FAR Study Sheet

Financial Accounting & Reporting

50 Essential Topics for CPA Exam Success

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CASH & RECEIVABLES

Bank Reconciliations

A bank reconciliation adjusts both the book balance and bank balance to arrive at the true cash balance. This is one of the most fundamental cash controls.

```
Book Balance ± adjustments = TRUE CASH = Bank Balance ± adjustments
```

Items that adjust the BOOK balance (require journal entries):

- **ADD to books:** Interest earned, notes collected by bank, EFT receipts, direct deposits
- **SUBTRACT from books:** Bank service charges, NSF checks, automatic payments, errors on books

Items that adjust the BANK balance (no journal entries needed):

- **ADD to bank:** Deposits in transit (already recorded on books, not yet at bank)
- **SUBTRACT from bank:** Outstanding checks (already recorded on books, not yet cleared)

Tip: Only BOOK-side adjustments require journal entries because they represent items the company didn't know about until receiving the bank statement.

Bad Debt Expense - Two Methods

The allowance method is required under GAAP. There are two approaches to estimate bad debts:

Balance Sheet Method (Aging of Receivables):

- Focus: What should the ending Allowance balance be?
- Calculate target allowance based on aging of A/R
- `Expense = Target Allowance – Current Allowance Balance`
- This method DOES consider the existing allowance balance

Income Statement Method (% of Sales):

- Focus: What should this period's expense be?
- `Expense = Bad Debt % × Credit Sales`
- This method IGNORES the existing allowance balance

Write-off Entry: DR Allowance for Doubtful Accounts / CR Accounts Receivable

- No income statement impact - expense was already recognized when allowance was created

Recovery Entry (2 steps):

- Step 1: Reverse write-off: DR A/R / CR Allowance
- Step 2: Record collection: DR Cash / CR A/R

A/R and Allowance Rollforwards

```
Beginning A/R + Credit Sales – Cash Collections – Write-offs + Recoveries = Ending A/R
```

```
Beginning Allowance + Bad Debt Expense + Recoveries – Write-offs = Ending Allowance
```

These rollforwards are frequently tested. Practice solving for any missing variable.

Factoring Receivables

Factoring is selling receivables to a third party (factor) to get immediate cash.

- **WITHOUT Recourse:** Factor assumes all collection risk → Treat as SALE (remove A/R from books)

- **WITH Recourse:** Seller retains collection risk → Treat as BORROWING (A/R remains on books)

  Cash Received = Face Value of A/R – Factor's Fee – Holdback (retained by factor)

Tip: 'Without recourse' = without the seller having to worry about bad debts = sale treatment.

INVENTORY

Inventory Cost Flow Assumptions

Different cost flow assumptions produce different results for COGS and ending inventory:

FIFO (First-In, First-Out):

- Oldest costs go to COGS first
- Ending inventory consists of newest (most recent) costs
- In rising prices: HIGHER ending inventory, LOWER COGS, HIGHER net income, HIGHER taxes

LIFO (Last-In, First-Out):

- Newest costs go to COGS first
- Ending inventory consists of oldest costs
- In rising prices: LOWER ending inventory, HIGHER COGS, LOWER net income, LOWER taxes (tax benefit!)
- LIFO is PROHIBITED under IFRS

Weighted Average:

- Average cost per unit = Total cost of goods available ÷ Total units available
- Results fall between FIFO and LIFO

Tip: In a period of RISING prices, LIFO gives the tax benefit (lower income = lower taxes). In FALLING prices, FIFO gives the tax benefit.

LIFO Reserve and LIFO Liquidation

- **LIFO Reserve** = FIFO Inventory – LIFO Inventory (the cumulative difference)
- **LIFO Liquidation** occurs when a company using LIFO sells more units than it purchases, dipping into old inventory layers with lower costs. This increases income and taxes.

To convert LIFO to FIFO:

```
FIFO Inventory = LIFO Inventory + LIFO Reserve
FIFO COGS = LIFO COGS – Change in LIFO Reserve
```

Lower of Cost or Net Realizable Value (LC-NRV)

Inventory must be written down if its value has declined below cost.

```
NRV = Estimated Selling Price – Costs to Complete – Costs to Sell
```

Report inventory at the LOWER of: Cost or NRV

- If NRV < Cost, write down inventory and recognize loss in COGS
- Under GAAP, write-downs can be reversed if NRV later increases (but not above original cost)
- Under IFRS, same rule applies

Inventory Errors

Inventory errors affect both the balance sheet and income statement:

- Ending inventory OVERSTATED → COGS UNDERSTATED → Net income OVERSTATED
- Ending inventory UNDERSTATED → COGS OVERSTATED → Net income UNDERSTATED
- Inventory errors are counterbalancing - they reverse in the following year

```
Beginning Inventory + Purchases – Ending Inventory = COGS
```

FIXED ASSETS & DEPRECIATION

Capitalization vs. Expense

The key question: Does this cost provide future economic benefit?

CAPITALIZE (add to asset cost):

- Extends the useful life of the asset
- Increases the capacity or efficiency of the asset
- Additions, improvements, betterments
- Interest during construction (for self-constructed assets)

EXPENSE (period cost):

- Maintains the asset in its current operating condition
- Ordinary repairs and maintenance
- Does not extend life or increase capacity

Depreciation Methods

Straight-Line:

```
Annual Depreciation = (Cost – Salvage Value) ÷ Useful Life
```

- Equal expense each year; most common method

Double-Declining Balance (DDB):

```
Annual Depreciation = (2 ÷ Useful Life) × Beginning Book Value
```

- Accelerated method; IGNORE salvage value until the end
- Switch to straight-line when SL produces higher depreciation

Sum-of-the-Years-Digits (SYD):

```
Annual Depreciation = (Remaining Life ÷ SYD) × (Cost – Salvage)
```

- SYD = n(n+1)/2 where n = useful life (e.g., 5-year life: SYD = 15)

Units of Production:

```
Depreciation = [(Cost – Salvage) ÷ Total Expected Units] × Units Produced
```

- Variable expense based on actual usage

Asset Disposal

```
Book Value = Cost – Accumulated Depreciation
Gain or Loss = Proceeds Received – Book Value
```

- Proceeds > Book Value = GAIN (credit to income)
- Proceeds < Book Value = LOSS (debit to expense)
- Fully depreciated asset (BV = 0): Any proceeds = gain

Asset Impairment (2-Step Test under GAAP)

Step 1 - Recoverability Test: Is carrying value > undiscounted future cash flows?

- If YES → Asset is impaired, proceed to Step 2
- If NO → No impairment, stop here

Step 2 - Measurement: Calculate impairment loss

Impairment Loss = Carrying Value – Fair Value

- Write asset down to fair value
- NO REVERSAL allowed under GAAP (IFRS allows reversal)

Tip: The recoverability test uses UNDISCOUNTED cash flows, but the loss is measured using FAIR VALUE.

BONDS & LONG-TERM DEBT

Bond Pricing Fundamentals

Bond price is determined by comparing the stated (coupon) rate to the market (effective) rate:

- Market Rate < Stated Rate → Bond sells at a PREMIUM (above face value)
- Market Rate > Stated Rate → Bond sells at a DISCOUNT (below face value)
- Market Rate = Stated Rate → Bond sells at PAR (face value)

```
Bond Price = PV of Interest Payments + PV of Principal (both discounted at market rate)
```

Effective Interest Method

This method is required under GAAP and results in a constant interest rate over the bond's life.

```
Interest Expense = Carrying Value × Market Rate
Cash Interest Payment = Face Value × Stated Rate
Amortization = |Interest Expense − Cash Payment|
```

Premium Bond:

- Cash payment > Interest expense (paying more than expense)
- Carrying value DECREASES toward face value over time

Discount Bond:

- Interest expense > Cash payment (expense more than paying)
- Carrying value INCREASES toward face value over time

Bond Issue Costs

- Recorded as a direct reduction of the bond liability (contra-liability)
- Amortized over the life of the bond using effective interest method

LEASES

Lease Classification - OWNES Test

If ANY ONE of these criteria is met, it's a FINANCE lease. All NO = OPERATING lease.

- **O**wnership transfers to lessee at end of lease
- **W**ritten bargain purchase option exists
- **N**inety percent test: PV of lease payments ≥ 90% of fair value
- **E**conomic life test: Lease term ≥ 75% of asset's remaining economic life
- **S**pecialized asset: Asset has no alternative use to lessor at end of lease

Lessee Accounting

Both Finance and Operating Leases (initial recognition):

- Record Right-of-Use (ROU) Asset and Lease Liability at PV of lease payments

Finance Lease (subsequent):

- Amortize ROU asset (usually straight-line)
- Record interest expense on lease liability (front-loaded)
- Total expense is HIGHER in early years (amortization + interest)

Operating Lease (subsequent):

- Single lease expense recognized on straight-line basis
- Equal expense each period

STOCKHOLDERS' EQUITY

Components of Stockholders' Equity

- **Common Stock:** Par value × shares issued
- **Additional Paid-in Capital (APIC):** Amount received above par value
- **Retained Earnings:** Cumulative net income minus dividends
- **Treasury Stock:** Cost of repurchased shares (contra-equity)
- **Accumulated Other Comprehensive Income (AOCI):** Unrealized gains/losses bypassing income statement

Stock Issuance

When stock is issued for cash:

```
DR Cash (total amount received)
CR Common Stock (par value × shares)
CR APIC (excess over par)
```

When stock is issued for non-cash consideration, record at FAIR VALUE of stock or consideration, whichever is more clearly determinable.

Stock Dividends vs. Stock Splits

Small Stock Dividend (<25%):

- Record at MARKET value of shares distributed
- DR Retained Earnings (market value)
- CR Common Stock (par value)
- CR APIC (excess)

Large Stock Dividend (≥25%):

- Record at PAR value of shares distributed
- DR Retained Earnings (par value)
- CR Common Stock (par value)

Stock Split:

- NO journal entry - just a memo entry
- Par value per share decreases; number of shares increases
- Total par value and total equity remain unchanged

Treasury Stock - Cost Method

Purchase of treasury stock:

```
DR Treasury Stock (at cost paid)
CR Cash
```

Reissue ABOVE cost:

```
DR Cash (amount received)
CR Treasury Stock (at cost)
CR APIC-Treasury Stock (excess)
```

Reissue BELOW cost:

```
DR Cash (amount received)
DR APIC-Treasury Stock (to extent available)
DR Retained Earnings (remainder if APIC exhausted)
CR Treasury Stock (at cost)
```

Tip: Never debit or credit a gain/loss account for treasury stock transactions - these are capital transactions, not income statement items.

REVENUE RECOGNITION (ASC 606)

The 5-Step Revenue Model

Step 1: Identify the CONTRACT

- Agreement with commercial substance, approved by parties, rights/obligations identifiable

Step 2: Identify PERFORMANCE OBLIGATIONS

- Distinct goods or services promised to the customer
- A good/service is distinct if customer can benefit from it alone or with readily available resources

Step 3: Determine TRANSACTION PRICE

- Amount entity expects to be entitled to in exchange for goods/services
- Consider variable consideration, financing components, non-cash consideration

Step 4: ALLOCATE transaction price to performance obligations

- Allocate based on relative standalone selling prices

Step 5: RECOGNIZE revenue when (or as) performance obligation is satisfied

- Point in time: Control transfers at a specific moment
- Over time: Control transfers continuously (use percentage of completion)

Percentage of Completion Method

Used when performance obligation is satisfied over time (e.g., long-term construction):

```
% Complete = Costs Incurred to Date ÷ Total Estimated Costs
Revenue to Date = % Complete × Total Contract Price
Current Period Revenue = Revenue to Date – Revenue Previously Recognized
```

DEFERRED TAXES

Temporary vs. Permanent Differences

Temporary Differences: Create deferred tax assets or liabilities

- Differences between book and tax basis that will reverse in future periods
- Examples: Depreciation differences, warranty expense, bad debt expense

Permanent Differences: NO deferred tax impact

- Differences that will never reverse
- Examples: Municipal bond interest (never taxed), fines/penalties (never deductible)

Deferred Tax Assets vs. Liabilities

Deferred Tax Asset (DTA):

- Future tax BENEFIT (will reduce future taxes)
- Created when book expense > tax expense (paid more tax now, less later)
- Examples: Warranty expense, bad debt expense, accrued liabilities

Deferred Tax Liability (DTL):

- Future tax OBLIGATION (will increase future taxes)

- Created when tax expense > book expense (paid less tax now, more later)
- Examples: Accelerated tax depreciation, installment sales

DTA or DTL = Temporary Difference × Enacted Tax Rate

Tip: If tax rates change, remeasure deferred taxes at the NEW enacted rate. The adjustment flows through Income Tax Expense.

INVESTMENTS & CONSOLIDATIONS

Accounting Based on Ownership Level

<20% Ownership (No Significant Influence):

- Use FAIR VALUE method
- Equity securities: Fair value through net income (trading) or through OCI (election)
- Debt securities: Classify as trading, available-for-sale, or held-to-maturity

20-50% Ownership (Significant Influence):

- Use EQUITY METHOD
- Record investment at cost initially
- Adjust for share of investee's income/loss and dividends

>50% Ownership (Control):

- CONSOLIDATE financial statements
- Combine all assets, liabilities, revenues, expenses
- Eliminate intercompany transactions

Equity Method Journal Entries

Initial Investment:

```
DR Investment in Affiliate / CR Cash
```

Record Share of Investee Income:

```
DR Investment in Affiliate
CR Equity in Earnings of Affiliate (% × Investee NI)
```

Record Dividends Received:

```
DR Cash
CR Investment in Affiliate (% × Dividends)
```

Note: Dividends REDUCE the investment balance under equity method (not income).

Consolidation Basics

Goodwill Calculation:

```
Goodwill = Purchase Price – Fair Value of Net Assets Acquired
```

Elimination Entries:

- Eliminate 100% of intercompany transactions (sales, loans, etc.)
- Eliminate investment account against subsidiary equity

Noncontrolling Interest (NCI):

- NCI = Subsidiary's Equity × NCI percentage
- Reported in equity section of consolidated balance sheet
- NCI share of income reported separately on consolidated income statement

EARNINGS PER SHARE

Basic EPS

```
Basic EPS = (Net Income – Preferred Dividends) ÷ Weighted Average Common Shares
```

- Only DECLARED dividends on cumulative preferred reduce numerator
- For non-cumulative preferred, only declared dividends
- Weight shares by the portion of year outstanding

Diluted EPS

Include potentially dilutive securities (convertible bonds, convertible preferred, options):

Convertible Securities (If-Converted Method):

- Add back interest expense (net of tax) or preferred dividends to numerator
- Add converted shares to denominator

Stock Options (Treasury Stock Method):

- Only dilutive if exercise price < average market price

```
Dilutive Shares = Options – (Options × Exercise Price ÷ Market Price)
```

Tip: Only include a security in diluted EPS if it DECREASES EPS. If it increases EPS, it's anti-dilutive and excluded.

STATEMENT OF CASH FLOWS

Indirect Method - Operating Section

Start with net income, then adjust for:

ADD back non-cash expenses: Depreciation, amortization, depletion

ADD losses / SUBTRACT gains: On sale of assets (these belong in investing)

Changes in current assets:

- INCREASE in current asset = SUBTRACT (used cash)
- DECREASE in current asset = ADD (freed up cash)

Changes in current liabilities:

- INCREASE in current liability = ADD (source of cash)
- DECREASE in current liability = SUBTRACT (used cash)

Classification of Cash Flows

OPERATING: Day-to-day business activities

- Cash from customers, payments to suppliers, interest paid*, taxes paid

INVESTING: Long-term asset transactions

- Purchase/sale of PP&E;, purchase/sale of investments, loans made to others

FINANCING: Debt and equity transactions

- Issuance/repayment of debt, issuance/repurchase of stock, dividends paid

*Interest paid is operating under GAAP (can be financing under IFRS)

GOVERNMENT & NOT-FOR-PROFIT

Government Fund Types

GOVERNMENTAL FUNDS (use modified accrual):

- **General Fund:** Main operating fund for general government activities
- **Special Revenue:** Restricted revenue sources for specific purposes
- **Capital Projects:** Acquisition/construction of major capital facilities
- **Debt Service:** Payment of principal and interest on long-term debt
- **Permanent:** Principal must remain intact; earnings are expendable

PROPRIETARY FUNDS (use full accrual):

- **Enterprise:** Business-type activities (utilities, airports)
- **Internal Service:** Services to other government departments

FIDUCIARY FUNDS (use full accrual):

- Pension Trust, Investment Trust, Private-Purpose Trust, Custodial

Modified Accrual Basis

Used by governmental funds:

- Revenue recognized when MEASURABLE and AVAILABLE
- Available = collectible within current period or soon enough to pay current liabilities (usually 60 days)
- Expenditures (not expenses) recognized when liability is incurred

Not-for-Profit Net Asset Classes

Without Donor Restrictions:

- No donor-imposed restrictions; available for general use
- Board designations are internal and don't change classification

With Donor Restrictions:

- **Purpose restrictions:** Must be used for specific purpose
- **Time restrictions:** Available after specified date
- **Perpetual restrictions:** Endowments - principal maintained forever

OTHER KEY TOPICS

Contingencies

Loss Contingencies:

- Probable + Reasonably Estimable = ACCRUE and disclose
- Probable + Range (no best estimate) = Accrue MINIMUM of range
- Reasonably Possible = DISCLOSE only (no accrual)
- Remote = No disclosure required

Gain Contingencies: NEVER accrue; disclose only if probable

Subsequent Events

- **Type I (Recognized):** Condition existed at B/S date → ADJUST financial statements
- **Type II (Non-recognized):** Condition arose after B/S date → DISCLOSE only
- Period: Balance sheet date through date F/S are issued (or available to be issued)

Fair Value Hierarchy

- **Level 1:** Quoted prices in active markets for identical assets (most reliable)
- **Level 2:** Observable inputs other than Level 1 (similar assets, yield curves)
- **Level 3:** Unobservable inputs based on company's own assumptions (least reliable)

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