**ENVIRONMENT AND THEORETICAL STRUCTURE OF FINANCIAL ACCOUNTING**

The Economic Environment and Financial Reporting

**Economic theory of information**

The economic goal of a society is to maximize wealth. For that to happen, resources (e.g. labor, capital, natural resources) must be allocated efficiently (allocated to private enterprises that will use them best to provide the goods and services desired by society, and not to enterprises that will waste them): allocation efficiency.

The capital markets provide a mechanism (supply and demand) to help our economy allocate resources efficiently. Markets need information to function and allocate resources. They need macroeconomic information (e.g. interest rates, exchange rates, GDP growth, employment), industry-specific information (e.g. number of firms, industry leadership, level of competition), and firm-specific information (e.g. financial condition, revenue growth, profitability). Financial accounting provides the firm-specific information.

**The Economic Environment and Financial Reporting**

Firms acquire capital from investors in exchange for ownership interest (e.g. stocks) and by borrowing from creditors (e.g. loans, bonds). A firm will be able to provide a return to investors and creditors only if it can generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service. The primary objective of financial accounting is to provide information to investors and creditors to help them <u>predict future cash flows</u>. The information is conveyed through financial statements and related notes.

1. Balance sheet or statement of financial position
2. Income statement or statement of operations
3. Statement of cash flows
4. Statement of shareholders' equity
5. Either

   a) a statement of other comprehensive income immediately following the income statement, or

   b) a statement of comprehensive income (including information on the income statement as well as on the statement of other comprehensive income).

*Cash versus accrual accounting*

Over short periods of time, recording only operating cash flow may not be an accurate predictor of future operating cash flows. The accrual accounting model records both cash flows and accruals and provides a measure of periodic performance called net income. Net income is considered a better indicator of future operating cash flows than is current net operating cash flows.

Example: Carter company paid $60,000 for 3 years’ rent at the beginning of year 1

| | Year 1 | Year 2 | Year 3 | Total |
|---|---|---|---|---|
| Sales (on credit) | $100,000 | $100,000 | $100,000 | $300,000 |
| **Net Operating Cash Flows:** | | | | |
| Cash receipts from customers | $ 50,000 | $125,000 | $125,000 | $300,000 |
| Cash disbursements | | | | |
| Prepayment of three years' rent | (60,000) | - 0 - | - 0 - | (60,000) |
| Salaries to employees | (50,000) | (50,000) | (50,000) | (150,000) |
| Utilities | (5,000) | (15,000) | (10,000) | (30,000) |
| **Net operating cash flow** | $(65,000) | $ 60,000 | $ 65,000 | $ 60,000 |

| | Year 1 | Year 2 | Year 3 | Total |
|---|---|---|---|---|
| Revenues | $100,000 | $100,000 | $100,000 | $300,000 |
| Expenses: | | | | |
| Rent | 20,000 | 20,000 | 20,000 | 60,000 |
| Salaries | 50,000 | 50,000 | 50,000 | 150,000 |
| Utilities | 10,000 | 10,000 | 10,000 | 30,000 |
| Total expenses | 80,000 | 80,000 | 80,000 | 240,000 |
| **Net Income** | $ 20,000 | $ 20,000 | $ 20,000 | $ 60,000 |

Upper panel is cash flow accounting: Notice that the prepayment of rent is only shown in year 1. There is no charge against net operating cash flows in years two and three due to rent, because the whole amount was paid in year 1.

Lower panel is accrual accounting: Notice that even though the rent was paid in year 1, there is a charge against net income in years 2 and 3 because of rent expense. One third of the rent prepayment is a rent expense each year under accrual accounting.

This example shows the motivation for using the accrual accounting model. Accrual income attempts to measure the resource inflows and outflows generated by operations during the reporting period, which may not correspond to cash inflows and outflows. In addition, the statement of cash flows reports information about cash flows from operating, investing, and financing activities, and provides important information to investors and creditors. Focusing on accrual accounting as well as cash flows provides a more complete view of a company and its operations.

**The Development of Financial Accounting and Reporting Standards**

A. Historical perspective and U.S. standards

Generally accepted accounting principles (GAAP) are a set of guidelines companies follow in measuring and reporting financial information. The Securities and Exchange Commission (SEC) has the authority to set accounting standards for companies, but always has delegated the task to the accounting profession. The Financial Accounting Standards Board (FASB) currently sets accounting standards.

HIERARCHY OF STANDARD-SETTING AUTHORITY:

Congress → SEC → Private Sector → 1938-1959 Committee on Accounting Procedure (CAP), 1959-1973 Accounting principles Board (APB), 1973-now Financial Accounting Standards Board (FASB)

The FASB Accounting Standards Codification became effective on July 1, 2009, and now represents the single source of authoritative nongovernmental U.S. GAAP, except for rules and interpretive release of the SEC, which remain also as sources of authoritative GAAP. The Codification is organized into nine main topics and approximately 90 subtopics.

| **Topic** | Numbered |
|---|---|
| General Principles | 100-199 |
| Presentation | 200-299 |
| Assets | 300-399 |
| Liabilities | 400-499 |
| Equity | 500-599 |
| Revenues | 600-699 |

| | |
|---|---|
| Expenses | 700-799 |
| Broad Transactions | 800-899 |
| Industry | 900-999 |

B. International standard setting

The International Accounting Standards Committee (IASC) was formed in 1973 to develop global accounting standards. The IASC reorganized itself and created a new standard-setting body called the International Accounting Standards Board (IASB). The IASC acts as an umbrella organization similar to the Financial Accounting Foundation in the United States. The International Accounting Standards Board (IASB) has responsibility for developing international financial reporting standards (IFRSs). The organizations involved in setting IFRSs parallel those involved in setting U.S. GAAP. IASB standards are used in some form in over 115 jurisdictions, including the companies in the European Union.

| | U.S. GAAP | IFRS |
|---|---|---|
| Regulatory oversight provided by: | Securities Exchange Commission (SEC) | International Organization of Securities Commissions (IOSCO)* |
| Foundation providing oversight, appointing members, raising funds: | Financial Accounting Foundation (FAF): 20 trustees | International Accounting Standards Committee Foundation (IASCF): 22 trustees |
| Standard-setting board: | Financial Accounting Standards Board (FASB): 7 members | International Accounting Standards Board (IASB): 16 members |
| Advisory council providing input on agenda and projects: | Financial Accounting Standards Advisory Council (FASAC): 30-40 members | Standards Advisory Council (SAC): 30-40 members |
| Group to deal with emerging issues: | Emerging Issues Task Force (EITF): 15 members | International Financial Reporting Interpretations Committee (IFRIC): 14 members |

*Each country's security regulator has authority. IOSCO includes representatives from numerous regulators, including the SEC, to facilitate coordination among those regulators and other organizations and encourage effective capital markets.

C. Convergence between FASB and IASB standards

In 2002 the FASB and IASB signed the Norwalk Agreement, pledging to remove existing differences between standards. Since then, both boards have been working towards convergence. In November 2008, the SEC proposed a Roadmap for the potential use of financial statements prepared in accordance with IFRS. The Roadmap sets forth several milestones that, if achieved, could lead to the required use of IFRS by publicly-traded U.S. companies.

In July 2012, the SEC staff issues its Final Staff Report in which it concludes that it is not feasible for the U.S. to simply adopt IFRS, given (1) a need for the U.S. to have strong influence on the standard-setting process and ensure that standards meet U.S. needs, (2) the high costs to companies of converting to IFRS, and (3) the fact that many laws, regulations, and private contracts reference U.S. GAAP.19 Therefore, the staff recommends that the SEC consider other approaches, such as developing a mechanism to consider endorsing individual IFRS standards for incorporation into U.S. GAAP, or to just maintain the current approach in which the FASB and IASB work together to converge standards. As of now, the SEC still had not made an announcement about whether it would adopt or incorporate IFRS into U.S. GAAP.

D. The establishment of accounting standards—A political process

A standard setter must consider potential economic consequences of accounting standards. The FASB undertakes a series of information gathering steps before issuing a substantive accounting standard.

| STEP | EXPLANATION |
|---|---|
| 1. | The Board identifies financial reporting issues based on requests/recommendations from stakeholders or through other means. |
| 2. | The Board decides whether to add a project to the technical agenda based on a staff-prepared analysis of the issues. |
| 3. | The Board deliberates at one or more public meetings the various issues identified and analyzed by the staff. |
| 4. | The Board issues an Exposure Draft. (In some projects, a Discussion Paper may be issued to obtain input at an early stage that is used to develop an Exposure Draft.) |
| 5. | The Board holds a public roundtable meeting on the Exposure Draft, if necessary. |
| 6. | The staff analyzes comment letters, public roundtable discussion, and any other information. The Board redeliberates the proposed provisions at public meetings. |
| 7. | The Board issues an Accounting Standards Update describing amendments to the Accounting Standards Codification. |

In the past, various interest groups have successfully lobbied standard setters for changes in standards involving such topics as accounting for stock-based compensation, business combinations, and other-than-temporary impairments of investments. Political pressures on IASB standard setting are severe, with funding dependent on voluntary contributions and important groups like the EU threatening to “carve out” aspects of standards that they view as undesirable.

**WHY IS ACCOUNTING REGULATED?**

Because when companies use the same rules to do the accounting, the users of the financial statements can **compare financial information over time for a company and among companies**.

**Encouraging high-quality financial reporting**

Auditors offer credibility to financial statements by verifying that they are presented fairly in conformity with GAAP. The Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as the Sarbanes-Oxley Act, provides for the regulation of auditors and the types of services they furnish to clients, increases accountability if corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators.

**Key Provisions of the Act:**

- **Oversight board.** The five-member (two accountants) Public Company Accounting Oversight Board has the authority to establish standards dealing with auditing, quality control, ethics, independence and other activities relating to the preparation of audit reports, or can choose to delegate these responsibilities to the AICPA. Prior to the act, the AICPA set auditing standards. The SEC has oversight and enforcement authority.

- **Corporate executive accountability.** Corporate executives must personally certify the financial statements and company disclosures with severe financial penalties and the possibility of imprisonment for fraudulent misstatement.

- N**on-audit services**. The law makes it unlawful for the auditors of public companies to perform a variety of non-audit services for audit clients. Prohibited services include bookkeeping, internal audit outsourcing, appraisal or valuation services, and various other consulting services. Other non-audit services, including tax services, require pre-approval by the audit committee of the company being audited.

- **Retention of workpapers.** Auditors of public companies must retain all audit or review work papers for seven years or face the threat of a prison term for willful violations.

- **Auditor rotation.** Lead audit partners are required to rotate every five years. Mandatory rotation of audit firms came under consideration.

- **Conflicts of interest.** Audit firms are not allowed to audit public companies whose chief executives worked for the audit firm and participated in that company's audit during the preceding year.

- **Hiring of auditor.** Audit firms are hired by the audit committee of the board of directors of the company, not by company management.

- **Internal Control.** Section 404 of the Act requires that company management document and assess the effectiveness of all internal control processes that could affect financial reporting. The PCAOB's *Auditing Standard No. 2* (since replaced by *Auditing Standard No. 5*) requires that the company auditors express an opinion on whether the company has maintained effective internal control over financial reporting.

## Ethics in Accounting

Recent accounting scandals have rekindled the debate over principles-based, or more recently termed, objectives-oriented, versus rules-based accounting standards. A principles-based approach to standard setting stresses professional judgment, as opposed to following a list of rules.

Ethical judgment is critical in accounting, particularly if decisions are not specified by rules.

1. Ethics deal with the ability to distinguish right from wrong.
2. Many professions have articulated ethical standards in a code of ethics.
3. There are a number of steps that provide a framework for analyzing ethical issues.

**Step 1.** Determine the facts of the situation. This involves determining the who, what, where, when, and how.

**Step 2.** Identify the ethical issue and the stakeholders. Stakeholders may include shareholders, creditors, management, employees, and the community.

**Step. 3** Identify the values related to the situation. For example, in some situations confidentiality may be an important value that may conflict with the right to know.

**Step 4.** Specify the alternative courses of action.

**Step 5.** Evaluate the courses of action specified in step 4 in terms of their consistency with the values identified in step 3. This step may or may not lead to a suggested course of action.

**Step 6.** Identify the consequences of each possible course of action. If step 5 does not provide a course of action, assess the consequences of each possible course of action for all of the stakeholders involved.

**Step 7.** Make your decision and take any indicated action.

## The Conceptual Framework

The purpose of the conceptual framework is to provide an underlying foundation for accounting standards (it does not prescribe GAAP).

The FASB and IASB are working together to develop a common and improved conceptual framework. The project consists of eight phases and only Phase A has been completed. The framework consists of a financial reporting objective, qualitative characteristics of information, financial statement elements, recognition and measurement concepts, and constraints.

## THE CONCEPTUAL FRAMEWORK

**Objective**

To provide financial information that is useful to capital providers.

**Phase A**

**Qualitative Characteristics**

**Primary**

**Relevance**

- Predictive value
- Confirmatory value
- Materiality

**Faithful Representation**

- Completeness
- Neutrality
- Free from error

**Enhancing**

**Comparability** (including consistency)

**Verifiability**

**Timeliness**

**Understandability**

**Phase A**

**Elements**

- Assets
- Liabilities
- Equity
- Investments by owners
- Distributions to owners
- Revenues
- Expenses
- Gains
- Losses
- Comprehensive income

**SFAC 6**

**Recognition and Measurement Concepts**

**Assumptions**

- Economic entity
- Going concern
- Periodicity
- Monetary unit

**Principles**

- Revenue recognition
- Expense recognition
- Mixed attribute measurement
- Full disclosure

**SFAC 5**
**SFAC 7**

**Constraint**

Cost effectiveness

**Phase A**

**Financial Statements**

- Balance sheet
- Income statement
- Statement of cash flows
- Statement of shareholders' equity
- Statement of Comprehensive Income
- Related disclosures

## QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

PRIMARY QUALITATIVE CHARACTERISTICS

**A: Relevance**

- Predictive value
- Confirmatory value
- Enhancing aspect: materiality

**B: Faithful representation**

- Completeness — All information that is necessary for faithful representation.
- Neutrality — Accounting standards should be set with overall societal goals and specific objectives in mind, and should try not to favor particular groups or companies.
- Free from error
- Conservatism – Greater verification before recognizing good news than bad news (losses are reflected in net income more quickly than gains, and net assets are biased downwards).

ENHANCING QUALITATIVE CHARACTERISTICS

A: Comparability

- Ability to help users see similarities and differences among events and conditions (also includes consistency).

B: Verifiability

- Consensus among different measurers.

C: Timeliness

- Available to users before a decision is made.

D: Understandability

- Users must understand the information.

KEY CONSTRAINT: COST EFFECTIVENESS (the benefit of information provided must exceed the costs of producing the information).

UNDERLYING ASSUMPTIONS

► Economic Entity Assumption

- All economic events can be identified with a particular economic entity.

► Going Concern Assumption

- In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.

► Periodicity Assumption

- The life of a company can be divided into artificial time periods to provide timely information to external users.

► Monetary Unit Assumption

- Financial statement elements should be measured in terms of the United States dollar.

## ELEMENTS OF FINANCIAL STATEMENTS

| | |
|---|---|
| **Assets** | Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. |
| **Liabilities** | Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. |
| **Equity (or net assets)** | Called shareholders' equity or stockholders' equity for a corporation is the residual interest in the assets of an entity that remains after deducting its liabilities. |
| **Investments by owners** | Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests in it. |
| **Distributions to owners** | Decreases in equity of a particular enterprise resulting from transfers to owners. |
| **Comprehensive income** | The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. |
| **Revenues** | Inflows or other enhancements of assets of an entity or settlements of its liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. |
| **Expenses** | Outflows or other using up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major, or central, operations. |
| **Gains** | Increases in equity from peripheral or incidental transactions of an entity. |
| **Losses** | Represent decreases in equity arising from peripheral or incidental transactions of an entity. |

**Recognition, Measurement, and Disclosure Concepts**

**Recognition** — An item should be recognized in the basic financial statements when it meets the following criteria:

- Definition — the item meets the definition of an element of financial statements.
- Measurability — the item has a relevant attribute measurable with sufficient reliability.
- Relevance — the information about it is capable of making a difference in user decisions.
- Reliability — the information is representationally faithful, verifiable, and neutral.

**Revenue recognition** recently changed due to issuance of ASU 2014-09. It requires that revenue be recognized when the seller transfers goods and services to customers, but does not allow revenue recognition if it is not probable that the seller will receive the cash it is entitled to receive. That has some similarities to the realization principle used in prior GAAP, which required that the earnings process be virtually complete and there be reasonable certainty as to the collectivity of assets to be received.

**Expense recognition** typically occurs in the period in which expenses are incurred to produce revenue. The **Matching Principle** requires first recognizing revenue and then recognizing all expenses that were incurred to generate that revenue.

**Measurement** — Associating numerical amounts to the elements.

GAAP uses a "mixed attribute" model, in which different attributes are used to measure different financial statement elements.

The five measurement attributes commonly employed in GAAP are:

a. **Historical cost:** amount given or received in the original exchange transaction

b. **Net realizable value:** amount of cash into which the asset or liability will be converted in the ordinary course of business, i.e. selling price less selling costs.

c. **Current cost:** the cost that would be incurred to purchase or reproduce an asset

d. **Present value:** future cash flows discounted for the time value of money

e. **Fair value:** the price that would be received to sell assets or transfer liabilities in an orderly market transaction. GAAP gives a company the option to report some or all of its financial assets and liabilities at fair value.

## FAIR VALUE HIERARCHY

| Level | Inputs | Example |
|---|---|---|
| 1<br>**Most Desirable** | Quoted market prices in active markets for identical assets or liabilities. | In Chapter 12 you will learn that certain investments in marketable securities are reported at their *fair values*. Fair value in this case would be measured using the quoted market price from the NYSE, NASDAQ, or other exchange on which the security is traded. |
| 2 | Inputs other than quoted prices that are *observable* for the asset or liability. These inputs include quoted prices for *similar* assets or liabilities in active or inactive markets and inputs that are derived principally from or corroborated by observable related market data. | In Chapter 10 we discuss how companies sometimes acquire assets with consideration other than cash. In any noncash transaction, the controlling valuation principle is that each element of the transaction is recorded at its *fair value*. If one of the assets in the exchange is a building, for instance, then quoted market prices for similar buildings recently sold could be used to value the building or, if there were no similar buildings recently exchanged from which to obtain a comparable market price, valuation could be based on the price per square foot derived from observable market data. |
| 3<br>**Least Desirable** | *Unobservable* inputs that reflect the entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. | Asset retirement obligations (AROs), discussed in Chapter 10, are measured at *fair value*. Neither level 1 nor level 2 inputs would be possible in most ARO valuation situations. Fair value would be estimated using level 3 inputs to include the expected cash flows estimated using the entity's own data if there is no information that indicates that market participants would use different assumptions. This level 3 input would be used in a present value calculation together with other inputs such as the credit-adjusted risk free interest rate. |

**Disclosure**

FULL-DISCLOSURE PRINCIPLE

- The **full-disclosure principle** means that the financial reports should include any information that could affect the decisions made by external users, subject to the cost effectiveness constraint.
  - Supplemental information is disclosed in a variety of ways, including **parenthetical** or **modifying comments** placed on the face of the financial statements.
  - **Disclosure notes** conveying additional insights about company operations, accounting principles, contractual agreements, and pending litigation.
  - **Supplemental financial statements** that report more detailed information than is shown in the primary financial statements.

**Evolution of Accounting Principles**

A. Two competing approaches for the recognition of revenues and expense are (1) the revenue/expense approach and (2) the asset/liability approach.

B. Under the revenue/expense approach, principles for recognizing revenues and expenses are emphasized, with assets and liabilities recognized as necessary to make the balance sheet reconcile with the income.

C. Under the asset/liability approach, principles for asset and liability measurement are emphasized, and revenues, expenses, gains and losses are recognized as necessary to make the balance sheet reconcile with the income statement.

**Work for class discussion on E1-1, E1-2, and E1-14.**