

FAR Complete Study Guide, Part I

Olivia Anderson · True North Accounting & Business Solutions · Study notes for educational use. Always confirm details against the current AICPA Blueprints and authoritative standards.

Financial Accounting and Reporting, Area I: Financial Reporting (30–40% of the FAR section). Parts 2 and 3 cover balance sheet accounts and select transactions.

The FASB Codification

The FASB Accounting Standards Codification (ASC) is the single source of authoritative GAAP for nongovernmental entities. SEC rules and staff guidance are also authoritative for public companies.

How a citation works: ASC 606-10-25-1 means Topic 606, Subtopic 10, Section 25, Paragraph 1.

- **Topic:** for example, 606 is revenue
- **Subtopic:** 10 is usually "Overall"
- **Section:** for example, 25 is recognition and 35 is subsequent measurement

TOPIC RANGE	AREA
105–199	General principles
205–299	Presentation
305–399	Assets
405–499	Liabilities
505–599	Equity
605–699	Revenue
705–799	Expenses
805–899	Broad transactions
905–999	Industries

The Conceptual Framework

The FASB's Concepts Statements aren't authoritative GAAP, but they guide how standards are written. Concepts Statement 8 now contains most of the framework.

Objective of Financial Reporting

To provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Qualitative Characteristics

Fundamental characteristics. Useful information must have both.

1. **Relevance:** capable of making a difference in decisions. It has predictive value, confirmatory value or both. Materiality is an entity-specific aspect of relevance.
2. **Faithful representation:** complete, neutral and free from error.

Enhancing characteristics: comparability, verifiability, timeliness and understandability.

The cost constraint: the benefits of reporting information should justify the costs.

Elements of Financial Statements

Concepts Statement 8, Chapter 4 (2021) defines:

- **Asset:** a present right of an entity to an economic benefit
- **Liability:** a present obligation of an entity to transfer an economic benefit
- **Equity:** the residual interest in assets after deducting liabilities
- **Revenues and expenses:** inflows and outflows from the entity's ongoing major or central operations
- **Gains and losses:** increases and decreases in equity from peripheral or incidental transactions
- **Comprehensive income:** all changes in equity except those from transactions with owners. It equals net income plus other comprehensive income (OCI).

Recognition and Measurement

An item is recognized when it meets the definition of an element, can be measured with a relevant measurement attribute and can be faithfully represented.

Measurement attributes include historical cost, current cost, fair value, net realizable value and the present value of future cash flows.

Underlying Assumptions and Principles

- **Economic entity:** the business is separate from its owners.
- **Going concern:** the entity is assumed to continue operating. If liquidation is imminent, the liquidation basis of accounting applies.
- **Monetary unit:** transactions are measured in a stable currency.
- **Periodicity:** the entity's life can be divided into reporting periods.
- **Historical cost:** assets and liabilities are initially recorded at cost.
- **Revenue recognition:** governed by ASC 606's five-step model.
- **Expense recognition:** expenses are matched with related revenues or recognized when benefits are used up.
- **Full disclosure:** provide the information users need, including notes.
- **Materiality:** GAAP need not be applied to items that are immaterial.

Financial Statement Presentation

The Balance Sheet

Shows financial position at a point in time: assets equal liabilities plus equity. It may use the account form (side by side) or the more common report form (top to bottom).

Current assets are expected to be realized within one year or the operating cycle, whichever is longer. Examples are cash, short-term investments, net receivables, inventory and prepaid expenses. The operating cycle runs from cash to inventory to receivables and back to cash.

Noncurrent assets include long-term investments, PP&E, intangible assets and other assets.

Current liabilities are obligations due within one year or the operating cycle, such as accounts payable, short-term notes, the current portion of long-term debt, accrued liabilities and contract liabilities expected to be satisfied within a year.

Short-term obligations expected to be refinanced can be classified as noncurrent if the company intends to refinance on a long-term basis **and** demonstrates the ability to do so, either by:

- Actually refinancing on a long-term basis after the balance sheet date but before the statements are issued, or
- Entering into a financing agreement before the statements are issued that clearly permits long-term refinancing

Stockholders' equity includes common stock at par, additional paid-in capital, retained earnings, accumulated OCI and treasury stock as a contra account.

Offsetting assets and liabilities is generally prohibited unless a right of setoff exists: amounts owed to each other, a legal right to offset, and the intent to offset.

Question: A \$500,000 bank loan is due in six months. Before the financial statements are issued, the company signs an agreement with the bank to refinance it for five years. How is it classified?

Answer: As a noncurrent liability. The company intends to refinance and has demonstrated the ability through a qualifying financing agreement signed before the statements were issued.

The Income Statement

Shows results of operations for a period.

Single-step format: total revenues less total expenses, then income tax, equals net income.

Multiple-step format:

LINE

Sales revenue

Less cost of goods sold = Gross profit

Less operating expenses = Operating income

Plus or minus other income, gains, expenses and losses = Income before income taxes

Less income tax expense = Income from continuing operations

Plus or minus discontinued operations, net of tax = Net income

Continuing operations include items that are unusual, infrequent or both. Extraordinary items were eliminated by ASU 2015-01. Unusual or infrequent items may be shown as separate line items within continuing operations, but not net of tax.

Discontinued operations report the disposal, or classification as held for sale, of a component or group of components that represents a **strategic shift** with a major effect on operations and results, such as selling a major line of business or geographic area. Results are reported net of tax, including any gain or loss on disposal.

Restructuring charges and impairment losses are reported in continuing operations.

Comprehensive Income

Comprehensive income equals net income plus OCI. Common OCI items, often remembered as **"PUFF"**:

- **P**ension and postretirement adjustments: net actuarial gains and losses and prior service cost
- **U**nrealized gains and losses on available-for-sale debt securities
- **F**oreign currency translation adjustments
- **F**air value changes on cash flow hedges, for the portion included in the assessment of effectiveness

Changes in a liability's fair value due to instrument-specific credit risk, under the fair value option, also go to OCI.

Comprehensive income may be presented in **one continuous statement** or **two consecutive statements**. OCI items are shown net of tax or with the tax shown separately. Accumulated OCI is reported in equity.

Statement of Changes in Equity

Shows changes in each equity account: common stock, APIC, retained earnings, AOCI, treasury stock and total. Typical rows are the beginning balance, net income, OCI, dividends, stock issuances, repurchases, share-based compensation and the ending balance. Nonpublic entities may disclose the changes in the notes instead.

Notes to the Financial Statements

The **summary of significant accounting policies** comes first, covering the basis of consolidation, depreciation and inventory methods, revenue recognition and the use of estimates.

Other common notes cover contingencies, commitments, related parties, subsequent events, fair value, debt terms and covenants, share-based compensation, pensions, leases, income taxes and segments.

The Statement of Cash Flows

Reports cash receipts and payments in three categories. The beginning cash balance plus the net change equals the ending balance, which must agree with the balance sheet. **Restricted cash** is included with cash and cash equivalents in this reconciliation.

Cash equivalents are short-term, highly liquid investments with original maturities of three months or less, such as Treasury bills, money market funds and commercial paper.

Operating Activities

Direct method: shows actual cash receipts and payments, including cash collected from customers and paid to suppliers, employees, lenders (interest) and taxing authorities. A reconciliation of net income to operating cash flow must still be provided.

- Cash from customers = sales – increase in receivables (or + decrease)
- Cash to suppliers = cost of goods sold + increase in inventory – increase in accounts payable

Indirect method: starts with net income and adjusts it.

ADJUSTMENT	EFFECT
Depreciation, amortization and other noncash expenses	Add
Losses on sales of assets	Add
Gains on sales of assets	Subtract
Increase in current operating assets, such as receivables	Subtract
Decrease in current operating assets	Add
Increase in current operating liabilities, such as payables	Add
Decrease in current operating liabilities	Subtract

Under GAAP, these are operating cash flows: interest received, dividends received, interest paid and income taxes paid.

Investing Activities

- **Inflows:** sales of PP&E, sales of investments in debt and equity securities of other entities, and collections of loans made to others
- **Outflows:** purchases of PP&E and investments, and loans made to others

Report gross amounts rather than netting purchases and sales.

Financing Activities

- **Inflows:** issuing stock, bonds and notes, and other borrowing
- **Outflows:** dividends paid, treasury stock purchases, repayment of principal and debt issuance costs

Noncash Investing and Financing Activities

Significant transactions that don't involve cash are disclosed separately, not in the body of the statement. Examples: buying an asset with a note, converting debt to equity, entering a finance lease and exchanging assets.

GAAP and IFRS Differences

ITEM	GAAP	IFRS
Interest paid	Operating	Operating or financing
Interest received	Operating	Operating or investing
Dividends paid	Financing	Operating or financing
Dividends received	Operating	Operating or investing

Use GAAP on the exam unless told otherwise. Operating cash flow is the same under the direct and indirect methods. Only the presentation differs.

Question: Net income is \$100,000, depreciation is \$20,000, receivables increased by \$15,000 and payables decreased by \$8,000. What is net cash from operating activities?

Answer: $\$100,000 + \$20,000 - \$15,000 - \$8,000 = \$97,000$.

Earnings per Share (ASC 260)

Required for public entities and entities in the process of going public. Not required for private companies.

Basic EPS

Basic EPS = (net income – preferred dividends) ÷ weighted average common shares outstanding

- Subtract **cumulative** preferred dividends for the year whether or not declared.
- Subtract **noncumulative** preferred dividends only if declared.

Weighting example:

- January 1: 100,000 shares outstanding
- April 1: 20,000 shares issued, for 120,000
- October 1: 10,000 shares repurchased, for 110,000

$$100,000 \times 3/12 + 120,000 \times 6/12 + 110,000 \times 3/12 = 25,000 + 60,000 + 27,500 = \mathbf{112,500 \text{ shares}}$$

Stock splits and stock dividends are applied retroactively to the beginning of the earliest period presented and are not time-weighted. A 2-for-1 split on December 31 makes 100,000 shares outstanding all year count as 200,000.

Diluted EPS

Reflects the dilution that would occur if potential common shares were issued: convertible bonds and preferred stock, options, warrants and contingently issuable shares. **Antidilutive** securities, which would increase EPS, are excluded. Test each one individually, from most dilutive to least.

If-converted method (convertible securities)

- *Convertible bonds*: add back after-tax interest to the numerator and add the conversion shares to the denominator, as of the beginning of the year or the issue date if later.
- *Convertible preferred*: add back the preferred dividends subtracted in basic EPS and add the conversion shares.

Treasury stock method (options and warrants)

Assume exercise, with the proceeds used to buy back shares at the average market price. Only in-the-money options are dilutive, and there's no numerator adjustment.

Example: 10,000 options at a \$20 exercise price, with an average market price of \$50.

- Shares issued: 10,000
- Shares repurchased: $(10,000 \times \$20) \div \$50 = 4,000$
- Incremental shares added to the denominator: **6,000**

Presentation

Basic and diluted EPS appear on the face of the income statement for income from continuing operations and for net income. EPS for discontinued operations may be shown on the face or in the notes.

Question: Net income is \$200,000, and 100,000 common shares were outstanding all year. There are 10,000 shares of \$100 par, 5% cumulative preferred stock, and no dividends were declared. What is basic EPS?

Answer: $(\$200,000 - \$50,000) \div 100,000 = \mathbf{\$1.50}$. The cumulative preferred dividend is subtracted even though it wasn't declared.

Interim Reporting (ASC 270)

GAAP mainly treats each interim period as an **integral part** of the annual period.

- **Revenue** is recognized the same way as in annual reporting.
- **Costs directly associated with revenue**, such as cost of goods sold, are recognized as in annual reporting.
- **Other costs** that benefit more than one period, such as annual insurance or property tax, are allocated across interim periods. A \$12,000 annual premium paid in January is expensed at \$3,000 per quarter.

Inventory

- Temporary LIFO liquidations expected to be replaced by year-end aren't reflected. Cost of sales includes the expected cost of replacement.
- Market or NRV declines are recognized in the interim period unless they are temporary and expected to recover by year-end.
- Planned standard cost variances expected to be absorbed by year-end are deferred.

Income taxes use the estimated annual effective tax rate applied to year-to-date income, less tax recognized in prior quarters.

Example: Q1 income is \$100,000 at a 30% estimated rate, so Q1 tax is \$30,000. Year-to-date income through Q2 is \$250,000, so tax through Q2 is \$75,000, and Q2 tax is \$75,000 – \$30,000 = **\$45,000**.

Changes in estimates are accounted for prospectively, without restating prior interim periods. Seasonal businesses should disclose their seasonality.

Segment Reporting (ASC 280)

Required for public entities. An **operating segment** engages in business activities, has its results regularly reviewed by the chief operating decision maker (CODM) and has discrete financial information.

Quantitative thresholds. A segment is reportable if it meets any one test:

1. **Revenue:** its revenue, external and intersegment, is 10% or more of combined revenue of all segments.
2. **Profit or loss:** its absolute profit or loss is 10% or more of the greater of combined profits of profitable segments or combined losses of loss segments.
3. **Assets:** its assets are 10% or more of combined assets.

Reportable segments must account for at least **75% of total external revenue**. If they don't, add segments until they do. More than ten reportable segments may be too many.

Disclosures include each segment's profit or loss measure, revenues, significant segment expenses regularly provided to the CODM (added by ASU 2023-07, including in interim periods), interest, depreciation and amortization, and assets if reviewed by the CODM. Reconciliations to consolidated totals are required.

Entity-wide disclosures apply even with only one segment: revenue by product or service, revenue and long-lived assets by geographic area, and reliance on major customers that provide 10% or more of revenue.

SEC Reporting

A company must register with the SEC if it lists securities on an exchange, or if it has at least \$10 million in total assets and a class of equity held by 2,000 or more holders of record, or 500 or more who aren't accredited investors.

Key Forms

FORM	PURPOSE	TIMING
S-1	Registration statement for an initial public offering	Before the offering
10-K	Annual report with audited financial statements, MD&A, risk factors and executive compensation	60, 75 or 90 days after year-end, depending on filer status
10-Q	Quarterly report with reviewed, condensed statements, for the first three quarters	40 or 45 days after quarter-end
8-K	Current report on significant events, such as a change in auditor, acquisitions or dispositions, bankruptcy, changes in control, director or officer departures and nonreliance on prior financial statements	Generally within four business days
DEF 14A	Proxy statement for the annual meeting	Before the meeting

- **Regulation S-X** governs the form and content of financial statements. Most registrants present audited balance sheets for two years and income, comprehensive income, equity and cash flow statements for three years. Smaller reporting companies present two years.
- **Regulation S-K** governs nonfinancial disclosures: the business description, risk factors, MD&A, market risk and executive compensation.

MD&A discusses liquidity, capital resources and results of operations, including known trends, events and uncertainties likely to affect future results, and material off-balance-sheet arrangements.

Not-for-Profit Entities (ASC 958)

Nongovernmental not-for-profits receive significant contributions from donors who don't expect a return, operate for purposes other than profit and have no ownership interests. Examples include charities, private colleges, private hospitals and religious organizations.

Required Statements

1. Statement of financial position
2. Statement of activities
3. Statement of cash flows
4. An analysis of expenses by **both function and nature**, required for all NFPs under ASU 2016-14. It may be a separate statement of functional expenses, part of the statement of activities or a note.

Net Assets

Net assets without donor restrictions: no donor-imposed restrictions. Board-designated amounts stay here, because the board's decision isn't a donor restriction.

Net assets with donor restrictions: donor-imposed restrictions on purpose or time, including perpetual restrictions such as permanent endowments.

When a restriction is met, the amount is **reclassified** from with donor restrictions to without donor restrictions, as "net assets released from restrictions."

Example: a \$100,000 gift restricted to building construction increases net assets with donor restrictions. When the building is placed in service, \$100,000 is released to net assets without donor restrictions, unless the donor stipulates otherwise.

Statement of Financial Position

Assets, liabilities and the two classes of net assets. It may be classified or unclassified, but information about liquidity must be provided.

Statement of Activities

Revenues, gains and other support, less expenses, equals the change in each class of net assets and in total net assets.

Expenses are reported as decreases in net assets **without donor restrictions**. Contributions increase net assets with or without donor restrictions depending on the donor's stipulations.

Contributions (ASC 958-605)

- An **unconditional promise to give** (pledge) is recognized as revenue and a receivable when made, at fair value. Pledges due in more than one year are measured at present value.
- A **conditional promise** is recognized only when the conditions are met. Under ASU 2018-08, a promise is conditional only if it has **both** a barrier that must be overcome **and** a right of return or right of release.

Example: a pledge of \$100,000 due in three years with a present value of \$75,000 is recorded as contribution revenue of \$75,000 and a pledge receivable of \$75,000, with donor restrictions because of the time restriction.

Contributed services are recognized only if they create or enhance nonfinancial assets, or require specialized skills, are provided by people with those skills and would otherwise need to be purchased. Examples include a lawyer's or contractor's services. General volunteer time is not recognized.

Gifts in kind, such as donated buildings or supplies, are recognized at fair value. Contributed nonfinancial assets must be presented as a separate line item in the statement of activities.

Variance power: if a donor gives a recipient organization unilateral power to redirect the gift to another beneficiary, the recipient recognizes the contribution. An organization that merely passes assets to a specified beneficiary acts as an agent and records a liability instead.

Expenses

- **Program services:** activities that fulfill the mission
- **Supporting services:** management and general, and fundraising
- **Natural classifications:** salaries, rent, supplies, depreciation, interest and so on

Shared costs are allocated to functions on a reasonable basis, such as square footage for rent.

Investments and Endowments

Investments in equity securities with readily determinable fair values and all debt securities are reported at fair value, with gains and losses in the statement of activities. Investment return increases net assets without donor restrictions unless the donor restricts it.

Endowment types

- **Perpetual (permanent) endowment:** the original gift is maintained in perpetuity. With donor restrictions.
- **Term endowment:** restricted until a time or event. With donor restrictions.
- **Board-designated (quasi-) endowment:** set aside by the board. Without donor restrictions.

Under state laws based on UPMIFA, earnings on donor-restricted endowments remain with donor restrictions until appropriated for spending.

Underwater endowments, where fair value has fallen below the original gift, stay in net assets with donor restrictions, and the organization must disclose its spending policy and the deficiencies.

Question: An NFP receives a \$50,000 pledge, payable in two years, for a new building. The present value is \$41,000. The donor may redirect the funds if construction hasn't started within six months. How is it recorded?

Answer: Nothing is recorded yet. Starting construction is a barrier, and the donor has a right of release, so the promise is conditional. When construction starts, record contribution revenue and a pledge receivable of \$41,000, with donor restrictions for the building's purpose.