

FINANCIAL 1 CLASS NOTES

Welcome to **Financial Accounting & Reporting**. This exam has a reputation as being demanding and the relative size of our four textbooks shows why. Most students find these topics to be the more challenging:

- Consolidations and Investments [F-3]
- Leases [F-5]
- Bonds and Long-Term Liabilities [F-5]
- Pensions [F-6]
- Accounting for Income Taxes [F-6]
- Governmental and Not-for-Profit [F-8 and F-9]

The AICPA Content Specifications for FARE break down the exam into the following general areas and approximate percentages of exam points:

1. Concepts and standards for financial statements (17%-23%)
2. Typical items – recognition, measurement, valuation and presentation in financial statements (27%-33%)
3. Specific types of transactions and events – recognition, measurement, valuation and presentation in conformity with GAAP (27%-33%)
4. Accounting and reporting for governmental entities (8%-12%)
5. Nongovernmental not-for-profit entity accounting (8%-12%)

Financial 1 includes the following:

I. SOURCES OF GAAP AND BASIC FRAMEWORK AND CONCEPTS

- A. The hierarchy of sources is important, especially Category A (BOSSII).
- B. Terminology is key here - know the components of **relevance** and **reliability** (PFT and NRFV).

II. REPORTING NET INCOME

- A. Income Statement is an important topic.
 1. Know the **IDEA** mnemonic
 - I: **income** from continuing operations
 - D: income from **discontinued** operations
 - E: **extraordinary** items
 - A: **accounting principle** change (to R/E)

III. DISCONTINUED OPERATIONS

- A. Accounting for discontinued operations can consist of gain or loss on **current year's operations**, gain/loss on **sale** and **impairment loss**. Discontinued operations are shown net of tax.
 - 1. Any of these must be reported as part of discontinued operations in the year incurred. If the operations are being "**held for sale**," they are treated as discontinued.

IV. EXTRAORDINARY ITEMS

- A. Extraordinary items must be *unusual and infrequent*. "Unusual" requires the event be unrelated to the typical business activities of the firm. "Infrequent" means the event is not expected to occur again in the foreseeable future. They are shown "net of tax."
 - 1. Unusual or infrequent items are reported within the "upper" (I) part of the income statement and before tax.

V. ACCOUNTING CHANGES

- A. Accounting changes appear in three varieties: estimate, principle and entity.
 - 1. **Changes in estimates**, such as the useful life of a plant asset, are incorporated into the accounting records for the **current and future periods**. No adjustment of prior financial statements is required. A change in depreciation method is a change in accounting principle that is inseparable from a change in estimate, and is accounted for as a change in estimate.
 - 2. **Changes in principle** (or method) involve switching from one acceptable method to another. The cumulative effect is the change in retained earnings that results from restating prior years from the "old" method to the "new" method at the **beginning** of the earliest year presented. The **cumulative effect** is reported in the statement of retained earnings, net of tax.
 - a. **Changes in principle - Exception:**

When it is **impracticable to estimate** the change in retained earnings that would result from restating the prior years financial statements, the change in method is applied prospectively [like changes in estimate]. In this case, no restatement of prior years occurs and there is no cumulative effect reported in the statement of retained earnings: e.g., changing to LIFO from any other inventory method.
 - 3. **Change in entity** requires restatement of prior year's financial statements to conform with the new accounting entity when the prior financials are presented comparatively.

VI. PRIOR PERIOD ADJUSTMENTS (CORRECTIONS OF ERRORS)

- A. Reported net of tax in the statement of retained earnings.

VII. COMPREHENSIVE INCOME

- A. Comprehensive Income includes all changes in owners' equity **other than transactions with owners**. The formula shows that comprehensive income must include net income plus/minus other changes in owners' equity not resulting from transactions with owners. These other changes are known as "other comprehensive income" items.
- B. The mnemonic "**PUFE**" shows the four commonly tested sources of "other comprehensive income."
 - **Pension** funded status changes; covered in F6.
 - **Unrealized** gains and losses on AFS securities; covered in F3.
 - **Foreign** currency translation items; covered in F2.
 - **Effective** portion of cash flows hedges; covered in F7.
- C. Accumulated other comprehensive income is a cumulative sum of all of the individual components of other comprehensive income. Accumulated other comprehensive income is an owners' equity item.
- D. There are three acceptable ways to present the statement of comprehensive income.

VIII. BALANCE SHEET AND DISCLOSURES OVERVIEW

- A. Review the terminology and be able to recognize a **classified** balance sheet.
- B. The **Summary of Significant Accounting Policies** reflects the methods and policies employed by the firm.

IX. INTERIM FINANCIAL REPORTING

- A. Interim financial reporting uses the same GAAP as do annual financial reports. Timeliness is emphasized over reliability and income taxes are estimated each quarter based on the estimated average tax rate for the whole year.

X. SEGMENT REPORTING

- A. A reportable segment exists if it meets one of three tests:
 - 10% of **combined revenues** to internal and external parties.
 - 10% of **reported profit or loss** (as an absolute amount). You should be familiar with the definition of operating profit: Segment revenues from sales to internal and external customers less directly traceable costs and also less reasonably allocated costs equals segment operating profit (loss).
 - 10% of the **combined assets** of all operating segments.
- B. The "**75% reporting sufficiency test**" is a "catch all" requirement that may require identification of additional segments to attain the 75% level. This test requires that reportable segments total at least 75% of revenue from external parties.
- C. The "**90% single industry dominance test**" means if one segment individually contains 90% or more of the firm's revenues, profits **and** assets, then the segment reporting requirement is waived for that firm.

XI. DEVELOPMENT STAGE ENTERPRISES

- A. These firms have not yet started their primary operations or have generated insignificant revenues to date.
- B. Development stage enterprises use "regular GAAP" with a couple of differences regarding labeling and summation of cumulative reporting.

XII. FAIR VALUE MEASUREMENT

- A. Fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants, measured in the principal, or most advantageous, market for the asset or liability.
- B. Entities can use the market approach, the cost approach, or the income approach, or a combination of these approaches, when measuring fair value.
- C. The fair value hierarchy prioritizes the inputs used in the market, cost & income valuation techniques. Level I inputs have the highest priority and Level III inputs have the lowest priority.