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FAR REVIEW NOTES

2024

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How to Use These Review Notes:

The best way to use these review notes is in the following ways:

1. Read from these review notes as a part of your mini sessions each day. Switch between reading a few pages of these notes and taking quizzes on the SuperfastCPA app. Doing this multiple times a day will get you through the notes at least a couple or more times throughout your study process.
2. When doing your 2-hour main study session each day, before starting a new section or topic, find that topic in these review notes and read through it to get a base understanding of what you are about to study. This doesn't need to be a deep read, just a primer to get you started.
3. Read through these review notes all the way through at least 2-3 times in the two days of your 48-hour cram session before your exam.

AICPA Blueprints and "Representative Tasks"

We have made these review notes to mirror the AICPA blueprints. You will notice that each section says one of the following: Remembering and Understanding, Application, Analysis, or Evaluation (Evaluation will only be on the Audit exam).

- If a section says Remembering and Understanding, that means it will almost certainly be tested as a Multiple Choice Question if it is tested.
- If a section says Application, that means it could be tested as either a Multiple Choice Question or a Simulation.
- If a section says either Analysis or Evaluation (for Audit only), it will almost certainly be tested as a Simulation.

Area II – Select Balance Sheet Accounts

A. Cash and Cash Equivalents

Application: Calculate cash and cash equivalents balances to be reported in the financial statements.

Cash and cash equivalents (CCE) include not only physical currency but also highly liquid investments that can be quickly converted into cash. Here's how you can calculate it:

Understanding Cash and Cash Equivalents

- Cash: This includes physical currency, bank account balances, and undeposited checks.
- Cash Equivalents: These are short-term, highly liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value due to changes in interest rates. Examples include:
- Treasury bills
- Money market funds
- Commercial paper
- Short-term government bonds (typically with a maturity of 3 months or less)

Steps to Calculate Cash and Cash Equivalents

- List All Components:
    - Identify all accounts and instruments that qualify as cash or cash equivalents.
    - This may involve reviewing bank statements, investment reports, and other financial records.

- Evaluate Maturity of Investments:
    - Ensure that any short-term investments included in cash equivalents have a maturity of three months or less from the date of purchase.
- Adjust for Foreign Currency:
    - If any cash or equivalents are held in foreign currency, convert them into the reporting currency at the current exchange rate.
- Sum Up All Amounts:
    - Add together the balances of all identified cash and cash equivalent accounts and instruments.

Analysis: Reconcile the cash balance per the bank statement to the general ledger.

Reconciling the cash balance per the bank statement to the general ledger involves ensuring that the balance shown in the company's general ledger (the book balance) matches the balance shown on the bank statement (the bank balance). Discrepancies can arise due to timing differences in recording transactions and potential errors. Here's how the reconciliation is done:

Steps to Reconcile Cash Balance

- **Start with the Ending Balances**:
  - Obtain the ending balance from the bank statement.
  - Obtain the ending balance from the company's general ledger.
- **Adjust the Bank Statement Balance**:
  - Add Deposits in Transit: Deposits made and recorded by the company but not yet reflected on the bank statement.
  - Subtract Outstanding Checks: Checks issued by the company not yet cleared and deducted from the bank statement.
- **Adjust the General Ledger Balance**:
  - Add Bank Credits: Items credited by the bank like interest earned, notes receivable collected by the bank, etc.
  - Subtract Bank Debits: Bank charges, automatic payments, NSF (non-sufficient funds) checks, etc.
  - Correct Errors: Adjust for any errors in the company's books.

- **Compare Adjusted Balances**:
    - After adjustments, the adjusted bank statement balance should equal the adjusted book balance.

Example

A company is reconciling its cash balance for the month of March. Here are the relevant figures:

- Bank Statement Ending Balance: $12,000
- General Ledger Balance: $11,500

Adjustments to Bank Statement Balance

- Deposits in Transit: $2,900 (deposited by the company on March 31st, not yet reflected in the bank statement)
- Outstanding Checks: $3,000 (checks written but not yet cleared by the bank)

Adjustments to General Ledger Balance

- Bank Credits: Interest earned of $50
- Bank Debits: Monthly bank charges of $100
- Errors: The company discovered an error where a $500 deposit was recorded as $50 in the general ledger.

Reconciliation Calculation

- Adjust Bank Statement Balance:
- Starting Balance: $12,000
- Add: Deposits in Transit: $2,900
- Subtract: Outstanding Checks: $3,000
- Adjusted Bank Balance: $11,900 ($12,000 + $2,900 - $3,000)

Adjust General Ledger Balance:

- Starting Balance: $11,500
- Add: Bank Credits (Interest): $50
- Subtract: Bank Debits (Charges): $100
- Correct Errors: Add back the under-recorded deposit: $450 ($500 - $50 already recorded)
- Adjusted Book Balance: $11,900 ($11,500 + $50 - $100 + $450)

Adjusted Bank Statement Balance: $11,900
Adjusted General Ledger Balance: $11,900

Analysis: Investigate unreconciled cash balances to determine whether an adjustment to the general ledger is necessary.

Here are some common instances of unreconciled cash balances, along with examples and whether an adjustment to the general ledger is needed:

1. Outstanding Checks

- Instance: Checks issued by the company but not yet cashed or cleared by the bank.
- Example: A company issues a check for $1,000, but the recipient hasn't deposited it by the bank statement's cutoff date.
- Adjustment Needed: No, since the check will eventually clear and be reflected in the bank balance.

2. Deposits in Transit

- Instance: Deposits made and recorded in the general ledger but not yet appearing on the bank statement.
- Example: A company deposits $2,000 on the last day of the month, which doesn't appear on that month's bank statement.
- Adjustment Needed: No, as the deposit will show up in the bank statement of the following period.

3. Bank Errors

- Instance: Mistakes made by the bank in recording transactions.
- Example: The bank accidentally records a $500 deposit as $50.

- Adjustment Needed: Yes, if the error is on the bank's part. The company should notify the bank to correct the mistake.

4. Bookkeeping Errors

- Instance: Errors in recording transactions in the company's general ledger.
- Example: A company mistakenly records a $200 expense as $2,000.
- Adjustment Needed: Yes, the company needs to correct the error in its records.

5. Bank Service Charges and Interest

Instance: Fees charged by the bank or interest earned, which are recorded by the bank but not yet in the company's books.
Example: The bank charges a monthly service fee of $25, or the company earns $15 in interest.
Adjustment Needed: Yes, these transactions need to be recorded in the general ledger.

6. NSF (Non-Sufficient Funds) Checks

- Instance: Checks received and recorded as deposits but bounced due to insufficient funds in the payer's account.
- Example: A $500 check deposited by the company is returned due to NSF.
- Adjustment Needed: Yes, the company must adjust its records to reverse the deposit and account for any bank fees.

B. Trade Receivables

Application: Calculate trade receivables and allowances (e.g., credit losses, sales returns) and prepare journal entries.

Let's start with sales discounts. Sales discounts are reductions in the sale price offered to customers as an incentive to encourage prompt payment. When accounting for sales discounts with trade receivables, there are two common methods: the gross method and the net method.

1. Gross Method

Under the gross method, sales are recorded at their full amount. If the customer takes advantage of the discount by paying early, the discount is recorded at the time of payment.

2. Net Method

The net method records sales at the net amount, assuming that the customer will take the discount. If the customer does not take the discount, the difference is recorded as sales discount forfeited.

Let's illustrate these methods with example journal entries:
Scenario

- Sale amount: $1,000
- Terms: 2/10, n/30 (2% discount if paid within 10 days; otherwise, net amount due in 30 days)

Gross Method

a. Journal Entry on Date of Sale

Account	Debit ($)	Credit ($)
Trade Receivables	1,000	
Sales Revenue		1,000

b. Entry if Payment Received Within Discount Period

- Payment received within 10 days for $980 ($1,000 - 2% of $1,000).

Account	Debit ($)	Credit ($)
Cash	980	
Sales Discounts	20	
Trade Receivables		1,000

c. Entry if Payment Not Received Within Discount Period

- Payment received after 10 days for the full amount of $1,000.

Account	Debit ($)	Credit ($)
Cash	1,000	
Trade Receivables		1,000

Net Method

a. Journal Entry on Date of Sale

- Sale recorded at the net amount ($1,000 - 2% of $1,000 = $980).

Account	Debit ($)	Credit ($)
Trade Receivables	980	
Sales Revenue		980

b. Entry if Payment Received Within Discount Period

- Payment received within 10 days for $980.

Account	Debit ($)	Credit ($)
Cash	980	
Trade Receivables		980

c. Entry if Payment Not Received Within Discount Period

- Payment received after 10 days for the full amount of $1,000.

Account	Debit ($)	Credit ($)
Cash	1,000	
Sale Discount Forfeited		20
Trade Receivables		980

In the net method, if the customer does not take the discount, the additional amount received is recognized as "Sales Discount Forfeited," which is generally treated as other income.

Uncollectible Accounts Receivable

The allowance method for expected credit losses is a way to account for potential uncollectible accounts within trade receivables. This method involves estimating the amount of receivables that are expected to be uncollectible and recording this estimate as an allowance for credit losses. The key steps in this method are:

1. **Estimating Credit Losses**: Estimate the amount of trade receivables that may not be collectible. This estimation can be based on historical data, industry averages, customer creditworthiness, and current economic conditions.
2. **Recording the Allowance**: Create or adjust an allowance account to reflect the estimated credit losses.
3. **Adjusting the Allowance**: If actual credit losses differ from estimates, adjust the allowance account accordingly.

Example Journal Entries

Let's assume a business estimates that 5% of its $100,000 in trade receivables will be uncollectible.

1. Initial Recording of the Allowance for Credit Losses

When the allowance is first established or adjusted:
This entry increases the expense for expected credit losses and also increases the allowance for credit losses (a contra-asset account).

Entry to record initial allowance:

Account	Debit ($)	Credit ($)
Bad Debt Expense	5,000	
Allowance for Credit Losses		5,000

2. Writing Off an Uncollectible Account

If a specific account, say $1,000, is deemed uncollectible:
This entry does not affect the income statement since the expense was already recognized when the allowance was created. It merely reduces the receivable and the allowance.

Account	Debit ($)	Credit ($)
Allowance for Credit Losses	1,000	
Trade Receivables		1,000

3. Recovery of a Written-Off Account

If a previously written-off account is later collected:
Reversing the Write-Off

Account	Debit ($)	Credit ($)
Trade Receivables	1,000	
Allowance for Credit Losses		1,000

Recording the Cash Receipt

Account	Debit ($)	Credit ($)
Cash	1,000	
Trade Receivables		1,000

Accounting for Sale Returns

Sales returns occur when customers return previously purchased goods to the seller. This event requires specific accounting treatments to reflect the change in revenue and inventory, if applicable.

Accounting for Sales Returns

- Recognizing the Return: When goods are returned, the seller needs to reverse the revenue recognized from the sale and adjust the inventory if the goods are restockable.
- Updating Receivables: If the original sale was made on credit, the seller also needs to reduce the accounts receivable.

Example and Journal Entries

Let's consider a scenario:

- Company A sells products to a customer for $500 on credit.
- The customer later returns goods worth $100.

First, we record the original sale:

Account	Debit ($)	Credit ($)
Accounts Receivable	500	
Sales Revenue		500

Upon the return of goods:

- Reducing Revenue: The sales return account, which is a contra-revenue account, is debited to show a reduction in revenue.

- Adjusting Receivables: The accounts receivable are credited to reflect the decrease in the amount owed by the customer.
- Updating Inventory: If the goods are restockable, inventory is debited to reflect the return of goods to inventory, and cost of goods sold is credited to reverse the expense recorded at the time of sale.

Journal entries for the return:

Adjusting Sales and Receivables

Account	Debit ($)	Credit ($)
Sales Returns and Allowances	100	
Accounts Receivable		100

Updating Inventory (if applicable)

Let's say the cost of the returned goods was $60.

Account	Debit ($)	Credit ($)
Inventory	60	
Cost of Goods Sold		60

Application: Prepare any required journal entries to record the transfer of trade receivables (secured borrowings, factoring, assignment, pledging).

Let's explain the difference between each term:

1. Secured Borrowing

- Definition: In secured borrowing, a company uses its trade receivables as collateral to obtain a loan. The company retains ownership of the receivables and continues to collect them.
- Key Points:
  - The receivables serve as security for the loan.
  - The company remains responsible for collecting the receivables.
  - Any default in receivables does not usually affect the loan unless it falls below the collateral value.
  - Interest is charged on the borrowed amount.
- Example
  - Company A uses $100,000 of its trade receivables as collateral for an $80,000 loan.
  - Note: There's no direct journal entry for pledging the receivables as collateral under normal secured borrowing. The receivables remain on the balance sheet, and details are disclosed in financial statement notes.

Account	Debit ($)	Credit ($)
Cash	80,000	
Note Payable		80,000

2. Factoring

- Definition: Factoring involves selling trade receivables to a third party (factor) at a discount. The factor then assumes the risk of collecting the receivables.
- Key Points:
  - The company gets immediate cash (less the factor's fees and discount).
  - The risk of uncollectible receivables is transferred to the factor.
  - It can be with recourse (company bears the risk of uncollectibles) or without recourse (factor bears the risk).
  - The transaction is a sale of financial assets.
  - In factoring arrangements, there is typically a "factor's margin" or "factor's fee," which is essentially the cost charged by the factor for providing the service. This fee is usually a percentage of the total value of the receivables. The factor's margin covers the factor's costs and provides them with a profit margin. It is the main way factors earn money from the factoring service.
- Example
  - Company A sells $100,000 of its trade receivables to a factor.
  - The factor advances 90% of the receivables value ($90,000) and retains a 5% margin ($5,000).

Account	Debit ($)	Credit ($)
Cash	90,000	
Factor's Fee	5,000	
Loss on Sale of Receivables	5,000	
Trade Receivables		100,000

IF the factoring was "with recourse", then Company A also needs to record a liability. Let's assume Company A estimates that 2% of the receivables might be uncollectible.

Account	Debit ($)	Credit ($)
Loss on Sale of Receivables	2,000	
Liability for Recourse		2,000

3. Assignment

- Definition: Assignment is similar to secured borrowing, where receivables are used as collateral. However, in assignment, specific receivables are designated as collateral for a specific loan.
- Key Points:
  - Specific receivables are earmarked for a particular debt.
  - The company remains responsible for collection.
  - The rights to the receivables are assigned to the lender but ownership usually remains with the company.
  - It is more tailored compared to general secured borrowing.

- Example
    - Company A assigns $100,000 of its trade receivables specifically as collateral for a $75,000 loan.
    - Note: Similar to secured borrowing, there's no direct journal entry for assigning the receivables, but details are disclosed in the financial statements.

Account	Debit ($)	Credit ($)
Cash	75,000	
Note Payable		75,000

4. Pledging

- Definition: Pledging is a form of secured borrowing where receivables are pledged as collateral for a loan, but the company retains control and continues to collect them.
- Key Points:
    - Similar to secured borrowing, but the term "pledging" often implies a more general claim against the receivables, rather than a specific lien.
    - The company retains both ownership and collection responsibility.
    - It is often used in broader financing arrangements, not tied to specific receivables.
- Example: Company A pledges $100,000 of its trade receivables for a general credit line of $70,000, from which it draws $50,000.

- Note: Like secured borrowing and assignment, the pledging itself doesn't require a journal entry; the receivables remain on the balance sheet.

Account	Debit ($)	Credit ($)
Cash	50,000	
Line of Credit Payable		50,000

Summary

- Secured Borrowing and Pledging: Both involve using receivables as collateral for a loan, with the company retaining ownership and control over the collection.
- Factoring: Involves selling the receivables outright, often transferring the risk to the factor.
- Assignment: Is a more specific form of secured borrowing where particular receivables are earmarked for a specific debt.

Analysis: Prepare a rollforward of the trade receivables account balance using various sources of data and information.

A rollforward is an accounting schedule that shows the beginning balance, additions, reductions, and ending balance for a particular account over a period. Let's walk through a hypothetical rollforward for the Trade Receivables account for a company.

Example: Rollforward of Trade Receivables

Let's assume the following for a company's trade receivables over a quarter:

- Beginning Balance: The amount of trade receivables at the start of the quarter.
- Sales on Credit: Total credit sales made during the quarter.
- Collections: Amounts collected from customers during the quarter.
- Write-offs: Accounts deemed uncollectible and written off during the quarter.
- Ending Balance: The amount of trade receivables at the end of the quarter.

Hypothetical Data:

- Beginning Balance (Start of Quarter): $100,000
- Sales on Credit (During Quarter): $50,000
- Collections (During Quarter): $40,000
- Write-offs (During Quarter): $5,000

Rollforward Schedule:

Description	Amount ($)
Beginning Balance	100,000
Add: Sales on Credit	50,000
Less: Collections	(40,000)
Less: Write-offs	(5,000)
Ending Balance	105,000

Explanation:

- Beginning Balance: The trade receivables at the start of the period were $100,000.
- Sales on Credit: The company made additional sales on credit totaling $50,000, which increased the receivables.
- Collections: Throughout the period, $40,000 was collected from customers, reducing the receivables.
- Write-offs: $5,000 of receivables were determined to be uncollectible and were written off, further reducing the receivables.
- Ending Balance: The ending balance of trade receivables is calculated as $100,000 + $50,000 - $40,000 - $5,000, which equals $105,000.

Analysis: Reconcile and investigate differences between the subledger and general ledger for trade receivables to determine whether an adjustment is necessary.

This task will be represented in a task-based simulation and would cover various aspects of the items covered previously in this topic.

C. Inventory

Application: Calculate the carrying amount of inventory and prepare journal entries using various costing methods.

Inventory valuation under GAAP involves the "lower of cost or market" (LCM) rule, which serves as a conservative measure to ensure that inventory is not overstated on the balance sheet. This rule is applied after determining the cost of inventory using one of the costing methods (FIFO, LIFO, or Average Cost). Here's how LCM ties in with these methods.

Lower of Cost or Market Rule

- Cost: As calculated using FIFO, LIFO, or Average Cost.
- Market Value: The current replacement cost of the inventory, but not exceeding the net realizable value (NRV) or below the NRV minus a normal profit margin.

Applying the LCM Rule

After calculating the inventory cost using one of the methods, you compare it with the market value:

- If Cost > Market Value: Write down the inventory to its market value.
- If Cost ≤ Market Value: No adjustment is needed.

Example Integration with Costing Methods
Suppose a company has calculated its inventory cost using FIFO, LIFO, and Average Cost:

- FIFO-based Cost: $1,300
- LIFO-based Cost: $1,100
- Average Cost: $1,266
- Current Market Value of Inventory: $1,200

Applying LCM

- FIFO: Inventory Cost ($1,300) > Market Value ($1,200) → Write down to $1,200
- LIFO: Inventory Cost ($1,100) < Market Value ($1,200) → No adjustment needed
- Average Cost: Inventory Cost ($1,266) > Market Value ($1,200) → Write down to $1,200

Journal Entry for Writing Down Inventory
Let's demonstrate the journal entry using the FIFO method:

Account	Debit ($)	Credit ($)
Loss on Inventory Write-Down	100	
Inventory		100

Note: The write-down amount is $100 ($1,300 FIFO cost - $1,200 market value).
This entry reflects a loss in the income statement and reduces the inventory value on the balance sheet.

Importance of LCM

The LCM rule is important for ensuring that inventory is reported at a value that is not higher than what it can realistically bring in. This aligns with the conservatism principle in accounting, which states that one should not overstate assets or income. Applying LCM after choosing a costing method ensures that inventory valuation reflects current market conditions and reduces the risk of overstating assets and earnings.

Inventory Costing Methods

Let's go through an example using different costing methods under GAAP: FIFO (First-In, First-Out), LIFO (Last-In, First-Out), and Average Cost. We'll calculate the carrying amount of inventory and demonstrate the associated journal entries.

Example Scenario

Let's say a company has the following inventory transactions in a month:

- Beginning Inventory: 100 units @ $5 each
- Purchase 1: 200 units @ $6 each
- Purchase 2: 300 units @ $7 each
- Sales: 400 units during the month

FIFO (First-In, First-Out)

Under FIFO, the oldest inventory is sold first.

Sales Entry: Assuming sales revenue of $10 per unit

Account	Debit ($)	Credit ($)
Cash or A/R	4,000	
Sales Revenue		4,000

FIFO Calculation for COGS

- Sell all 100 units from beginning inventory @ $5 each = 100 units x $5 = $500
- Then sell 200 units from Purchase 1 @ $6 each = 200 units x $6 = $1,200
- Finally, sell 100 units from Purchase 2 @ $7 each = 100 units x $7 = $700

So, the total COGS = $500 (from beginning inventory) + $1,200 (from Purchase 1) + $700 (from Purchase 2) = $2,400

Account	Debit ($)	Credit ($)
COGS	2,400	
Inventory		2,400

FIFO Calculation for Ending Inventory
Remaining from Purchase 2: 200 units @ $7 each = 200 units x $7 = $1,400

LIFO: (Last-In, First-Out)
LIFO Calculation for COGS
Under LIFO, we sell the most recent inventory first:

- Sell all 300 units from Purchase 2 @ $7 each = 300 units x $7 = $2,100

- Then sell 100 units from Purchase 1 @ $6 each = 100 units x $6 = $600

So, the total COGS = $2,100 (from Purchase 2) + $600 (from Purchase 1) = $2,700
COGS Journal Entry (Sales entry is same as FIFO example)

Account	Debit ($)	Credit ($)
COGS	2,700	
Inventory		2,700

LIFO Calculation for Ending Inventory

- Remaining from Beginning Inventory: 100 units @ $5 each = 100 units x $5 = $500
- Remaining from Purchase 1: 100 units @ $6 each = 100 units x $6 = $600

So, the ending inventory = $500 (from Beginning Inventory) + $600 (from Purchase 1) = $1,100

Average Cost Method

First, calculate the total cost of the inventory and then find the average cost per unit.

- Total cost of beginning inventory = 100 units x $5 = $500
- Total cost of Purchase 1 = 200 units x $6 = $1,200
- Total cost of Purchase 2 = 300 units x $7 = $2,100
- Total cost of all inventory = $500 + $1,200 + $2,100 = $3,800
- Total units available = 100 + 200 + 300 = 600 units

Average cost per unit = Total cost / Total units = $3,800 / 600 = $6.33 (rounded to two decimal places)

Calculating COGS

COGS for 400 units sold = 400 units x $6.33 = $2,532

COGS Journal Entry (Sales entry is same as FIFO example)

Account	Debit ($)	Credit ($)
COGS	2,532	
Inventory		2,532

Calculating Ending Inventory

Ending inventory = 200 units remaining (600 total units - 400 units sold)

Cost of ending inventory = 200 units x $6.33 = $1,266

Application: Use the lower of cost and net realizable value or the lower of cost or market approach to calculate the carrying amount of inventory.

The concepts of "Lower of Cost and Net Realizable Value" and "Lower of Cost or Market" are conservative approaches in accounting for inventory valuation. Both methods ensure that inventory is not reported at an amount greater than the benefits it can provide. Here's how each one works:

Lower of Cost and Net Realizable Value (LCNRV)

- **Used In**: This approach is primarily used in International Financial Reporting Standards (IFRS).
- **Cost**: The amount paid to purchase or produce the inventory.
- **Net Realizable Value (NRV)**: The estimated selling price in the ordinary course of business minus estimated costs of completion, disposal, and transportation.
- **Approach**: Compare the cost of each inventory item (or group of items) to its NRV. If the cost exceeds the NRV, write down the inventory to its NRV.

Example Calculation

- Cost of Inventory: $1,000
- Estimated Selling Price: $1,200
- Estimated Completion and Disposal Costs: $250
- NRV: $1,200 - $250 = $950
- Carrying Amount: Lower of $1,000 (Cost) and $950 (NRV) = $950

Lower of Cost or Market (LCM)

- **Used In**: This method is used under GAAP in the United States.
- **Cost**: As determined by FIFO, LIFO, or Average Cost methods.
- **Market Value**: Typically the replacement cost of the inventory, but not higher than the net realizable value (NRV) or lower than NRV minus a normal profit margin.
- **Approach**: Compare the cost of the inventory to its market value. If the cost exceeds the market value, write down the inventory to the market value.

Example Calculation

- Cost of Inventory (using FIFO): $1,000
- Replacement Cost: $900
- Estimated Selling Price: $1,200
- Estimated Completion and Disposal Costs: $250
- NRV: $1,200 - $250 = $950
- Market Value for LCM: Lower of Replacement Cost ($900) and NRV ($950) = $900
- Carrying Amount: Lower of $1,000 (Cost) and $900 (Market Value) = $900

Analysis: Prepare a rollforward of the inventory account balance using various sources of data and information.

An inventory rollforward is a reconciliation method that explains the changes in the inventory balance over a period. It starts with the beginning balance, adds purchases, adjusts for cost of goods sold (COGS) and other factors like write-offs or adjustments, and ends with the closing balance. Here's an example:

Example Inventory Rollforward

Let's assume the following activity for a company's inventory during a particular month:

- Beginning Inventory: $20,000
- Purchases: $15,000
- COGS: $18,000
- Inventory Write-offs: $2,000
- Other Adjustments (like returns, discounts, etc.): $1,000 addition

Rollforward:

Description	Amount($)	Running Total($)
Beginning Inventory	20,000	20,000
Add: Purchases	15,000	35,000
Less: COGS	(18,000)	17,000
Less: Inventory Write-Offs	(2,000)	15,000
Add: Other Adjustments	1,000	16,000
Ending Inventory		**16,000**

Analysis: Reconcile and investigate differences between the subledger and general ledger for inventory to determine whether an adjustment is necessary.

This task will be represented in a task-based simulation and would cover various aspects of the items covered previously in this topic.

D. Property, Plant and Equipment

Application: Calculate the gross and net property, plant and equipment balances and prepare journal entries.

Gross Book Value and Net Book Value are two distinct concepts used in accounting for Property, Plant, and Equipment (PP&E).

Gross Book Value (GBV)

- Definition: Gross Book Value of PP&E is the total historical cost of these assets before accounting for any depreciation. It includes the purchase price and all costs necessary to bring the asset to its usable condition, such as installation costs, transportation fees, and any other direct costs associated with the asset.
- Usage: GBV is useful for understanding the total amount invested in the assets. It doesn't reflect the current value or the wear and tear on the assets.

Net Book Value (NBV)

- Definition: Net Book Value is the Gross Book Value minus accumulated depreciation and any impairment losses. It represents the estimated current value of the assets on the company's books.
- Usage: NBV is commonly used in financial reporting because it provides a more realistic view of an asset's value on the balance sheet. It takes into account the reduction in value due to depreciation and impairments, offering a closer approximation to the asset's current market value.

Here's a breakdown of the elements that contribute to the Gross Book Value of Property, Plant, and Equipment (PP&E) and those that are subtracted to arrive at the Net Book Value:

Additions to Gross Book Value of PP&E

- Purchase Price: The initial cost of acquiring the asset.
- Installation Costs: Expenses related to setting up and installing the asset.
- Delivery and Handling Charges: Costs incurred in transporting the asset to its location.
- Site Preparation Costs: Expenses for preparing the location where the asset will be used.
- Legal Fees: Costs associated with legal services for the purchase of the asset.
- Professional Fees: Fees paid for architects, engineers, and consultants involved in the asset's acquisition or construction.
- Testing and Preparation: Costs incurred to ensure the asset is functioning properly before use.
- Improvements: Expenditures that extend the life of the asset, increase its capacity, or improve its efficiency.
- Reconstruction or Overhaul Costs: Major costs incurred to rebuild or overhaul the asset, thereby extending its useful life.
- Capitalized Interest: Interest costs related to the funds borrowed to construct or acquire the asset can be capitalized during the construction period.

Subtractions to Arrive at Net Book Value of PP&E

- Accumulated Depreciation: The cumulative depreciation of the asset over its useful life.
- Impairment Losses: Reductions in the recoverable value of the asset, when the carrying amount exceeds its recoverable amount.
- Accumulated Amortization: If the asset is an intangible with a finite life, the cumulative amortization.
- Disposal Costs (if asset is disposed): The costs associated with selling or disposing of the asset.

Note:

- Not Included in GBV: Routine maintenance and repair costs are typically expensed as incurred and do not add to the asset's GBV.
- Asset Upgrades vs. Repairs: Only upgrades and improvements that significantly enhance the asset's value or extend its useful life are added to GBV. Regular repairs and maintenance are treated as expenses.

Example

Let's walk through an example of valuing a building purchased along with land under GAAP. This will include differentiating between various costs and categorizing them appropriately.

A company purchases a property that includes land and a building for $1,000,000. The fair market values are $700,000 for the land and $300,000 for the building. Additional costs are incurred in preparing the land and building.

Additional Costs:

- Leveling Ground for the Building: $50,000
- Digging a Hole for the Foundation: $30,000
- Legal Fees for Purchase: $10,000
- Building Improvements (e.g., adding a new roof): $100,000
- Repairs (e.g., painting walls): $20,000

1. Allocating Purchase Price Between Land and Building

- Land: $700,000
- Building: $300,000

2. Capitalize Costs Directly Attributable to the Asset

- Land Preparation Costs:
  - Leveling Ground: Capitalized as Land Cost ($50,000).
  - Digging Hole for Foundation: Capitalized as Building Cost ($30,000), as it's directly related to the building's construction.
- Legal Fees: Capitalized proportionally to Land and Building based on their fair market values.
- Building Improvements vs. Repairs:
  - Improvements (e.g., new roof): Capitalized as they extend the useful life of the building ($100,000).
  - Repairs (e.g., painting): Expensed in the period incurred ($20,000).

3. Calculating Total Capitalized Cost

- Land Total Cost: $700,000 (purchase) + $50,000 (leveling) + Part of Legal Fees

- Building Total Cost: $300,000 (purchase) + $30,000 (foundation) + $100,000 (improvements) + Part of Legal Fees

4. Legal Fees Allocation (Example Allocation Method)

- Total Legal Fees: $10,000
- Allocation Based on Fair Market Values:
- To Land: ($700,000 / $1,000,000) * $10,000 = $7,000
- To Building: ($300,000 / $1,000,000) * $10,000 = $3,000

5. Final Valuation

- Land Valuation: $700,000 + $50,000 + $7,000 = $757,000
- Building Valuation: $300,000 + $30,000 + $100,000 + $3,000 = $433,000

Initial Purchase Entry:

Account	Debit ($)	Credit ($)
Land	757,000	
Building	433,000	
Cash/Loan		1,190,000

Recording Repairs:

Account	Debit ($)	Credit ($)
Repairs and Maintenance	20,000	
Cash		20,000

Summary:

- Costs directly related to preparing the land (like leveling) are capitalized as part of the land's cost.

- Costs directly associated with making the building ready for use (like foundation work) are capitalized as part of the building's cost.
- Building improvements are capitalized as they extend the useful life of the asset.
- Repairs and maintenance expenses, like painting, are expensed as they occur since they don't prolong the asset's life or enhance its value.
- Legal fees are allocated between the land and building based on their fair market values.

Accumulated Depreciation and Net Book Value

From the previous example, the building would be depreciated, and the accumulated depreciation would be netted against the building’s gross book value to determine the net book value.

If the depreciation for the year was $15,000, the journal entry would be:

Account	Debit ($)	Credit ($)
Depreciation Expense	15,000	
Accumulated Depreciation		15,000

Application: Calculate gains or losses on the disposal of long-lived assets to be recognized in the financial statements.

Gains or losses on the disposal of long-lived assets, such as property, plant, and equipment (PP&E), are recognized in the financial statements when an asset is sold, retired, or otherwise disposed of. These gains or losses are the difference between the proceeds from the disposal and the asset's carrying amount (book value) at the time of disposal.

Example Scenario:
Let's say a company disposes of a piece of machinery.

Assumptions:

- Original Purchase Price of Machinery: $100,000
- Accumulated Depreciation to Date of Disposal: $60,000
- Proceeds from Disposal: $50,000

Step-by-Step Calculation:

- Calculate Carrying Amount (Net Book Value) of the Asset at Disposal:
  - Original Purchase Price: $100,000
  - Less: Accumulated Depreciation: $60,000
  - Carrying Amount: $40,000
- Calculate Gain or Loss on Disposal:
  - Proceeds from Disposal: $50,000
  - Less: Carrying Amount: $40,000
  - Gain on Disposal: $10,000

If the proceeds from disposal had been $30,000, it would have been a $10,000 loss instead.

Application: Calculate impairment losses on long-lived assets to be recognized in the financial statements.

An impairment loss on a long-lived asset occurs when the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. Under GAAP, the process of calculating impairment losses involves several steps. Let's walk through an example to illustrate this.

Example
Suppose a company owns a piece of manufacturing equipment.

Assumptions:

- Original Cost of Equipment: $100,000
- Accumulated Depreciation to Date: $40,000
- Estimated Remaining Useful Life: 5 years
- Current Fair Value of the Equipment: $45,000
- Costs to Sell: $5,000
- Estimated Future Cash Flows (undiscounted) from the use of the equipment: $55,000

Steps to Calculate Impairment Loss:

- **Determine Carrying Amount**:
    - Original Cost: $100,000
    - Less: Accumulated Depreciation: $40,000
    - Carrying Amount: $60,000
- **Perform Recoverability Test**:
    - Compare the carrying amount with the sum of the undiscounted future cash flows.
    - Carrying Amount: $60,000

    - Undiscounted Future Cash Flows: $55,000
    - Since the carrying amount exceeds the undiscounted cash flows, an impairment test is required.
- **Calculate Fair Value Less Costs to Sell**:
    - Fair Value: $45,000
    - Less: Costs to Sell: $5,000
    - Fair Value Less Costs to Sell: $40,000
- **Calculate Impairment Loss**:
    - Impairment Loss = Carrying Amount - Fair Value Less Costs to Sell
    - Impairment Loss = $60,000 - $40,000 = $20,000

Account	Debit ($)	Credit ($)
Impairment Loss (Income Statement)	20,000	
Accumulated Depreciation (Balance Sheet)		20,000

Note:

- The Impairment Loss account is debited to reflect the loss on the income statement.
- The credit to Accumulated Depreciation or directly to the Equipment account reduces the carrying amount of the asset on the balance sheet.
- Post-impairment, the new carrying amount of the equipment becomes $40,000.
- Under GAAP, subsequent reversal of impairment losses is generally not permitted if the fair value of the asset increases in later periods.

Application: Determine whether an asset qualifies to be reported as held for sale in the financial statements.

To determine whether an asset qualifies as "held for sale" in the financial statements, certain criteria under GAAP must be met. These criteria ensure that the asset is genuinely intended to be sold and that the sale is highly probable. Once an asset is classified as held for sale, it is no longer depreciated and is reported separately in the financial statements.

Criteria for Classifying an Asset as Held for Sale

An asset (or disposal group) is classified as held for sale if all the following conditions are met:

- **Management Commitment to a Plan**: There must be a committed plan to sell the asset.
- **Available for Immediate Sale**: The asset must be in a condition ready for sale in its present condition.
- **Active Program to Locate a Buyer**: There must be an active program to locate a buyer and complete the plan.
- **Sale is Highly Probable**: The sale should be highly probable within one year from the date of classification.
- **Reasonable Price**: The asset must be actively marketed at a price that is reasonable in relation to its current fair value.
- **Unlikely Significant Changes to Plan**: It's unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Let's illustrate this with an example:

A company decides to sell one of its warehouses. As of June 1, 2023, the following conditions are met:

- The company's board approves a plan to sell the warehouse.
- The warehouse is ready for immediate sale and does not require any significant refurbishing.
- The company has engaged a real estate agent to find a buyer.
- The company expects to sell the warehouse within the next six months.
- The warehouse is listed for sale at a market price of $500,000, which is its fair value.
- The company has no intention of withdrawing the sale plan and believes it's unlikely that significant changes will be made to the plan.

Accounting Treatment
Given these conditions, the warehouse meets the criteria to be classified as held for sale as of June 1, 2023.

Financial Statement Reporting:
- **Balance Sheet**: The warehouse is no longer classified as PP&E but as a separate line item under "Assets held for sale."
- **No Depreciation**: From June 1, 2023, the company will no longer depreciate the warehouse.
- **Measurement**: If the fair value of the warehouse (less costs to sell) is lower than its carrying amount, an impairment loss is recognized.

Journal Entry (if impairment is required):
Suppose the carrying amount of the warehouse is $550,000. An impairment loss of $50,000 is recognized to write it down to the fair value less costs to sell.

Account	Debit ($)	Credit ($)
Impairment Loss (Income Statement)	50,000	
Accumulated Depreciation (Balance Sheet)		50,000

Summary

- Assets are classified as held for sale when specific criteria are met, signifying a high probability and readiness for sale.
- Such assets are reported separately in the financial statements and are not depreciated.
- Impairment losses may be recognized if the fair value less costs to sell is lower than the carrying amount.

Application: Adjust the carrying amount of assets held for sale and calculate the loss to be recognized in the financial statements.

Adjusting the carrying amount of assets held for sale and recognizing any resulting loss is an important aspect of financial reporting. This process involves comparing the carrying amount of the asset with its fair value less costs to sell, and recognizing a loss if the fair value is lower.

Process for Adjustment and Loss Calculation

- **Classify the Asset as Held for Sale**: First, ensure the asset meets the criteria to be classified as 'held for sale' under GAAP.
- **Determine Carrying Amount**: This is the amount at which the asset is currently recorded on the balance sheet. It includes the original cost minus accumulated depreciation and any previous impairment losses.
- **Determine Fair Value Less Costs to Sell**:
    - **Fair Value**: The amount for which the asset could be sold in a transaction between knowledgeable, willing parties.
    - **Costs to Sell**: Additional costs directly attributable to the sale, like legal fees, broker commissions, etc.
- **Compare and Adjust**: If the carrying amount exceeds the fair value less costs to sell, reduce the carrying amount to this lower value.
- **Recognize Loss**: Record a loss for the difference between the carrying amount and the revised (lower) amount.

Let's illustrate with an example:

Assumptions:

- A company classifies a piece of machinery as held for sale.
- Carrying Amount of Machinery: $100,000
- Fair Value of Machinery: $90,000
- Costs to Sell: $5,000
- Fair Value Less Costs to Sell: $90,000 - $5,000 = $85,000

Steps:

1. Carrying Amount: $100,000
2. Fair Value Less Costs to Sell: $85,000
3. Loss on Adjustment: $100,000 (carrying amount) - $85,000 (fair value less costs to sell) = $15,000

Entry to adjust the carrying amount and recognize the loss:

Account	Debit ($)	Credit ($)
Loss on Write-Down of Assets Held for Sale	15,000	
Accumulated Depreciation (Balance Sheet)		15,000

Note:

- When an asset is classified as held for sale, its carrying amount must be reviewed.
- If the fair value less costs to sell is lower than the carrying amount, the carrying amount is reduced to this lower value.
- The loss due to this reduction is recognized in the income statement, reflecting the decline in the asset's value.

Analysis: Prepare a rollforward of the property, plant and equipment account balance using various sources of data and information.

Let's walkthrough an example. Here's the initial Balances and Activities:

Asset A:

- Beginning Balance: $250,000
- Beginning Accumulated Depreciation: $50,000
- Depreciation: $20,000

Asset B:

- Beginning Balance: $150,000
- Beginning Accumulated Depreciation: $50,000
- Addition: $50,000
- Depreciation: $15,000

Asset C:

- Beginning Balance: $150,000
- Beginning Accumulated Depreciation: $50,000
- Disposal: (Original Cost $25,000, Accumulated Depreciation $10,000, so the net disposal is $15,000)
- Impairment Loss: $5,000
- Depreciation: $10,000

PPE Rollforward (in thousands)

Asset	Orig. Cost	Add.	Beg. Accum Dep.	Dep.	End. Accum Dep.	Disposals	Imp. Loss	End. Book Value
A	$250		($50)	($20)	($70)			$180
B	$200	$50	($50)	($15)	($65)			$185
C	$150		($50)	($10)	($60)	($15)	($5)	$70
Total	**$600**	**$50**	**($150)**	**($45)**	**($195)**	**($15)**	**($5)**	**$435**

Analysis: Reconcile and investigate differences between the subledger and general ledger for property, plant and equipment to determine whether an adjustment is necessary.

This task will be represented in a task-based simulation and would cover various aspects of the items covered previously in this topic.