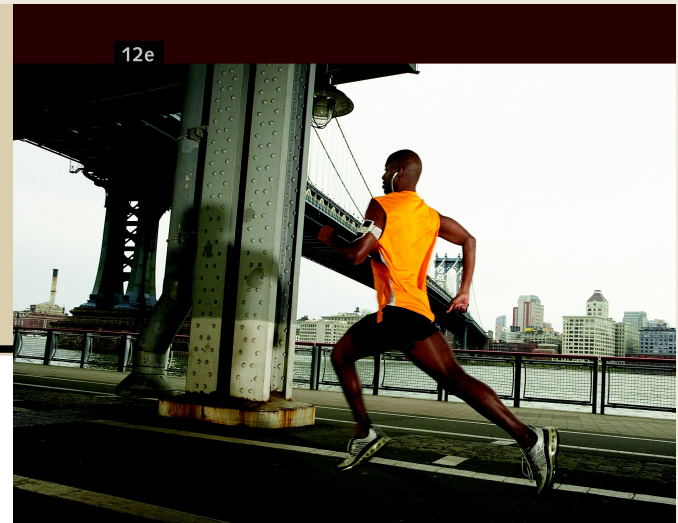


FIN400 - Chapter 1

Introduction to Financial Reporting



Financial Reporting & Analysis

Using Financial Accounting Information

Charles H. Gibson



GAAP

- Generally Accepted Accounting Principles (GAAP) in United States
- Major Sources of GAAP
 - Securities and Exchange Commission (SEC)
 - American Institute of Certified Public Accountants (AICPA)
 - Financial Accounting Standards Board (FASB)

Securities and Exchange Commission

- Securities Act of 1933
 - Regulates IPOs (initial public offerings)
- Securities Exchange Act of 1934
 - Regulates secondary market and national exchanges
 - SEC was created by this Act
 - SEC has the authority to determine GAAP
 - Regulation S-X describes disclosure requirements

AICPA's Role in GAAP

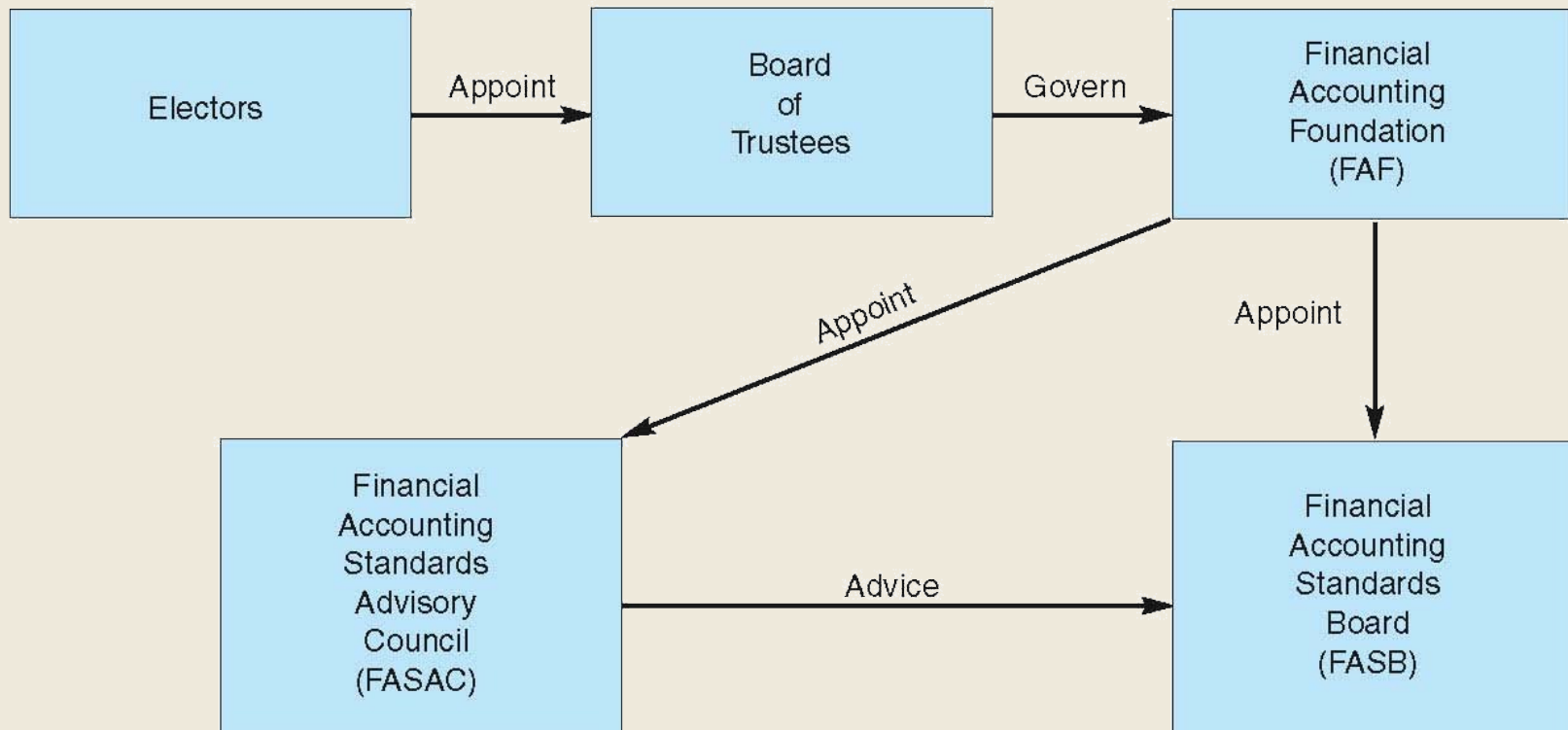
Organization	Years of Activity	Issued
Committees on Accounting Procedures & Terminology	1939...1959	Accounting Research Bulletins (ARBs)
Accounting Principles Board	1959...1973	APB Opinions (APBOs)

The FASB

- Financial Accounting Standards Board
- Promulgates GAAP
 - SFASs: *Statements of Financial Accounting Standards*
 - *Interpretations* of SFASs, APBOs, and ARBs
 - *Technical Bulletins*
 - *Statement of Financial Accounting Concepts*
- Conceptual Framework
 - Statements of Accounting Concepts (not GAAP)

FASB Structure

Exhibit 1-1



FASB Operating Procedure

- Topic is added to the technical agenda
- Public comments solicited
 - Discussion Memorandum
 - Invitation to Comment
 - Holds hearing to review comments
- Issues Exposure Draft

FASB Conceptual Framework

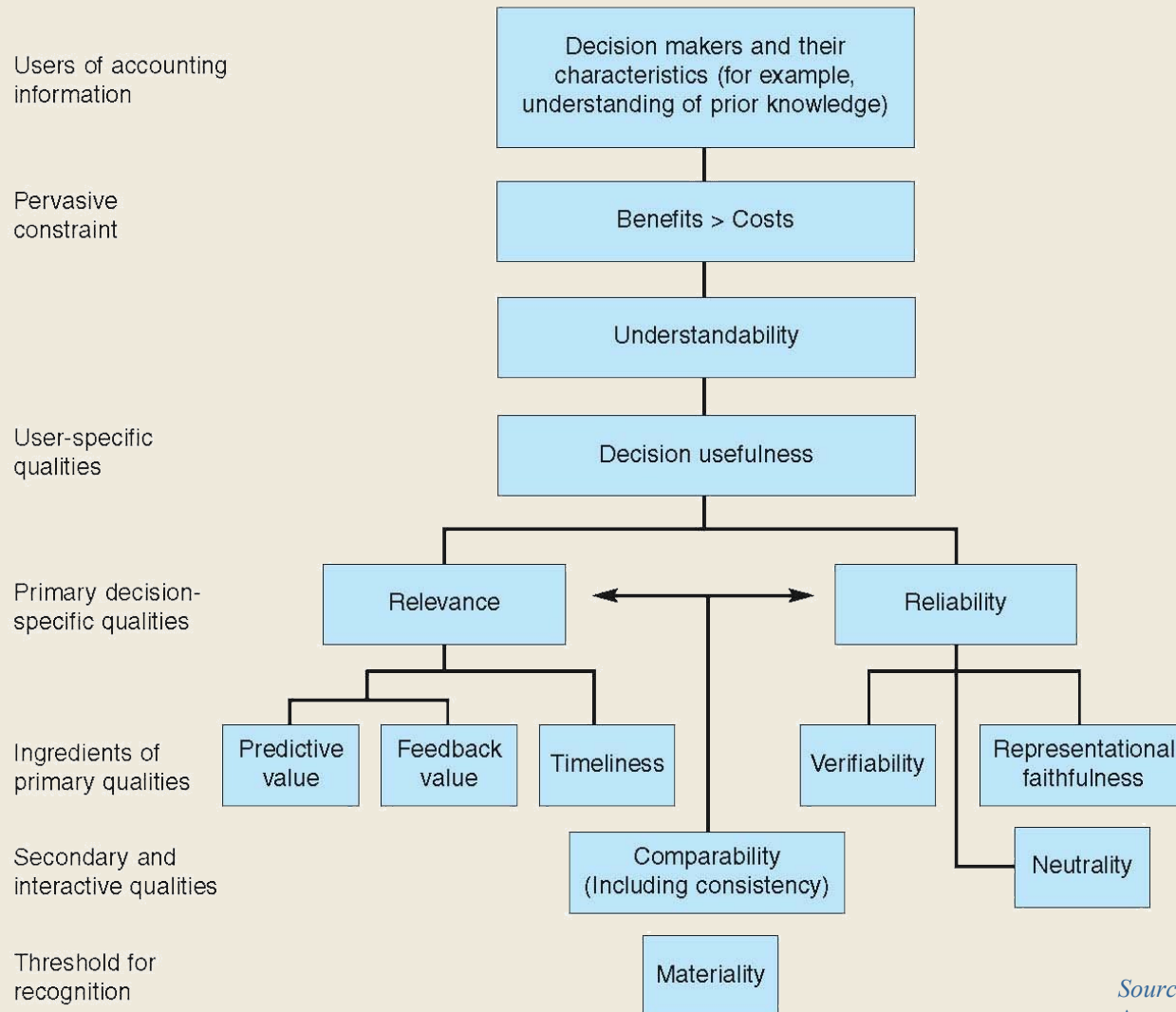
- A system of interrelated objectives and underlying concepts
- Serves as the basis for evaluating existing standards of financial accounting and reporting
- *SFACs*
 - *Statements of Financial Accounting Concepts*

Objectives of Financial Reporting (SFAC 1)

- Provide information useful in making business and economic decisions
- Information is comprehensible to those having a reasonable understanding of business and economic activities
- Helps users to assess future cash flows
- Primary focus is earnings and its components
- Information is provided about economic resources and the claims against those resources

A Hierarchy of Accounting Qualities

Exhibit 1-2



Source: "Qualitative Characteristics of Accounting Information." Adapted from Figure 1 in FASB Statement of Financial Accounting Concepts No. 2 (Stamford, Conn.: Financial Accounting Standards Board, 1980).

Elements of Financial Statements (SFAC 6)

- **Assets**
 - Probable future economic benefits obtained or controlled; the result of past business transactions
- **Liabilities**
 - Obligations to transfer assets or provide services in the future; the result of past business transactions
- **Equity**
 - The owner's residual interest in the assets after deducting liabilities

Elements of Financial Statements (SFAC 6) (con't)

- **Investments by owners**
 - Increases in equity due to transfers of value for the purpose of obtaining or increasing ownership
- **Distribution to owners**
 - Decrease in equity resulting from transfer of asset, rendering of service, or incurrence of liabilities by the entity to owners
- **Comprehensive income**
 - The change in equity during a period due to nonowner transactions, events, and circumstances

Elements of Financial Statements (SFAC 6) (con't)

- **Revenues**
 - Inflows and other enhancements of revenue or reductions of liabilities from delivering or providing goods or services related to the central operations
- **Expenses**
 - Outflows or consumption of assets from delivering or providing goods or services related to the central operations
- **Gains**
 - Increases in equity from peripheral transactions of the entity
- **Losses**
 - Decreases in equity from peripheral transactions of the entity

Recognition and Measurement (SFAC 5)

- To be recognized an item should be
 - One of the defined elements
 - Measurable with sufficient reliability
 - Based on information that is
 - Relevant
 - Reliable
- Measurement attributes
 - Historical cost/proceeds
 - Current cost
 - Current market value
 - Net realizable (settlement) value
 - Present (discounted) value of future cash flows

Recognition and Measurement (SFAC 5) (cont'd)

- A full set of financial statements for a period should show
 - Financial position at the end of the period
 - Earnings (net income)
 - Comprehensive income (total nonowner change in equity)
 - Cash flows during the period
 - Investments by and distributions to owners during the period

American Institute of Certified Public Accountants

- Pre-1973
 - ARB (ARBs)
 - APB Opinions (APBOs)
 - Post-1972
 - Accounting Standards Division
 - Accounting Standards Executive Committee
 - Industry Audit Guides
 - Industry Accounting Guides
 - Statements of Position
- Part of GAAP

Emerging Issues Task Force

- Established by the FASB (1984)
- Identifies
 - Emerging issues affecting reporting
 - Problems in implementing authoritative pronouncements
- Ability to react quickly
- Issues statements that are part of GAAP

A New Reality

- Major financial failures
 - Enron
 - WorldCom
- Major legislation: **Sarbanes-Oxley Act of 2002**
 - Public Companies Accounting Oversight Board
 - Impact on the AICPA's role in audit standard setting
 - Fee-based financial support
 - CEOs and CFOs must certify financial statement disclosures
 - Section 404 requires companies to document adequate internal controls and procedures
- FASB Accounting Standards Codification (Codification)
 - 2009 single source of authoritative U.S. GAAP and FASB

Annual Report on Internal Control Systems

Required by the SEC to include

1. A statement of management's responsibilities for established and maintaining an adequate system
2. Identification of the framework used to evaluate the internal controls
3. A statement as to whether or not the internal control system is effective as of year-end
4. The disclosure of any material weaknesses in the system
5. A statement that the company's auditors have issued an audit report on management's assessment

The Public Company Accounting Oversight Board (PCAOB)

- Created by the Sarbanes-Oxley Act
- An arm of the SEC
- 5 members: 2 CPAs, 3 non-CPAs
- Promulgates auditing standards for companies subject to the Sarbanes-Oxley Act
 - AICPA still issues auditing standards for non-public companies

FASB Accounting Standards Codification

- Provide single source of authoritative U.S. GAAP
- 2009 Codification organized in a tiered structure.
 - Organized in eight areas from industry-specific to general financial statement matters.
 - Electronic real time updates.

Traditional Assumptions of the Accounting Model

- Business Entity
- Going Concern (Continuity)
- Time Period
- Monetary Unit
- Historical Cost
- Conservatism
- Realization
- Matching
- Consistency
- Full Disclosure
- Materiality
- Industry Practices
- Transaction Approach
- Cash Basis
- Accrual Basis

Business Entity

- The business entity is separate and distinct from the owners of the entity
- The entity is an economic unit that stands on its own

Going Concern (Continuity)

- The entity will remain in business for an indefinite period of time
- Disregards possibility of liquidation or bankruptcy
- Impacts how assets and liabilities are measured and reported
- Financial statements must disclose if the presumption of continuity is not applicable

Time Period

- Finite reporting periods applied to the presumed indefinite life of a business
 - Natural business year
 - Calendar year
 - Fiscal year
 - 52-53 Week fiscal year
- Allows measurement of the results of operations prior to the liquidation of a business entity's life

Monetary Unit

- Standard of measure for business transactions
- U.S. dollar for domestic entities
- Supplementary disclosure of inflation-adjusted financial data currently not required by U.S. GAAP

Historical Cost

- Often used because it is objective and determinable
- Acceptable deviations
 - When it becomes apparent that the historical cost cannot be recovered (justified by the conservatism concept)
 - Where specific standards call for another measurement attribute such as current market value, net realizable value, or present value

Conservatism

- Select from various measures of value
- Each of the alternatives must have reasonable support
- Conservatism guides selection of the alternative that has the
 - Least favorable impact on net income
 - Least favorable impact on financial position

Realization of Revenue

- In general, the point of recognition of revenue should be the point in time when revenue can be reasonably and objectively determined
- Point of sale
 - Earning process is virtually complete
- End of production
 - If price of item is known and a ready market exists
- Receipt of cash
 - Collection cannot be reasonably estimated

Realization of Revenue (cont'd)

- During production
 - Revenue is recognized proportional to effort
- Cost recovery
 - Applicable for highly speculative transactions
- There are many other acceptable methods of recognizing revenue

Matching

- Match costs associated with revenue recognized
 - Direct association (i.e., inventory sales and cost of the inventory)
- Costs that have no direct connection with revenue
 - Systematic recognition, usually in the period incurred

Consistency

- Same accounting treatment given to comparable transactions from period to period
- Entity results from several years are comparable
- Supports trend analysis
- If a change is made
 - Justification of change is discussed
 - Impact of the change on the financial must be explained

Full Disclosure

- Accounting reports must disclose all the facts that may influence the judgment of an informed reader
- Methods of disclosure
 - Parenthetical
 - Supporting schedules
 - Cross-references
 - Footnotes
- Reasonable summary of significant financial information

Materiality

- Considers the relative size and importance of an item to the business entity
- Immaterial items not subject to concepts and principles
 - Handle in most economical and expedient manner
- Does the information influence an informed reader of the financial statements?
 - Yes: material
 - No: immaterial

Industry Practices

- Industry-specific reports
- Do not conform to general accounting guidelines
 - Government regulation
 - Unique needs or peculiarities of an industry
- Effort to minimize but will probably never be completely eliminated

Transaction Approach

- Record transactions that
 - Affect the financial position of the entity
 - Can be reasonably determined in monetary terms
- Many transactions are nonmonetary in nature
 - Not recorded
 - May be disclosed in compliance with “full disclosure” principle

Cash Basis

- Recognize revenue when cash is collected
- Recognize expense when cash is paid
- Usually does not provide reasonable information about the earning capability of the entity in the short run
- Acceptability
 - Usually not GAAP
 - May be used if difference between cash basis and accrual basis is not material

Accrual Basis

- Revenue recognized when realized (realization concept)
- Expenses recognized when incurred (matching concept)
- Numerous year-end adjustments required
- More complex than cash basis

Accrual Basis (cont'd)

- Result is more representational of financial condition
- Supports the *time period* assumption
- Modified accrual
 - Adjusts for buildings and equipment
 - Immaterial items
 - Specific standards have allowed the cash basis

Accrual vs Cash Basis Accounting (Example)

- Sold inventory for \$25,000 on credit, which cost \$12,500.
- Purchase inventory of \$30,000 on credit.
- Paid suppliers \$18,000 for inventory this year.
- Collected \$15,000 from previous sales.

	Accrual	Cash	
Sales	\$25,000	Receipts	\$15,000
Cost of Goods Sold	<u>-12,500</u>	Expenditures	<u>-18,000</u>
Income	<u>\$12,500</u>	Loss	<u>\$- 3,000</u>