned balance)

> **Memory trick:** "**N**ever **R**eally **C**an **A**nyone **U**nderstand" — Nonspendable, Restricted, Committed, Assigned, Unassigned.

Net position (government-wide and proprietary): **net investment in capital assets** (capital assets net of depreciation, less related debt), **restricted**, and **unrestricted**.

Government-wide statements

- **Statement of net position:** assets + deferred outflows − liabilities − deferred inflows = net position. Includes **capital assets** (with infrastructure) and **long-term liabilities** of governmental activities. Columns for governmental activities, business-type activities and discretely presented component units.
- **Statement of activities:** a **net (expense) revenue** format by function. For each function, expenses less **program revenues** (charges for services, operating grants and contributions, capital grants and contributions) give net expense; **general revenues** (taxes, unrestricted grants, investment earnings) are shown at the bottom.
- **Fiduciary funds are excluded** from the government-wide statements. Internal service funds are usually folded into governmental activities.
- Infrastructure may be depreciated or reported under the **modified approach** (no depreciation if an asset management system and condition assessments show assets are preserved at a set level).

Reconciling governmental funds to governmental activities

From change in fund balance to change in net position	Direction
Capital outlay expenditures	**Add**
Depreciation expense	**Subtract**
Long-term debt proceeds (other financing source)	**Subtract**
Principal repayments of long-term debt (expenditure)	**Add**
Revenues deferred in funds but earned (unavailable revenue)	Add the increase
Accrued expenses not using current resources (compensated absences, accrued interest)	Subtract the increase
Internal service fund net revenue	Add

Example: The total change in governmental fund balances is +$50,000. Capital outlays were $900,000, depreciation $300,000, bond proceeds $1,000,000 and bond principal repaid $200,000.

Change in net position = 50,000 + 900,000 − 300,000 − 1,000,000 + 200,000 = **−$150,000**.

Proprietary and fiduciary statements

Fund group	Statements
Proprietary	Statement of net position; statement of revenues, expenses and changes in fund net position (operating vs. nonoperating); statement of cash flows using the **direct method** with **four** categories — operating, noncapital financing, capital and related financing, investing
Fiduciary	Statement of fiduciary net position; statement of changes in fiduciary net position

In the proprietary cash flow statement, interest **paid** on capital debt is **capital and related financing**, and interest **received** is **investing** — different from business GAAP.

Other GASB topics

Topic	Rule
Leases (GASB 87)	Lessee: intangible right-to-use asset and lease liability (government-wide); in governmental funds, an expenditure and an **other financing source** at commencement
Subscription-based IT arrangements (GASB 96)	Similar to leases: right-to-use subscription asset and liability
Compensated absences (GASB 101)	Liability for leave that is attributable to services already rendered, accumulates, and is more likely than not to be used or paid
Component units	Legally separate organizations for which the primary government is financially accountable; **blended** (presented as if part of the government) or **discretely presented** (separate column)
Interfund activity	Loans (receivable/payable), services provided and used (revenue/expenditure as if external), reimbursements (reduce the reimbursed fund's expenditure) and **transfers** (other financing sources and uses)
Special assessment debt	If the government is obligated in some manner: general long-term debt; if not obligated: custodial fund

GASB 103 (financial reporting model improvements, effective for fiscal years beginning after June 15, 2025) refines MD&A, unusual or infrequent items, proprietary fund operating subtotals and the presentation of budgetary comparisons as RSI.

Common traps

- Reporting bond proceeds as revenue in a governmental fund.
- Including fiduciary funds in the government-wide statements.
- Recognizing property taxes collected more than 60 days after year-end as fund revenue.
- Treating encumbrances as liabilities or expenditures.
- Reporting capital assets or depreciation in governmental funds.
- Classifying a scholarship fund for private individuals as a permanent fund (it is a private-purpose trust).
- Using business GAAP cash flow categories for proprietary funds.

Key takeaways

- Governmental funds: current financial resources, modified accrual; everything else (and government-wide): economic resources, full accrual.
- Revenue in funds when measurable and available (property taxes: 60 days); expenditures when the liability is incurred; debt service when due.

- Capital outlay is an expenditure; bond proceeds are other financing sources; neither creates assets or liabilities in governmental funds.
- Fund balance: nonspendable, restricted, committed, assigned, unassigned.
- Reconciliation: + capital outlay − depreciation − bond proceeds + principal repaid.
- Fiduciary funds are excluded from government-wide statements.

18. Not-for-Profit Entities

Nongovernmental not-for-profit entities (NFPs) — charities, private universities, private hospitals, museums, religious organizations — follow U.S. GAAP in **ASC 958**. (Governmental NFPs, such as a public university, follow GASB.) The big ideas: net assets are classified by **donor restrictions**, contributions are recognized when **unconditional**, and **all expenses** are reported in net assets without donor restrictions.

The financial statements

Statement	Key features
Statement of financial position	Assets, liabilities and net assets in **two classes**: without donor restrictions and with donor restrictions
Statement of activities	Revenues, expenses, gains, losses and **releases** (reclassifications) by net asset class; change in each class and in total net assets
Statement of cash flows	Direct or indirect method; the indirect reconciliation starts from the **change in net assets**
Analysis of expenses by function and nature	Required for **all** NFPs (in a separate statement, on the face of the statement of activities, or in the notes): program services, management and general, fundraising — by natural class (salaries, rent, depreciation)

Also required: qualitative and quantitative information about **liquidity** and availability of financial assets for general expenditures within one year. A measure of operations is optional; if shown, it must be described.

Classifying cash flows unique to NFPs

Cash flow	Category
Unrestricted contributions	Operating
Contributions restricted for **long-term purposes** (endowment, buildings, equipment)	**Financing**
Interest and dividends restricted for long-term investment	Financing
Purchase and sale of investments and PP&E	Investing

Net asset classes

Class	Contains
Without donor restrictions	Resources the board may use for any purpose, including **board-designated** amounts (quasi-endowments) — a board designation is not a donor restriction
With donor restrictions	Purpose restrictions, time restrictions (including future pledge payments) and perpetual restrictions (endowments whose principal must be maintained)

When a restriction is satisfied — the purpose is fulfilled or the time passes — the amount is **released**: a reclassification that decreases net assets with donor restrictions and increases net assets without donor restrictions. Expenses are then reported in the unrestricted class.

> **Memory trick:** "**Expenses live Without**" — every expense is reported in net assets without donor restrictions.

> **Example:** A donor gives Riverbend Food Bank $50,000 restricted to buying a refrigerated truck. When received: contribution revenue, **with** donor restrictions, $50,000. When the truck is bought and placed in service (absent a donor stipulation about how long it must be used), $50,000 is released to net assets without donor restrictions, and depreciation is charged there over the truck's life.

Contributions

A contribution is an **unconditional, voluntary, nonreciprocal** transfer. Distinguish it first from an **exchange transaction** (the resource provider receives commensurate value — membership benefits, a research contract for a company, sale of goods) and from an **agency transaction** (the NFP is an intermediary passing resources to a specified beneficiary — a liability, not revenue).

Contribution	Recognition
Unconditional cash or promise (pledge)	Revenue when received or promised, at fair value; classify by donor restriction
Multi-year pledge	**Present value** of future collections (allowance for uncollectibles); **with donor restrictions** (implied time restriction) until collected; discount accretion is contribution revenue
Conditional promise — has a **barrier** to overcome **and** a right of return or release	Not recognized until the barrier is overcome; cash received early is a refundable advance (liability)
Contributed nonfinancial assets (gifts in kind)	Fair value; presented as a separate line with disclosure (ASU 2020-07)
Contributed services	Recognized only if they (a) create or enhance **nonfinancial assets** or (b) require **specialized skills**, are provided by people with those skills and would otherwise have to be **purchased**
Collection items (art, historical treasures)	Need not be capitalized if held for public exhibition or research, protected and preserved, and proceeds from sales are used to buy other collection items or for direct care of the collection

> **Memory trick:** Conditional = "**B + R**": **B**arrier plus **R**ight of return. Contributed services = "**Skill or Build**."

Example: On December 31, Year 1, a donor pledges $10,000 per year for three years, payable each December 31 starting in Year 2, with no other restrictions. The appropriate discount rate is 5% (PV of an ordinary annuity, 3 periods = 2.7232).

- Contribution revenue (with donor restrictions — time) = 10,000 × 2.7232 = **$27,232**.
- Year 2 discount accretion = 27,232 × 5% = **$1,362**, also contribution revenue (with donor restrictions).
- Each $10,000 collected is released from restrictions as the time restriction expires.

Account	Debit	Credit
Contributions receivable	30,000	
Discount on contributions receivable		2,768
Contribution revenue — with donor restrictions		27,232

Example: A foundation promises $100,000 if the NFP raises $100,000 of matching gifts from other donors by year-end; otherwise the promise lapses. This is **conditional** (a measurable barrier and release from the obligation). Nothing is recognized until the matching gifts are raised.

Example: A CPA volunteers 40 hours to prepare the NFP's financial statements; the NFP would otherwise have paid $5,000. The service requires specialized skills and would have been purchased → recognize **$5,000** contribution revenue and $5,000 expense (management and general). Volunteers who staff a fundraising phone bank do **not** meet the criteria and are not recognized.

Special events and membership dues

A payment that is part exchange and part contribution is split: the fair value of benefits received is exchange revenue; the excess is a contribution.

Example: Riverbend sells 200 gala tickets at $250 each. The dinner and entertainment have a fair value of $90 per person.

- Contribution revenue = (250 − 90) × 200 = **$32,000**.
- Special event (exchange) revenue = 90 × 200 = **$18,000**.

Direct costs of the event may be netted against special event revenue only when the event is peripheral or incidental; otherwise they are reported as expenses (fundraising or as appropriate).

Membership dues are exchange revenue to the extent members receive benefits of commensurate value, recognized over the membership period; any excess is a contribution.

Expenses and functional classification

Function	Includes
Program services	Activities that fulfill the mission (meals served, classes taught, research)
Management and general	Oversight, accounting, budgeting, HR, board meetings
Fundraising	Campaigns, donor lists, grant proposals, special-event costs that solicit contributions
Membership development	Soliciting new members

Joint costs (for example, a mailing that educates and solicits) are allocated to program services only if the **purpose, audience and content** criteria are all met; otherwise everything goes to fundraising.

Investments and endowments

- Debt securities and equity securities with readily determinable fair values are measured at **fair value**; gains and losses are reported in the statement of activities in the class determined by donor restrictions (or law).
- **Investment return** is reported **net** of external and direct internal investment expenses (with no separate disclosure of those expenses required).
- Endowment earnings are with donor restrictions until appropriated for expenditure under the state's version of UPMIFA.
- An **underwater** endowment (fair value below the original gift) is reported within net assets with donor restrictions, with disclosures.

Healthcare and other NFP points

- **Depreciation** is required on long-lived assets (except land and qualifying collections).
- NFP healthcare entities report **patient service revenue** under ASC 606 at the amount expected to be collected; implicit price concessions reduce revenue, and **charity care** is not revenue (disclose its cost).

Common traps

- Recognizing conditional pledges before the barrier is met.

- Recognizing general volunteer hours as revenue.
- Reporting expenses in the with-donor-restrictions class.
- Treating a board designation as a donor restriction.
- Recording the full gala ticket price as contribution revenue.
- Recognizing an agency transaction as contribution revenue.
- Classifying restricted contributions for a building as operating cash flows.

Key takeaways

- Two net asset classes: without and with donor restrictions; releases are reclassifications.
- Unconditional contributions → revenue when received or promised at fair value (pledges at present value); conditional (barrier + right of return) → wait.
- Contributed services: only specialized skills that would otherwise be purchased, or services that build nonfinancial assets.
- All expenses in net assets without donor restrictions; all NFPs present an analysis of expenses by function and nature.
- Special events: payment − fair value of benefits = contribution.
- Long-term restricted contributions are financing cash flows.

Final Review Checklist

Use this checklist in the last week before your exam. For each line, ask yourself whether you could explain the rule and work a numeric example without notes. Anything you cannot do quickly, reread in its chapter and drill in the matching bank chapter.

Formula and number sheet

Item	Rule
Exam format	4 hours; 50 MCQs + 7 TBSs; 50/50 weighting; pass at 75
PV of annuity due	Ordinary annuity factor (n − 1) + 1
Bond issue price	Face × PV of $1 + coupon × PV of annuity, at market rate per period
Effective interest	Carrying amount × market rate; amortization = expense − cash
Capitalized interest	Lesser of avoidable interest on WAAE and actual interest
Impairment (held and used)	Test: carrying amount > undiscounted cash flows; loss: carrying amount − fair value
Goodwill	Consideration + FV of NCI − FV of identifiable net assets
Gross profit % from markup on cost	Markup ÷ (1 + markup)
Total tax expense	Current + ΔDTL − ΔDTA (± valuation allowance)
UTP benefit	Largest amount with cumulative probability > 50%
Treasury stock method	Options − (proceeds ÷ **average** price)
If-converted	+ interest × (1 − tax rate); + conversion shares
SEC deadlines	10-K 60/75/90 days; 10-Q 40/40/45 days; 8-K 4 business days
Segment tests	10% of revenue, profit/loss (greater of profits or losses), assets; 75% external revenue
Property tax availability	Collected within 60 days after year-end
Major fund	≥ 10% of category **and** ≥ 5% of governmental + enterprise combined
Finance lease criteria	OWNES (90% PV, 75% life benchmarks)

Chapter 1 — Conceptual framework and statements

☐ I can name the fundamental (relevance, faithful representation) and enhancing (CVTU) characteristics.

☐ I can build a multiple-step income statement with discontinued operations net of tax.

☐ I can list OCI items and compute comprehensive income.

☐ I can compute interim tax expense with a revised annual effective rate.

☐ I can apply the three 10% segment tests and the 75% test.

☐ I know the 10-K, 10-Q and 8-K deadlines by filer status.

Chapter 2 — Revenue recognition

☐ I can walk through the five steps and test whether a good or service is distinct.

☐ I can estimate variable consideration and apply the constraint.

☐ I can allocate a bundle discount by relative standalone selling prices.

☐ I can apply the three over-time criteria and compute cost-to-cost revenue and gross profit by year.

☐ I can recognize a full loss on a loss contract.

☐ I can record a sale with a right of return (refund liability and return asset).

☐ I can decide principal versus agent and handle consignments and bill-and-hold.

Chapter 3 — Cash and receivables

☐ I can classify items as cash, cash equivalents, restricted cash or investments.

☐ I can prepare a bank reconciliation and say which items need entries.

☐ I can compute the CECL allowance from an aging and plug credit loss expense.

☐ I can compute proceeds and loss when discounting a note.

☐ I can tell a sale of receivables from a secured borrowing and record factoring.

Chapter 4 — Inventory

☐ I can decide ownership for FOB terms and consignments.

☐ I can compute FIFO, LIFO and weighted-average ending inventory and COGS.

☐ I can apply LCNRV and LCM (ceiling, floor, middle value).

☐ I can compute dollar-value LIFO layers.

☐ I can apply the gross profit and conventional retail methods.

☐ I can trace an inventory error through two years.

Chapter 5 — PP&E, intangibles and software

☐ I can assign costs to land, land improvements, building and equipment.

☐ I can compute capitalized interest from WAAE.

☐ I can record an ARO and its accretion.

☐ I can compute SL, SYD, DDB and units-of-production depreciation.

☐ I can account for exchanges with and without commercial substance.

☐ I can run the two-step impairment test and the held-for-sale rule.

☐ I know the software capitalization windows (for sale; internal use; cloud implementation) and the crypto fair value rule.

Chapter 6 — Investments

☐ I can classify debt as trading, AFS or HTM and equity securities correctly.

☐ I can build an effective interest table for a bond investment and the AFS fair value adjustment.

☐ I can compute the AFS credit loss allowance (lesser of credit loss and FV shortfall).

☐ I can roll forward an equity-method investment with excess cost amortization.

☐ I know that a change to the equity method is prospective.

Chapter 7 — Payables and contingencies

☐ I can apply the probable / reasonably possible / remote grid and the minimum-of-range rule.

☐ I can compute warranty expense and liability, sales tax in receipts, payroll tax expense and bonuses.

☐ I know when compensated absences and sick pay are accrued.

☐ I can time ASC 420 one-time termination benefits.

☐ I can classify short-term debt refinanced after year-end.

Chapter 8 — Bonds and notes

☐ I can price a bond with semiannual periods.

☐ I can amortize a discount and a premium with the effective interest method.

☐ I can compute the gain or loss on extinguishment.

☐ I can record a zero-interest note and bonds with detachable warrants.

☐ I can account for a debtor's troubled debt restructuring.

Chapter 9 — Leases (lessee)

☐ I can classify a lease using OWNES.

☐ I can measure the lease liability with an annuity due and the ROU asset with IDC, prepaid rent and incentives.

☐ I can compute Year 1 finance lease interest and amortization.

☐ I can compute operating lease cost and the plug ROU amortization.

☐ I know which payments are excluded (usage-based variable payments) and how RVGs are measured.

Chapter 10 — Income taxes

☐ I can sort items into permanent and temporary differences.

☐ I can compute taxable income, current tax, DTA, DTL and total tax expense.

☐ I can apply enacted future rates and record a rate change.

☐ I can compute a valuation allowance and an NOL DTA.

☐ I can measure an uncertain tax position using cumulative probabilities.

Chapter 11 — Equity and EPS

☐ I can record treasury stock purchases and reissues under the cost method.

☐ I can record small and large stock dividends and property dividends.

☐ I can compute weighted-average shares with retroactive stock dividends.

☐ I can compute basic and diluted EPS with options and convertible bonds, testing antidilution.

☐ I can allocate partnership income and apply the bonus method on admission.

Chapter 12 — Cash flows

☐ I can classify cash flows under U.S. GAAP, including interest, dividends and lease payments.

☐ I can prepare the indirect-method operating section.

☐ I can compute direct-method receipts and payments.

☐ I can reconstruct equipment proceeds and dividends paid.

☐ I can identify noncash investing and financing activities.

Chapter 13 — Accounting changes and errors

☐ I can classify a change as principle, estimate, entity or error.

☐ I can compute new depreciation after an estimate change.

☐ I can compute a net-of-tax cumulative effect and a prior-period adjustment.

☐ I can tell counterbalancing from non-counterbalancing errors.

Chapter 14 — Fair value, FX and subsequent events

☐ I can pick the principal or most advantageous market and compute fair value.

☐ I can place inputs in Level 1, 2 or 3.

☐ I can compute foreign currency transaction gains and losses at year-end and settlement.

☐ I know translation (OCI) versus remeasurement (net income).

☐ I can classify subsequent events as recognized or nonrecognized and know the evaluation date.

Chapter 15 — Consolidations

☐ I can compute goodwill or a bargain purchase gain with NCI at fair value.

☐ I can eliminate intercompany sales, balances and unrealized profit.

☐ I can compute NCI in net income and consolidated net income attributable to the parent.

☐ I know how to treat acquisition costs and intercompany PP&E gains.

Chapter 16 — Special purpose frameworks and ratios

☐ I can name the SPFs, their statement titles and required disclosures.

☐ I can convert cash-basis revenue and expenses to accrual.

☐ I can compute liquidity, activity, solvency and profitability ratios, including DuPont ROE.

☐ I can predict how a transaction changes the current ratio and working capital.

Chapter 17 — State and local governments

☐ I can choose the right fund for an activity among the eleven fund types.

☐ I can state the measurement focus and basis for each fund group.

☐ I can compute property tax revenue in the general fund and government-wide.

☐ I can record budgetary and encumbrance entries.

☐ I can classify fund balance and net position.

☐ I can reconcile governmental fund balances to governmental activities net position.

Chapter 18 — Not-for-profit entities

☐ I can classify net assets with and without donor restrictions and record releases.

☐ I can tell contributions from exchange and agency transactions, and conditional from unconditional promises.

☐ I can measure a multi-year pledge at present value.

☐ I can apply the contributed services criteria.

☐ I can split a special event payment between contribution and exchange revenue.

☐ I can classify NFP cash flows, including long-term restricted contributions.

The night before

☐ Reread the Key takeaways at the end of each chapter.

☐ Review your error log, not new material.

☐ Confirm your testing appointment, ID requirements and travel time.

☐ Sleep. A rested brain classifies and computes faster than a crammed one.

Good luck on FAR.

Now practice it

Every chapter in this guide has matching practice tests, simulations and mock exams at **UPractice.org**.