

Financial Accounting

Prepared by Dr. Sara Ahmed

MGM 611

Orientation Lecture





مجموعة جامعة
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Environment and Theoretical Structure of Financial Accounting

MGM 611

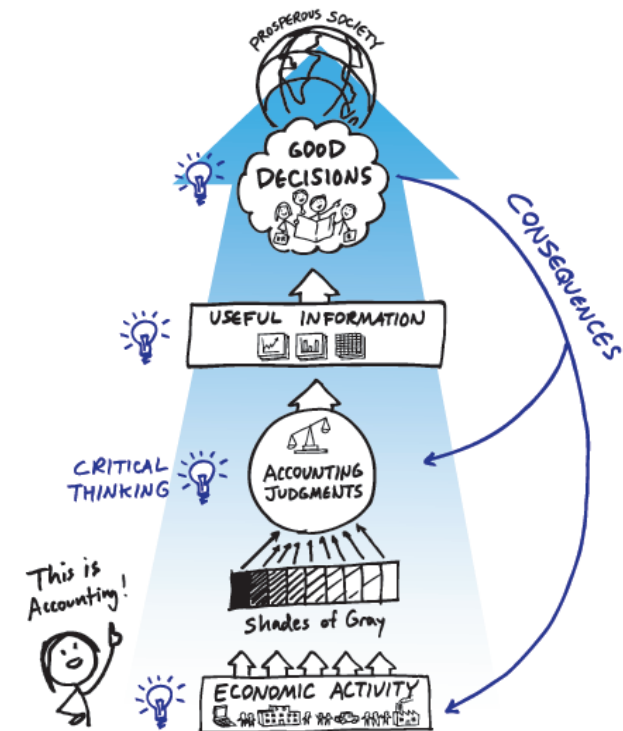
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Visualize the Important Role of Accounting

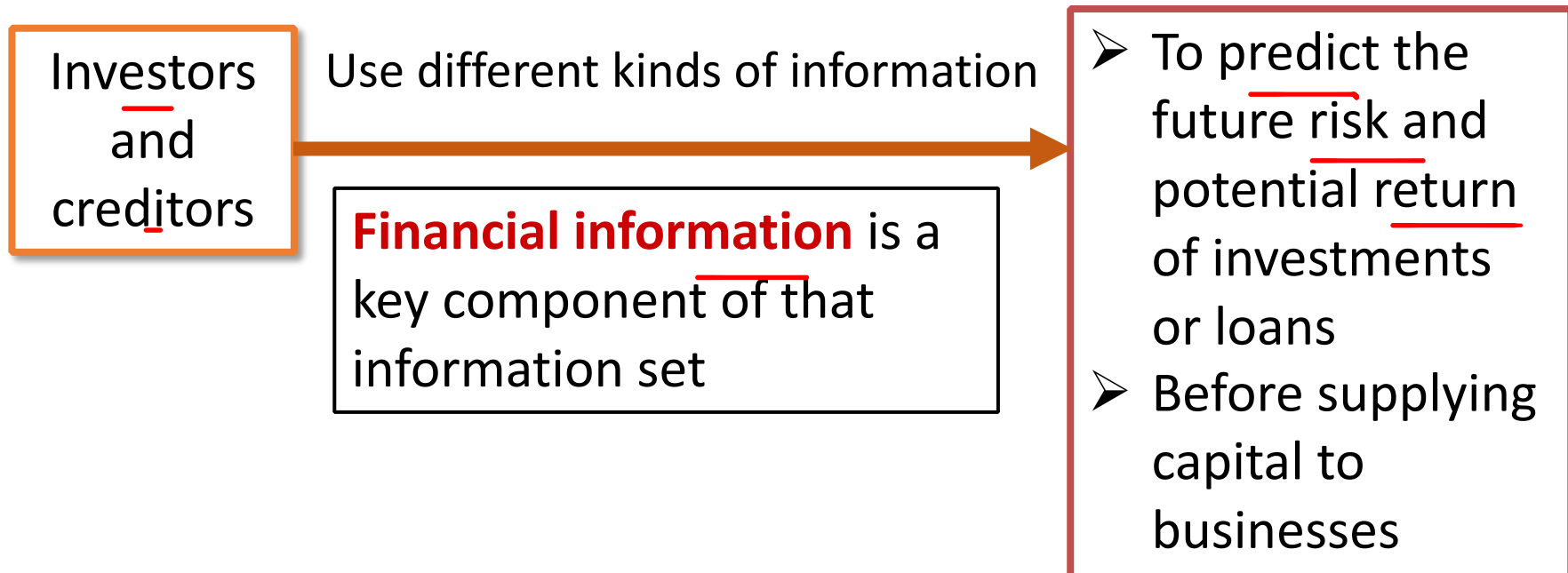
- Accounting provides useful information about economic activity to help:
 - Produce good decisions
 - Foster a prosperous society



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Primary Focus of Financial Accounting

- Providing financial information to various external users
 - Investors ✓
 - Creditors ✓
 - Other external users ✓



Financial Accounting

- Financial information is conveyed through **financial statements** and related disclosure notes
 - Balance sheet ✓
 - Income statement ✓ (and the statement of comprehensive income)
 - Statement of cash flows ✓
 - Statement of shareholders' equity ✓
- **Financial Reporting**
 - Refers to the process of providing financial information to external users

Financial Information Providers and External User Groups

PROVIDERS OF FINANCIAL INFORMATION

- Profit-oriented companies
- Not-for-profit entities (e.g., government entities, charitable organizations, schools)
- Households



USERS OF FINANCIAL INFORMATION

- Investors —
- Creditors (banks, bondholders, other lenders) —
- Employees —
- Labor unions —
- Customers —
- Suppliers —
- Government regulatory agencies (e.g., Internal Revenue Service, Securities and Exchange Commission)
- Financial intermediaries (e.g., financial analysts, stockbrokers, mutual fund managers, credit-rating organizations)

The Economic Environment and Financial Reporting

Capital markets provide a mechanism to help the economy allocate resources efficiently

Corporations acquire capital from:

- Investors in exchange for ownership interest and;
- Creditors by borrowing
 - Either through individual loans or publicly traded debt such as bonds

The Investment-Credit Decision—A Cash Flow Perspective

Why do investors and creditors provide capital?

- They want to earn a fair return on the resources they provide
- Shareholders receive cash from:
 - Sale of the ownership shares of stock
 - Periodic dividends

Key variables in investment decision

- **Rate of return**
- **Uncertainty or risk**

Rate of Return

Example calculation of rate of return:

Assume an investor provides a company with \$10,000 cash by purchasing stock at the end of 2020, receives \$400 in dividends from the company during 2021, and sells the ownership interest (shares) at the end of 2021 for \$10,600.

$$\frac{\$400 \text{ dividends + \$600 \text{ share price appreciation}}{\$10,000 \text{ initial investment}} = 10\%$$

Investors and creditors like to invest in stocks or bonds that provide a high expected rate of return

Example of Uncertainty

Consider the following two investment options.
Which would you pick?

- Investing \$10,000 in a savings account insured by the U.S. government that will generate a 5% rate of return

- Investing \$10,000 in a profit-oriented company



Risk/Return tradeoff: Most investors would invest in the profit-oriented company only if the potential return is high enough.

Objective of Financial Accounting

- **Primary objective of financial accounting**
 - Provided information should be useful for decision making
 - Information should help investors and creditors evaluate the following characteristics of the enterprise's future cash receipts and disbursements.
 1. **Amounts** ✓
 2. **Timing** ✓
 3. **Uncertainty** ✓

Cash versus Accrual Accounting

Cash Basis Accounting

- Measurement of **cash receipts** and **cash payments** from transactions related to providing goods and services
- Difference is net operating cash flow

Accrual Basis Accounting

- Measurement of **revenues** and **expenses**, *regardless of when cash is received or paid*
- Difference is net income or net loss

Cash Basis Example

- Carter Company paid \$60,000 for 3 years' rent at the beginning of year 1
 - Under cash basis accounting, the rent payment is shown when paid

	Year 1	Year 2	Year 3	Total
Sales (on credit)	<u>\$100,000</u>	<u>\$100,000</u>	<u>\$100,000</u>	<u>\$300,000</u>
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	<u>(5,000)</u>	<u>(15,000)</u>	<u>(10,000)</u>	<u>(30,000)</u>
Net operating cash flow	<u>\$ (65,000)</u>	<u>\$ 60,000</u>	<u>\$ 65,000</u>	<u>\$ 60,000</u>

Accrual Basis Example

- Carter Company paid \$60,000 for 3 years' rent at the beginning of year 1
 - Under accrual basis accounting, rent is recognized as an expense all three years even though it was paid in year 1

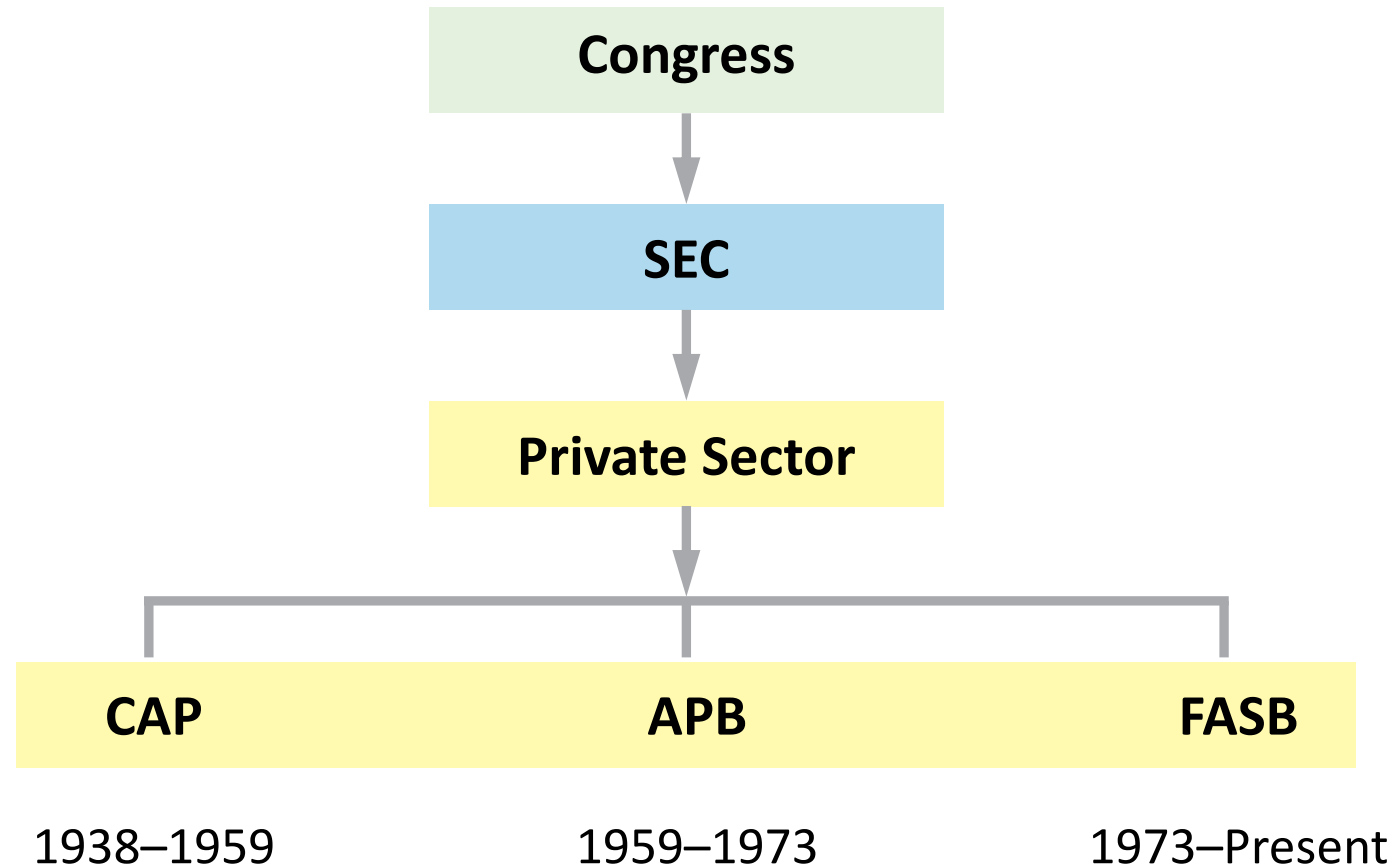
CARTER COMPANY Income Statements				
	Year 1	Year 2	Year 3	Total
Revenues	<u>\$100,000</u>	<u>\$100,000</u>	<u>\$100,000</u>	<u>\$300,000</u>
Expenses:				
Rent	20,000	20,000	20,000	60,000
Salaries	50,000	50,000	50,000	150,000
Utilities	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>	<u>30,000</u>
Total expenses	<u>80,000</u>	<u>80,000</u>	<u>80,000</u>	<u>240,000</u>
Net Income	<u>\$ 20,000</u>	<u>\$ 20,000</u>	<u>\$ 20,000</u>	<u>\$ 60,000</u>

The Development of Financial Accounting and Reporting Standards

- **Generally Accepted Accounting Principles (GAAP)**
 - GAAP is a dynamic set of both **broad and specific guidelines** that companies should follow when measuring and reporting the information in their financial statements and related notes
 - GAAP facilitates decision making by investors and creditors by allowing them to **compare** financial information among companies

Accounting Standard Setting

HIERARCHY OF STANDARD-SETTING AUTHORITY



Historical Perspective and Standards

- **Securities and Exchange Commission (SEC)**
 - Created by Congress in response to the stock market crash of 1929
 - Goal: To restore investor confidence
- **1933 Securities Act**
 - Applies to initial offerings of securities (stocks and bonds)
- **1934 Securities Exchange Act**
 - Applies to secondary market transactions
 - Mandates reporting requirements for companies whose securities are publicly traded

Early U.S. Standard Setting

- **Committee on Accounting Procedure (CAP)** (1938 to 1959)
 - First private sector standard-setting body
 - Committee of the American Institute of Accountants (AIA)
 - AIA: National professional organization for certified professional public accountants
 - AIA: Renamed as American Institute of Certified Public Accountants (AICPA)
 - Issued 51 Accounting Research Bulletins (ARBs)
- **Accounting Principles Board (APB)** (1959 to 1973)
 - Issued 31 Accounting Principles Board Opinions (APBOs), various Interpretations, and four Statements
 - Replaced by Financial Accounting Standards Board (FASB)

Financial Accounting Standards Board (FASB)

- **FASB created in 1973**
 - Established to set U.S. accounting standards
 - Supported by **Financial Accounting Foundation (FAF)**
 - Seven full-time members
- **Emerging Issues Task Force (EITF) created in 1984**
 - Identifies financial reporting issues and attempts to resolve them without involving the FASB
 - Primarily addresses implementation issues
 - Speeding up the standard-setting process
 - EITF rulings are ratified by the FASB and are considered part of GAAP
- **Government Accounting Standards Board (GASB):**
develop accounting standards for governmental units such as states and cities

Codification

- **FASB Accounting Standards Codification**
 - Only source of authoritative nongovernmental U.S. GAAP
 - Organizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics
 - Also includes portions of SEC accounting guidance
- **Accounting Standards Update (ASU):** any new standard issued by FASB
- Located at the [FASB website](#)

FASB Accounting Standards Codification Topics

FASB Accounting Standards Codification Topics	
Topic	Numbered
General Principles	100–199
<u>Presentation</u>	200–299
Assets	300–399
Liabilities	400–499
Equity	500–599
Revenues	600–699
Expenses	700–799
Broad Transactions	800–899
Industry	900–999

International Standard Setting

- **International Accounting Standards Committee (IASC)**
 - Formed in 1973 to develop global accounting standards
 - Created a new standard-setting body called the **International Accounting Standards Board (IASB)** (2001)
- **IASB:**
 - To develop a single set of high-quality, understandable, and enforceable global accounting standards
 - Endorsed 41 International Accounting Standards (IASs)
 - Issued new standards of its own—called **International Financial Reporting Standards (IFRS)**

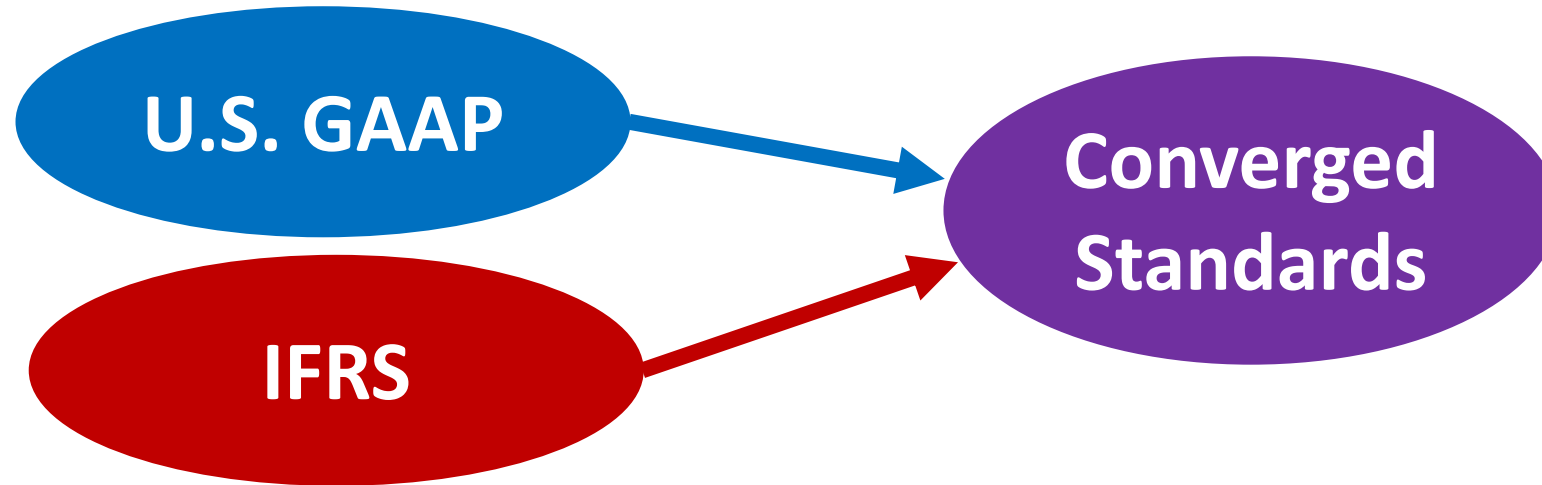
Comparison of Organizations of U.S. and International Standard Setters

	U.S. GAAP	IFRS
Regulatory oversight provided by:	Securities Exchange Commission (SEC)	Monitoring Board
Foundation providing oversight, appointing members, raising funds:	Financial Accounting Foundation (FAF): 14-18 trustees	IFRS Foundation: 22 trustees
Standard-setting board:	Financial Accounting Standards Board (FASB): 7 members	International Accounting Standards Board (IASB): 14 members
Advisory council providing input on agenda and projects:	Financial Accounting Standards Advisory Council (FASAC): 30–40 members	IFRS Advisory Council: approx. 50 members
Group to deal with emerging issues:	Emerging Issues Task Force (EITF): approx. 15 members	IFRS Interpretations Committee: 14 members

International Financial Reporting Standards (IFRS)

- Since 2001, the IASB has revised many International Accounting Standards (IASs) and has issued new standards of its own, called ***International Financial Reporting Standards (IFRS)***
- More and more countries are basing their national accounting standards on IFRS
- By 2018, more than 120 jurisdictions, including Hong Kong, Egypt, Canada, Australia, and the countries in the European Union (EU), require or permit the use of IFRS or a local variant of IFRS

Efforts to Converge U.S. and International Standards



- FASB and IASB have been working for many years to converge to one global set of accounting standards, however, recent events suggest that full convergence **will not be achieved in the foreseeable future**
- While it appears likely that the FASB and IASB will continue to work together to converge where possible, some differences between IFRS and U.S. GAAP will remain

The FASB's Standard-Setting Process

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.

Politics in Standard Setting

- Mid-1990's—accounting for employee **stock options**
- Implementation of the **fair value accounting** standard issued in 2007

International Financial Reporting Standards: Politics in International Standard Setting

Politics in International Standard Setting. Political pressures on the IASB's standard-setting process are severe. Politicians from countries that use IFRS lobby for the standards they prefer. The European Union (EU) is a particularly important adopter of IFRS and utilizes a formal evaluation process for determining whether an IFRS standard will be endorsed for use in EU countries. Economic consequences for EU member nations are an important consideration in that process.

For example, in 2008 the EU successfully pressured the IASB to suspend its due process and immediately allow reclassification of investments so that EU banks could avoid recognizing huge losses during a financial crisis. Commenting on standards setting at that time, Charlie McCreevy, European Commissioner for Internal Markets and Service, stated that "Accounting is now far too important to be left to ...accountants!"

Encouraging High-Quality Financial Reporting

- **Role of an Auditor**
 - Offer credibility to financial statements
 - **Express an opinion** on the compliance of financial statements with GAAP
 - Licensed by states to provide audit services—**certified public accountants (CPAs)**

Financial Reporting Reform

ACCOUNTING SCANDALS

Enron

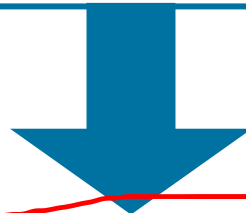
WorldCom

Xerox

Merck

Adelphia Communications

Increased the pressure on lawmakers to pass measures that would restore credibility and investor confidence in the financial reporting process

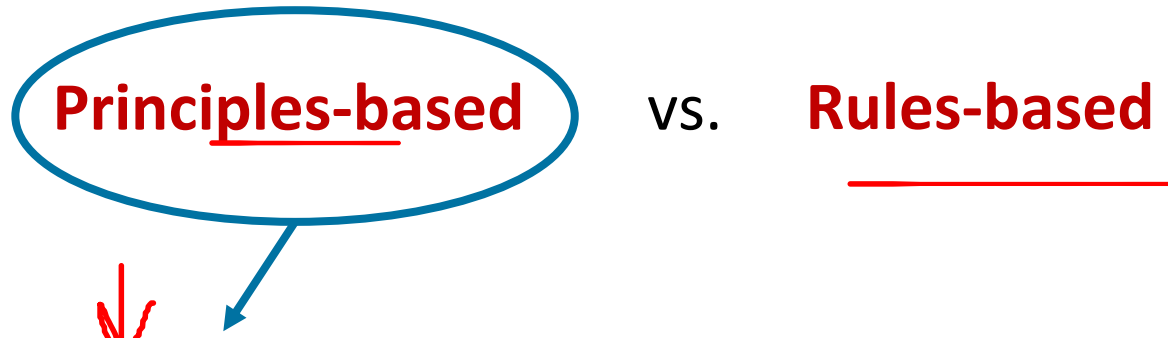


Sarbanes-Oxley Act

Key Provisions of the Sarbanes-Oxley Act

- Oversight board
- Corporate executive accountability
- Nonaudit services ____
- Retention of work papers ____
- Auditor rotation ____
- Conflicts of interest ____
- Hiring of auditor ____
- Internal control ____

A Move Away from Rules-Based Standards?



Objectives-oriented

- A principles-based, or objectives-oriented, approach to standard-setting stresses professional judgment, as opposed to following a list of rules or bright lines
- Regardless, poor ethical values on the part of management are at the heart of accounting abuses and scandals

Ethics and Professionalism

- **Ethics** deals with the ability to distinguish right from wrong
- **Codes of Ethics** or **Codes of Professional Conduct** are provided by:
 - American Institute of Certified Public Accountants (AICPA)
 - Institute of Management Accountants (IMA)
 - Institute of Internal Auditors (IIA)

Analytical Model for Ethical Decisions

Step 1. Determine the facts of the situation —

Step 2. Identify the ethical issue and the stakeholders —

Step 3. Identify the values related to the situation —

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 —

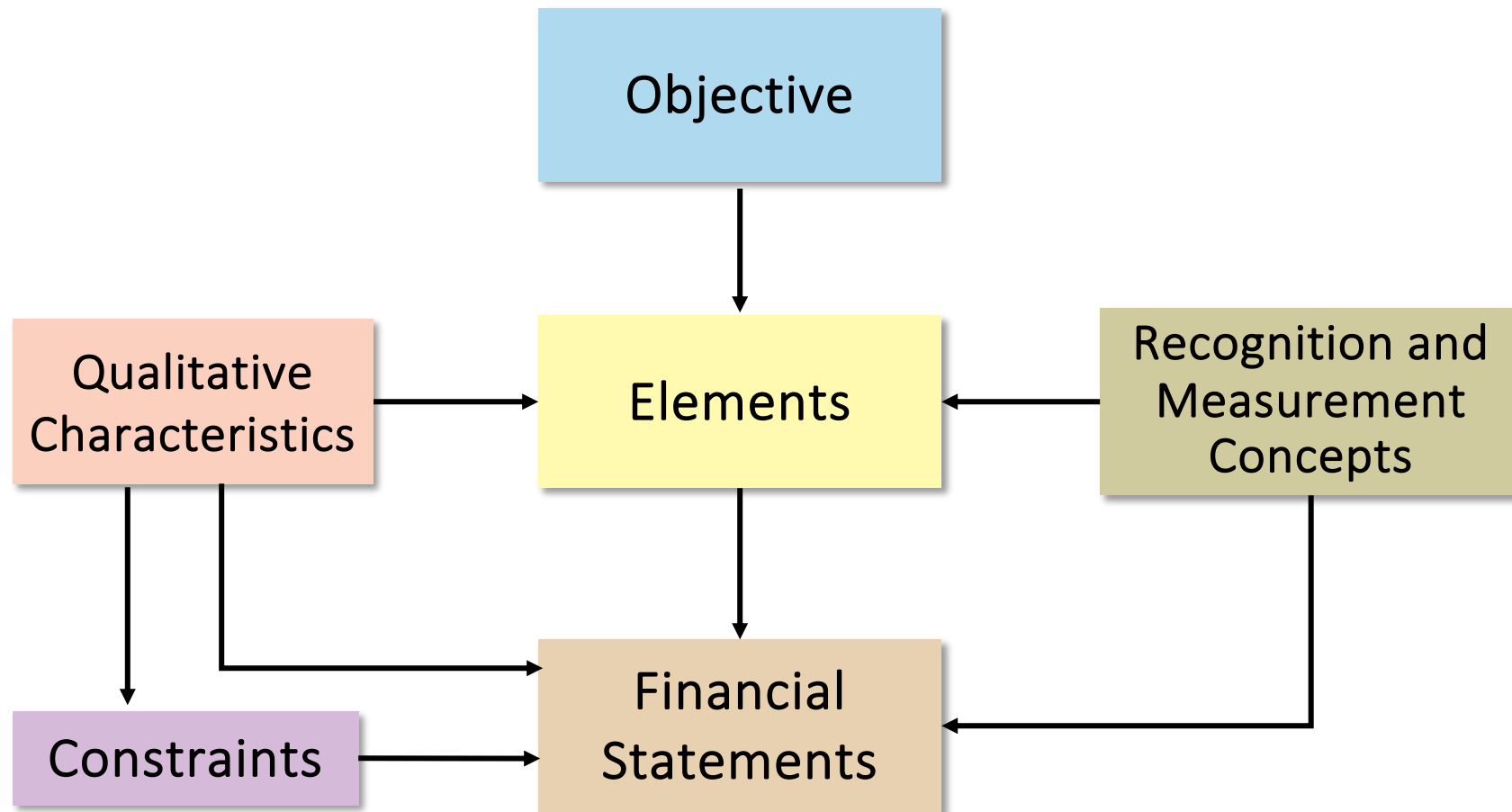
Step 6. Identify the consequences of each possible course of action —

Step 7. Make your decision and take any indicated action

The Conceptual Framework

- Described as an **Accounting Constitution**
- Provides an **underlying foundation for U.S. accounting standards**
 - Guides the selection of events to be accounted for
 - Measurement of those events
 - Means of summarizing them and communicating them to interested parties
- Provides structure and direction to financial accounting and reporting
- Disseminated by FASB through Statements of Financial Accounting Concepts (SFACs)

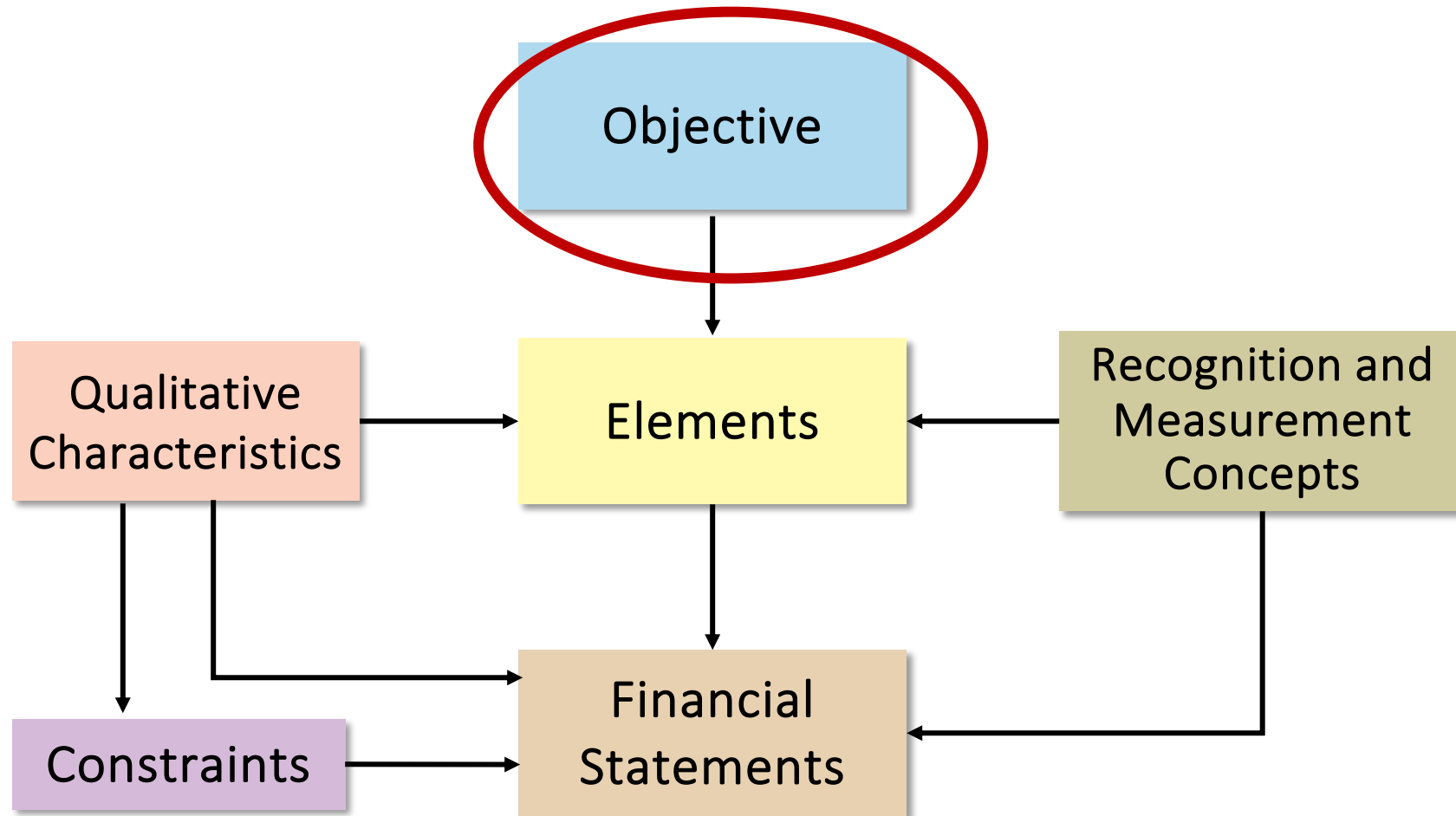
Objective of Financial Reporting



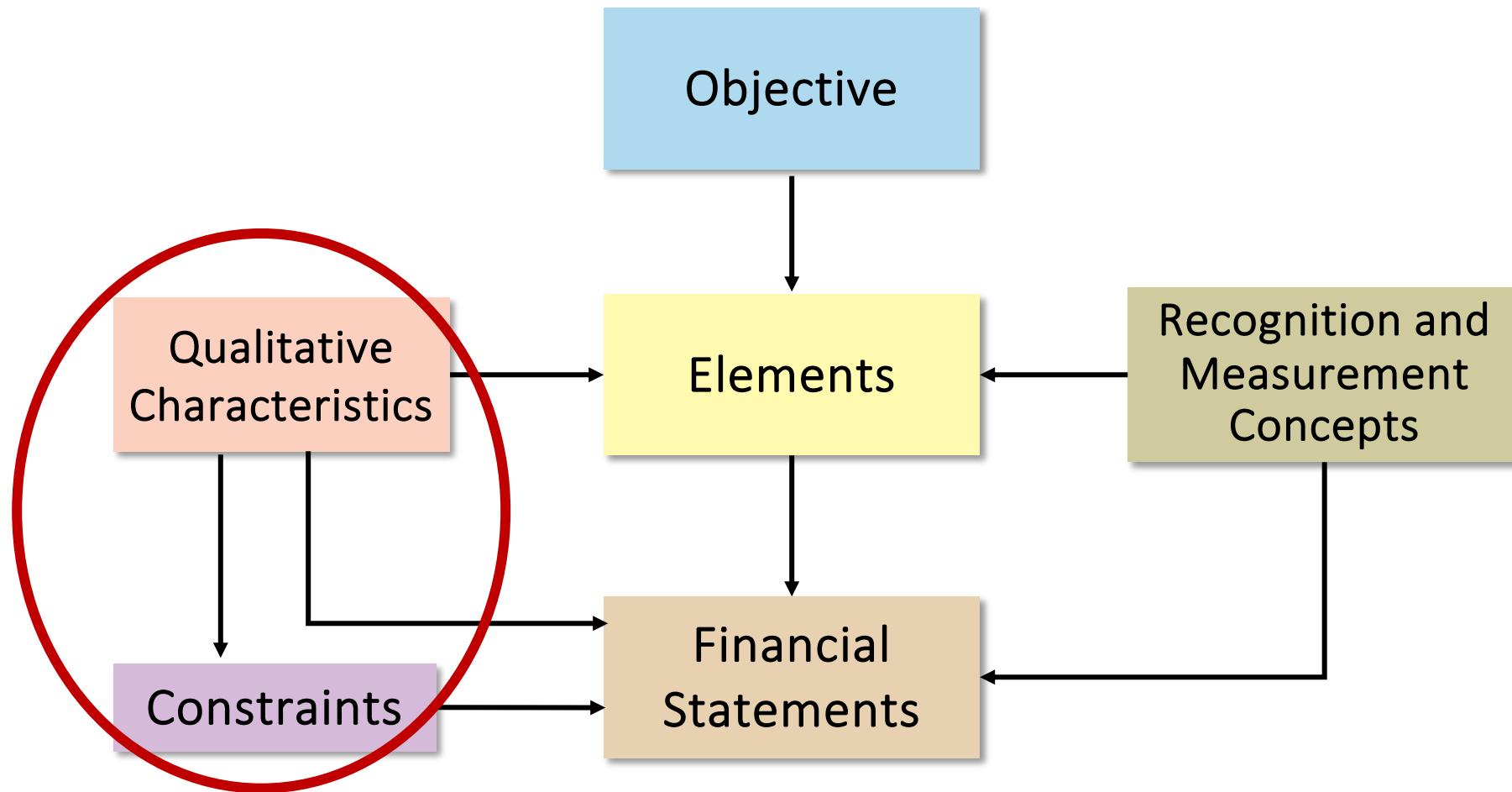
International Financial Reporting Standards: Role of the Conceptual Framework

Role of the conceptual framework. The conceptual frameworks in U.S. GAAP and IFRS are very similar, and are converging even more with ongoing efforts by the FASB and IASB. However, in U.S. GAAP, the conceptual framework primarily provides guidance to standard setters to help them develop high-quality standards. In IFRS the conceptual framework guides standard setting, but in addition it provides a basis for practitioners to make accounting judgments when another IFRS standard does not apply. Also, IFRS emphasizes the overarching concept of the financial statements providing a “fair presentation” of the company. U.S. GAAP does not include a similar requirement, but U.S. auditing standards require this consideration.

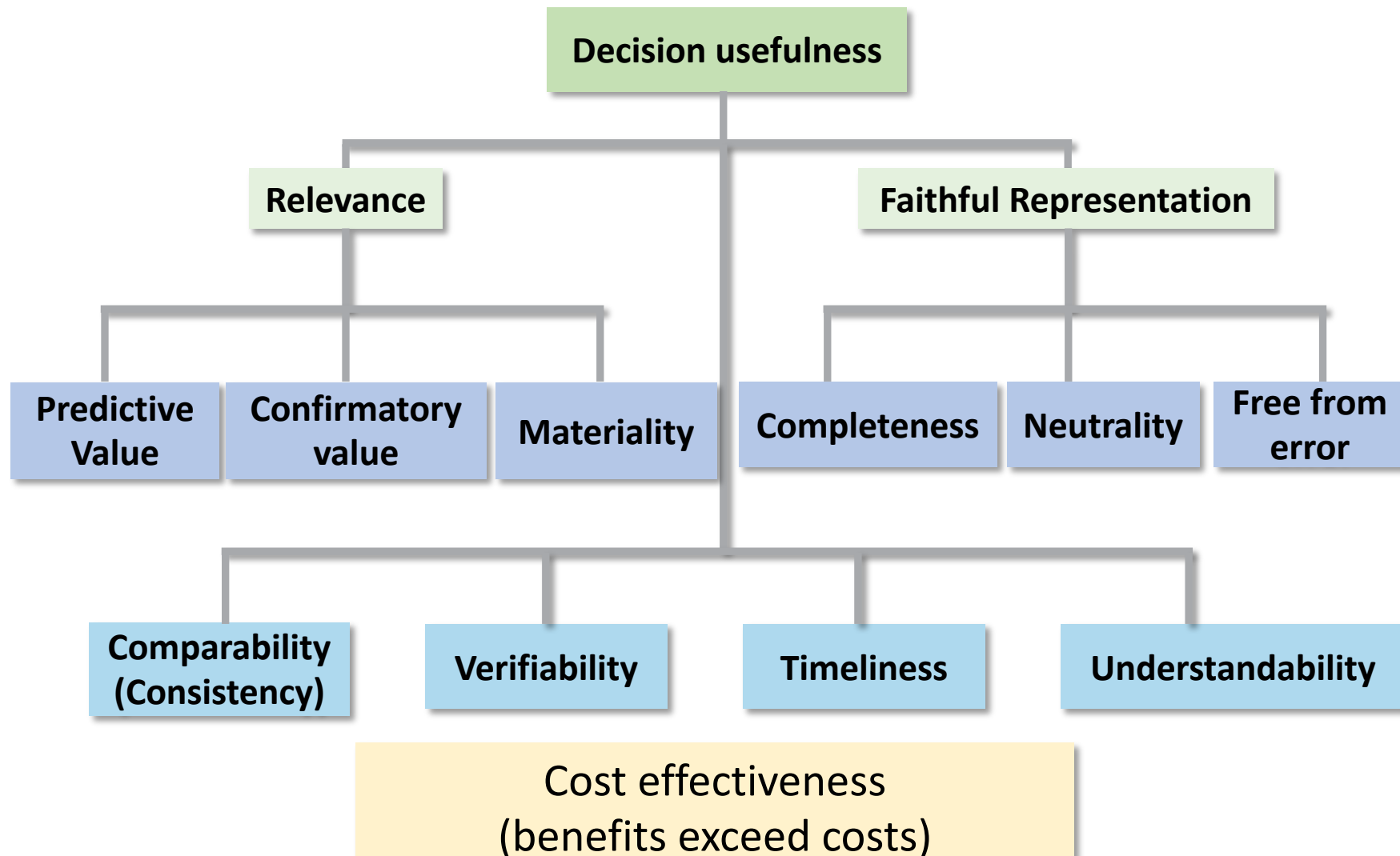
Objective of Financial Reporting



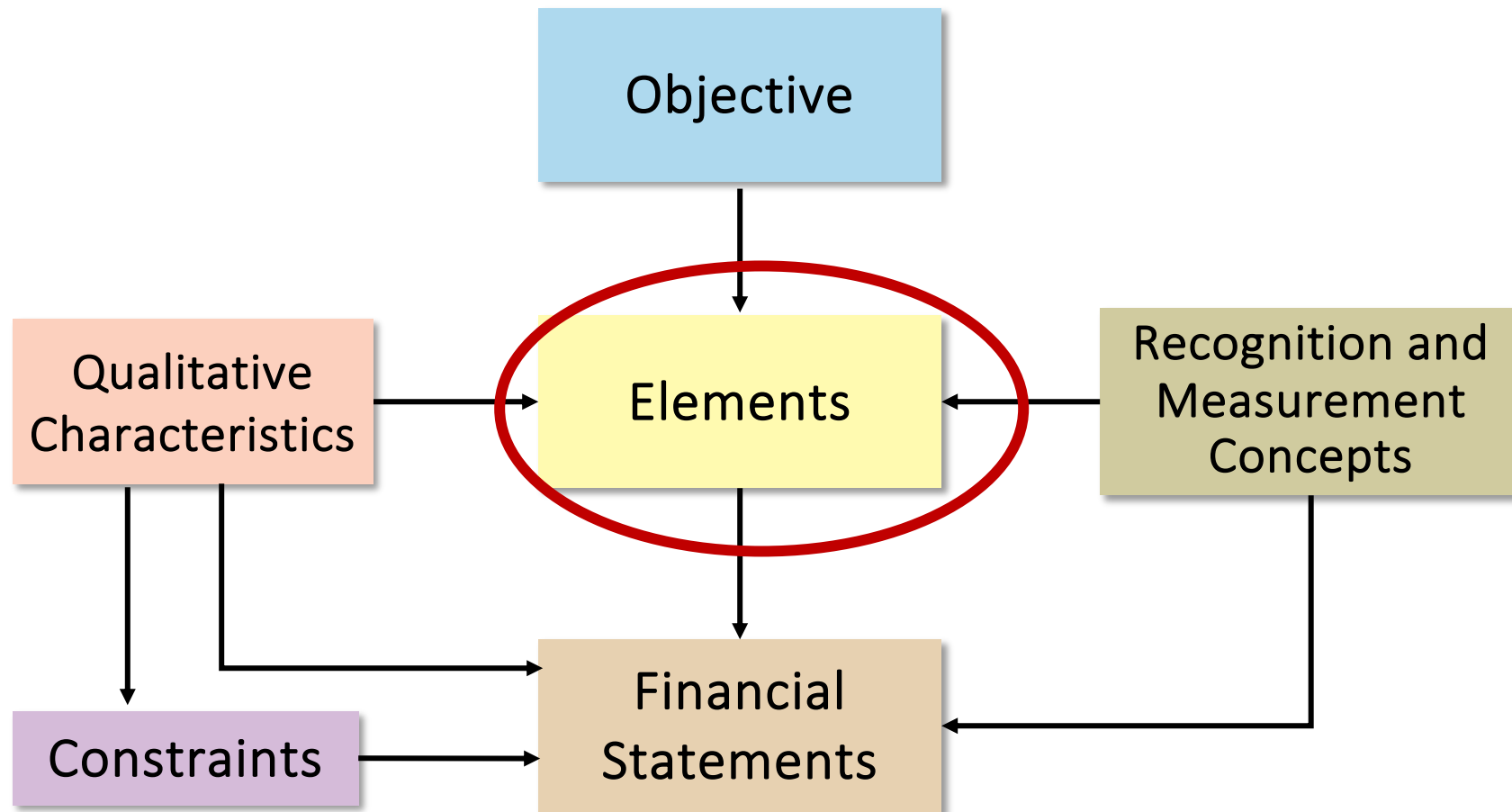
The Conceptual Framework: Recognition, Measurement, and Disclosure Concepts



Hierarchy of Qualitative Characteristics of Financial Information



The Conceptual Framework: Recognition, Measurement, and Disclosure Concepts



Elements of Financial Statements

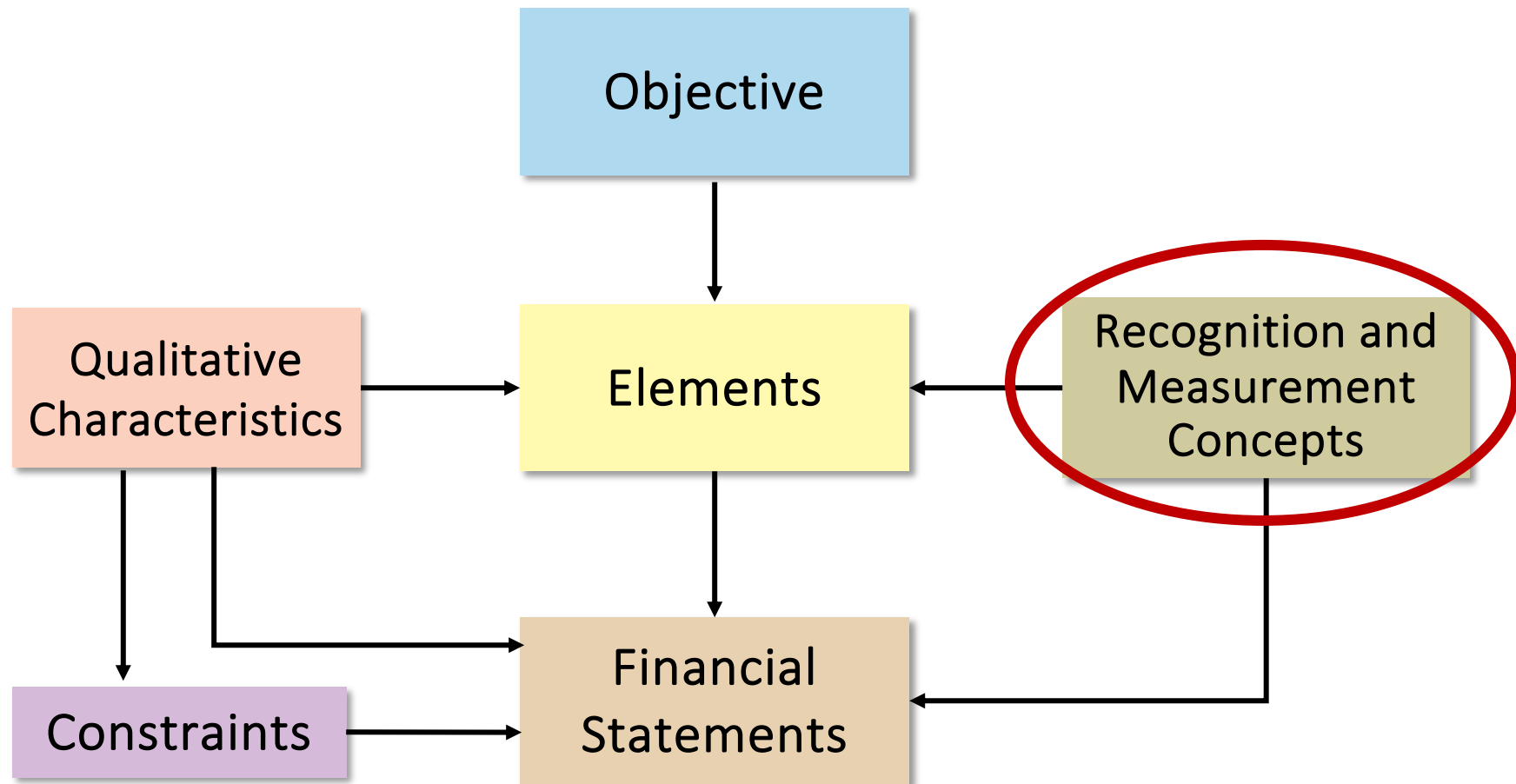
- Assets
- Liabilities
- Equity (or net assets)
- Investments by owners
- Distributions to owners
- Comprehensive income
- Revenues
- Expenses
- Gains
- Losses

Underlying Assumptions

Four basic assumptions underlie GAAP

- The **economic entity** assumption presumes that economic events can be identified specifically with an economic entity
- The **going concern** assumption anticipates that a business entity will continue to operate indefinitely
- The **periodicity** assumption allows the life of a company to be divided into artificial time periods to provide timely information
- The **monetary unit** used in U.S. financial statements is the U.S. dollar

The Conceptual Framework: Recognition, Measurement, and Disclosure Concepts



Recognition, Measurement, and Disclosure Concepts

- **Recognition** refers to the process of admitting information into the financial statements
- **Measurement** is the process of associating numerical amounts with the elements
- **Disclosure** refers to the process of including additional pertinent information in the financial statements and accompanying notes

General Recognition Criteria

- Definition, Measurability, Relevance, and Reliability

Revenue Recognition

- **Revenue:** Inflows of assets or settlements of liabilities resulting from providing a product or service to a customer
- Revenue recognition used to be guided by the **realization principle** (two criteria)
 - Earnings process is judged to be complete or virtually complete
 - Reasonable certainty as to the collectability of the asset to be received (usually cash)
- FASB issued **ASU No. 2014-09**, which requires that we **recognize revenue when goods or services are transferred to customers** for the amount the company expects to be entitled to receive in exchange for those goods or services

Expense Recognition

Often matches revenues and expenses that arise from the same transactions or other events

Four approaches:

- Based on an **exact cause-and-effect relationship**
- By **associating an expense with the revenues** recognized in a specific time period
- By a **systematic and rational allocation** to specific time periods
- **In the period incurred**, without regard to related revenue

Measurement

- GAAP currently employs a “**mixed attribute**” measurement model.
- The five attributes are:
 1. **Historical cost:** original transaction value adjusted for depreciation and amortization
 2. **Net realizable value:** the amount of cash into which an asset is expected to be converted in the ordinary course of business
 3. **Current cost:** the cost that would be incurred to purchase or reproduce the asset
 4. **Present value:** the current value of future cash flows, calculated by applying the time value of money
 5. **Fair value:** the price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Historical Cost

- **Historical Cost:** *Original transaction value*
 - Bases measurements on the amount given or received in the exchange transactions
- **For assets:**
 - Value of what is given in exchange (usually cash) for the asset at its initial acquisition
- **For liabilities:**
 - Current cash equivalent received in exchange for assuming the liability
- **Long-lived, revenue-producing assets (equipment):**
 - Adjusted subsequent to its initial measurement by recognizing depreciation or amortization

Net Realization Value, Current Cost, and Present Value

- **Net Realizable Value**
 - Estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation
 - Amount of cash into which an asset or liability is expected to be converted in the ordinary course of business
- **Current cost**
 - Cost that would be incurred to purchase or reproduce the asset
 - Reported if the company operates in inflationary economies
- **Present value** (SFAC 7)
 - Framework for using future cash flows as the basis for accounting measurement
 - Indicates that the objective in valuing an asset or liability using present value is to approximate its fair value

Fair Value

- **Fair value**, originally called **current market value**
 - Bases measurements on the price that would be received to sell assets or paid to transfer liabilities in an orderly market transaction
- Fair value can be measured using:
 - **Market approach**: Valuation based on market information
 - **Income approach**: Estimates future amounts and then mathematically converts those amounts to a single present value
 - **Cost approach**: Estimates the amount that would be required to buy or construct an asset of similar quality and condition

Fair Value Hierarchy

Fair Value Hierarchy		
Level	Inputs	Example
1 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 <i>fair values</i> . 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 <i>observable</i> for the asset or liability. These inputs include quoted prices for <i>similar</i> 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, each element of the transaction is recorded at its <i>fair value</i> . 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 Least Desirable	<i>Unobservable</i> 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 <i>fair value</i> . 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 present value of expected cash flows estimated using the entity's own data if there is no information indicating that market participants would use different assumptions.

Fair Value Option

- **Fair Value Option:** GAAP gives a company the option, in some circumstances, to choose whether to report specified *financial* assets and liabilities at fair value
 - Provides companies a way to reduce volatility in reported earnings without having to comply with complex hedge accounting standards
 - Helps to converge with international accounting standards

Disclosure

- **Full-disclosure principle**: requires that the financial reports should include any information that could affect the decisions made by external users
- Such information can be disclosed in a variety of ways:
 - **Parenthetical comments** or **modifying comments**
 - Placed on the face of the financial statements
 - **Disclosure notes**
 - Convey additional insights
 - **Supplemental schedules and tables**
 - Report more detailed information than is shown in the primary financial statements

Summary of Recognition, Measurement, and Disclosure Concepts

Concept	Description
Recognition	General criteria: 1. Meets the definition of an element 2. Has a measurement attribute 3. Is relevant 4. Is reliable (representationally faithful) Examples of recognition timing: 1. Revenues 2. Expenses
Measurement	Mixed attribute model in which the attribute used to measure an item is chosen to maximize relevance and representational faithfulness. These attributes include: 1. Historical cost 2. Net realizable value 3. Current cost 4. Present (or discounted) value of future cash flows 5. Fair value
Disclosure	Financial reports should include all information that could affect the decisions made by external users. Examples of disclosures: 1. Parenthetical amounts 2. Notes to the financial statements 3. Supplemental schedules and tables



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Thank You

