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The Financial Reporting Environment

Overview

Chapter 1 presents an overview of the financial reporting environment to explain how capital markets rely on the credibility of published financial statements. Many factors impact decisions made by firms and, thus, the financial reporting process extends far beyond the financial statements. This chapter provides a definition of financial accounting and the supply and demand of accounting information, discusses economic entities that prepare financial information and the users of such information, and explains the factors that shape financial information.

Learning Objectives

1. Define financial accounting and describe the demand for financial information, including the role of general-purpose financial statements, the information needs of financial statement users and other parties, and the factors that influence financial reporting.
2. Discuss the role of financial accounting standard setters in the United States and internationally.
3. Detail the standard-setting process.
4. Explain three recent trends in standard setting: principles-based, rules-based, and objectives-oriented standards; the asset/liability approach; and fair value measurements.

Teaching Outline

Learning Objective 1: Overview of Financial Reporting

I. The definition of financial reporting contains four major elements:

- Financial information
- Economic entity
- User groups
- Legal, economic, political, and social environment

Financial reporting is the process of identifying, measuring, and communicating financial information about an economic entity to various user groups within the legal, economic, political, and social environment.

A. Financial Information (first element of financial accounting)

- Information that is or is not governed by rules set forth by the accounting standard-setting bodies (for example, financial statements and footnotes)
- Information that is not governed by rules set forth by the accounting standard-setting bodies (for example, management discussion and analysis) (regulated by other authoritative bodies)

1. Demand for Financial Information: The form, content, and extent of financial information are based on market participant demand. The demand for financial information is linked to the allocation of scarce resources. *See Exhibit 1.1.*

2. Sources of Financial Information: The four basic financial statements are the (1) balance sheet, (2) statement of comprehensive income, (3) statement of cash flows, and (4) statement of shareholders' equity.

- a. General-purpose financial statements: Referred to as published financial statements that provide information to investors, creditors, financial analysts, customers, employees, competitors, suppliers, unions, and government agencies.
- b. Financial Accounting Standards Board (FASB): Body responsible for promulgating U.S. GAAP.
- c. Financial information is a broader term than financial statements and includes:
 - Letters to the shareholders
 - Formal discussion and analysis
 - Management report
 - Auditors' report
 - Financial summary

B. Economic Entity (second element of financial reporting): An organization or a unit with activities that are separate from those of its owners and other entities. Can be corporations, partnerships, sole proprietorships, or governmental organizations.

C. Financial Statement User Groups (third element of financial reporting): *See Exhibit 1.2.* Includes equity investors, creditors, and other debt investors, competitors, financial analysts, employees and labor unions, suppliers and customers, and government agencies

1. Equity Investors: Shareholders of the company
 - a. Purchase a percentage of ownership.
 - b. Expect to see a return on their investment.

- c. Use financial information to determine a company's ability to generate earnings and cash flow.
 - d. Make assessments as to potential risk and returns.
 - e. Assess an entity's ability to pay dividends and grow over time.
2. Creditors and Other Debt Investors: Entities that lend money to the company
 - a. Debt can be public or privately held. For example, public traded debt may include bonds, and private debt may include lenders such as commercial banks.
 - b. Creditors receive a return on investment by way of interest income.
 - c. Public debt may also receive a return by way of the price of the bond.
 3. Competitors: Use financial information to determine their market position related to the reporting entity. Analyze competitor strategy to assess ability to compete.
 4. Financial Analysts: Use information to provide guidance to individuals and other entities in making investment and credit decisions. Act as financial intermediaries to examine extensive financial data and reduce to manageable amount of information for use by investors.
 5. Employees and Labor Unions: Assess the economic performance and liquidity of entities employing members of the union.
 6. Suppliers and Customers: Use financial information to determine a company's financial position, assess ability to pay for goods and services, assess the quality of the product, and determine an entity's ability to honor warranties.
 7. Government Agencies: Variety of reasons
- D. Other Parties Involved in the Preparation and Use of Financial Information:
- Financial Statement preparers: Other parties involved in the financial statement process include: *See Exhibit 1.3.*
- External auditors: Independent of the company. Ensure compliance with accounting standards and ensure that the financial statements fairly represent the financial condition of the company.
 - Internal auditors: Employees of the company who serve an advisory role to management.
 - Standard setters: Develop and promulgate accounting concepts, rules, and guidelines necessary to the relevant and faithful representation of the economic performance of the reporting entity.
 - Regulatory bodies such as the SEC: Protect investors and oversee the accounting standard-setting process.
 - Professional organizations such as the AICPA: Provide support to accounting professionals.
- E. Legal, Economic, Political, and Social Environment (fourth element of financial reporting): The ever-changing environment of financial reporting lends itself to legal consideration as the procedure interacts both reactively and proactively.
1. Reactive Factors: *See Exhibit 1.4.* Pressures from various groups and changes in the environment require that accounting theory and procedures evolve to meet the

- changes. **Example:** FASB made changes to accounting for off-balance-sheet subsidiaries following the discovery of the fraud scheme at Enron in the early 2000s.
2. Proactive Factors: Changes in financial accounting can influence the environment by providing feedback information and can influence managerial behavior.
- F. Data Analytics and Technology Innovation are changing the business world. Analysis of this data can provide powerful insights to increase the efficiency and effectiveness of our business world.
1. Data Analytics: *See Exhibit 1.5.* The process of analyzing large data sets in order to draw useful conclusions. In financial reporting, we can use data analytics to improve the quality of our estimates and valuations.

Learning Objective 2: Role of Standard Setters

- I. Standard setters work to develop concepts, rules, and guidelines for financial reporting that will satisfy the requirement to provide financial information that is accurate. They encourage transparency and truthful reporting.
 - A. The Importance of Understanding International Accounting Standards: *See Exhibit 1.5.*
 - U.S. companies operate subsidiaries outside of the United States. Many of these subsidiaries report under IFRS.
 - Non-U.S. companies operate in the United States and prepare their financial statements using IFRS.
 - The SEC permits the use of IFRS-based financial statements by international companies with shares trading on the U.S. stock exchanges.
 - The SEC promotes high-quality, globally accepted accounting standards.
 - Many U.S. accountants now spend time working outside the United States. IFRS is required or permitted in 144 countries worldwide.
 - The accounting profession has determined that working knowledge of IFRS is important.

Learning Objective 3: The Standard-Setting Process

- I. The FASB sets U.S. accounting standards, and the IASB sets global accounting standards.
 - A. Standard Setting: *See Exhibit 1.6.*
 1. History of Standard Setting
 - a. Began with the Securities Exchange Act of 1934, which gave the SEC the power to promulgate accounting standards for all publicly traded firms.
 - b. The Committee on Accounting Procedures (CAP) was formed in 1939 as a subcommittee of the AICPA to reduce inconsistencies and the number of accounting methods. CAP produced 51 standards known as Accounting Research Bulletins (ARBs or Bulletins).
 - c. The Accounting Principles Board (APB) was also formed as a subcommittee of the AICPA and replaced CAP in 1959. APB issued 31 APB Opinions and 4 APB Statements.
 - d. The Financial Accounting Standards Board (FASB) replaced the APB in 1973. Not a subcommittee of the AICPA and not affiliated with any professional

organization. Issues Accounting Standards Updates (ASUs) as part of the Accounting Standards Codifications (ASC).

2. The Standard-Setting Structure: *See Exhibit 1.7*. The FASB is part of a larger organizational structure that also includes:
 - a. Financial Accounting Foundation (FAF): Responsible for the oversight, administration, and finances of the FASB.
 - b. Governmental Accounting Standards Board (GASB): Sets standards for state and local governmental units.
 - c. Financial Accounting Standards Advisory Council (FASAC): Advises the FASB on technical issues.
 - d. Governmental Accounting Standards Advisory Council (GASAC): Advises the GASB on technical issues.
 - e. Emerging Issues Task Force (EITF): Formed in 1984 to assist the FASB by addressing issues that are not as broad in scope as those found on the GASB's agenda.
 - f. Private Company Council (PCC): Established to set accounting standards for U.S. private companies.
3. The Standard-Setting Process: Seven-step process as follows:
 - a. Step 1: Identification of an issue: Based on recommendations from analysts, government agencies, and other market participants.
 - b. Step 2: Decision to pursue: Chairperson decides to add the issue to the technical agenda.
 - c. Step 3: Public meetings: To deliberate the various issues.
 - d. Step 4: Exposure Draft (ED): Issued by the board to solicit input from financial statement preparers, auditors, and user of financial statements.
 - e. Step 5: Public roundtables: To discuss the ED.
 - f. Step 6: Redeliberation: Based on comments from financial statement preparers, auditors, and user of financial statements, as well as the roundtable discussions and any other information.
 - g. Step 7: Publication of the final standard: Issues and ASU, which will be incorporated into the codification of U.S. GAAP.

IFRS Breakaway

II. IFRS Standard Setting

- A. History of Global Standard Setting: *See Exhibit 1.8*. Most countries have historically had their own accounting standards. With almost 200 countries in the world, investors and creditors struggled to compare accounting standards when analyzing companies and making investment decisions.
 1. The International Accounting Standards Committee (IASC) was organized in 1973 because of a need for comparability.
 2. IASC initiated an improvement project in the 1990s to develop a cohesive set of standards.

3. The IASC began to recognize the limitations in the existing structure, and so the International Accounting Standards Board (IASB) replaced the IASC. The IASB promulgates International Financial Reporting Standards (IFRS).
- B. The Global Standard-Setting Structure: *See Exhibit 1.9*. The IASB is part of a larger organizational structure that includes:
1. The IFRS Foundation: Oversees the IASB and is responsible for financing the IASB's operations.
 2. The Monitoring Board: Formed in 2009 to enhance the public accountability of the IFRS Foundation, while still allowing for independence of the standard-setting process.
 3. The IFRS Advisory Council: Advises the IASB and the IFRS Foundation on many issues.
 4. The IFRS Interpretations Committee: Interpretative body of the IASB.
- C. Standard-Setting Process: Follows a similar process as FASB. However, the IASB is required to carry out a post-implementation review of each new standard or significant change.

III. Standard Setting as a Political Process

- A. Managers have incentives to oppose changes in standards or new standards.
- B. Financial Statement User Level: Changes should provide a more transparent environment.
- C. Standard setters address the concerns of both managers and financial statement users by using the standard setting process.

Learning Objective 4: Trends in Standard Setting

- I. There are three current trends in standard setting that will be reviewed in later chapters:
 - A move toward a less *rules-based* (more *principles-based*) system found in IFRS.
 - A move toward standards that are focused on the *asset/liability approach*.
 - A move toward measuring balance sheet items at *fair value* rather than historical cost.
- A. Rules- versus Principles-Based Standards
 1. Principles-Based Standards: Rely on theories, concepts, and principles of accounting that are linked to a theoretical framework.
 - a. Provide a clear discussion of the accounting objective.
 - b. Involve few exceptions.
 - c. Involve no tests (referred to as bright-line tests) that require meeting a threshold.
 - d. Provide insufficient guidance to implement the standard.
 - e. Involve a significant amount of interpretation.
 2. Rules-Based Standards: Contain specific, prescriptive procedures.
 - a. Contain numerous exceptions.
 - b. Contain numerous bright-line tests.
 - c. Result in inconsistencies.

- d. Contain detailed application guidance.
 - e. Do not rely on professional judgment.
3. Objectives-Oriented Standards: Like principles-based standards, objectives-oriented standards are derived from a high-quality theoretical framework and clearly stated accounting objectives. But they *also* provide a sufficient level of rules to provide detail and structure.
4. U.S. GAAP and IFRS: Rules versus Principles: *See Exhibit 1.10*. Neither GAAP nor IFRS fits perfectly into rules- or principles-based approaches. However, on the continuum, GAAP is more rules based, whereas IFRS is more principles based.
- B. Asset/Liability Approach: A focus on asset/liability indicates a shift from a focus on the income statement to the focus on the balance sheet.
- C. Fair Value Measurements: A move toward measuring balance sheet items at fair value rather than historical cost.

Student Supplement to Teaching Outline

Learning Objective 1: Overview of Financial Reporting

- I. Overview of Financial Reporting
 - A. Financial Information
 - 1. Demand for Financial Information
 - 2. Sources of Financial Information
 - B. Economic Entity
 - C. Financial Statement User Groups
 - 1. Equity Investors
 - 2. Creditors and Other Debt Investors
 - 3. Competitors
 - 4. Financial Analysts
 - 5. Employee and Labor Unions
 - 6. Suppliers and Customers
 - 7. Government Agencies
 - D. Other Parties Involved in the Preparation and Use of Financial Information
 - E. Legal, Economic, Political, and Social Environment
 - 1. Reactive Factors
 - 2. Proactive Factors
 - F. Data Analytics and Technology Innovation

Learning Objective 2: Role of Standard Setters

- I. Role of Standard Setters
 - A. Importance of Understanding International Accounting Standards

Learning Objective 3: The Standard-Setting Process

- I. The Standard-Setting Process
 - A. Standard Setting
 - 1. History of Standard Setting
 - 2. The Standard-Setting Structure
 - 3. Standard-Setting Process

IFRS Breakaway

II. IFRS Standard Setting

- A. History of Global Standard Setting
- B. The Global Standard-Setting Structure
- C. Standard-Setting Process

III. Standard Setting as a Political Process

Learning Objective 4: Trends in Standard Setting

I. Trends in Standard Setting

- A. Rules- versus Principles-Based Standards
 - 1. Principles-Based Standards
 - 2. Rules-Based Standards
 - 3. Objectives-Oriented Standards
 - 4. U.S. GAAP and IFRS: Rules versus Principles
- B. Asset/Liability Approach
- C. Fair Value Measurements

Assignment Grid

Assignment	Topic(s)	Learning Objective(s)	Estimated Time in Minutes	Level of Difficulty
Questions				
Q1-1	Definition of Financial Accounting	1	10	Easy
Q1-2	Purpose of Generating Financial Statements	1	10	Easy
Q1-3	Allocation of Capital Linked to the Demand for Financial Reporting	1	10	Easy
Q1-4	Roles of an Auditor	1	10	Easy
Q1-5	Data Analytics	1	10	Easy
Q1-6	Accounting Standard Setters	2	10	Medium
Q1-7	IFRS	2	5	Easy
Q1-8	FASB	3	5	Easy
Q1-9	Politics and Financial Accounting	3	15	Medium
Q1-10	Principles-Based Standards versus Rules-Based Standards	4	15	Medium
Q1-11	FASB and Standard Setting	4	15	Medium
Brief Exercises				
BE1-1	General Purpose Financial Statements	1	15–20	Easy
BE1-2	Financial Reporting Definition	1	5-10	Easy
BE1-3	Financial Statement Users and Other Parties Involved in Financial Reporting	1	10–15	Easy
BE1-4	Financial Statement Users	1	10–15	Easy
BE1-5	Parties in the Financial Reporting Process	1	10–15	Easy
BE1-6	Economic Entity	1	5-10	Easy
BE1-7	Standard-Setting Process	3	10–15	Easy
BE1-8	Standard-Setting Process	3	10-15	Medium
BE1-9	FASB's Standard-Setting Process	3	5-10	Easy
BE1-10	IASB's Standard-Setting Process	3	10-15	Moderate
BE1-11	SEC's Role	3	10-15	Moderate
BE1-12	Characteristics of Principles-Based or Rules-Based Accounting System	4	5-10	Moderate
Exercises				
E1-1	Financial Accounting	1	10–15	Easy
E1-2	Factors That Influence Financial Reporting	1	15–20	Medium
E1-3	Convergence of Accounting Standards	2	15–20	Medium

E1-4	History of Standard Setting in the United States	3	20–25	Medium
E1-5	Rules- versus Principles-Based Accounting	4	10–15	Easy
E1-6	Asset/Liability Approach	4	15–20	Medium
E1-7	Rules- versus Principles-Based Accounting	4	15–20	Medium

Suggestions for Class Activities

Learning Objective 1

- Students will have a general understanding of the overview of financial accounting but may not have a clear understanding of the detail involved in the definition. Have students interview businesses and individuals to learn how the businesses or individuals use financial information and what is important to them in reading financial information. Ensure that students understand the perspective of whom they are interviewing, whether it be a lender, an investor, a customer, or another user.
- Have students locate news articles in which financial accounting becomes part of a legal, economic, political, or social discussion. This activity can be done all semester to emphasize the role of accounting in numerous areas of life.

Learning Objective 2

- Students are engaged in becoming educated in matters of accounting at an interesting time in history. To highlight the importance of learning about international accounting standards, have students locate the financial data on a company where they may like to shop. Have students note the countries in which the store has a presence. Discuss the problems that arise for such a company regarding financial reporting. Have students submit the discussion as a written submission or as an in-class discussion.

Learning Objective 3

- The standard-setting process is somewhat confusing. Have students map out, pictorially, the history and structure of the standard-setting process. The process of having students pictorially represent the process can be completed as an individual or group assignment that takes place either inside or outside the classroom. Be sure that students include global standard setting in their picture. Students can complete the assignment by hand or use various forms of electronic help, such as online infographic design tools.

Learning Objective 4

- To convey the difference between principles-based and rules-based standards, divide students into two groups. One group will be the rules-based group, and the other group will be the principles-based group. Give each of the groups an assignment based on a set of rules for the rules-based group and based on principles for the principles-based group. The assignment will be the same, just modified to either include a rules or principles approach to the communications of the criteria of the assignment. This assignment can be completed individually or in groups and may be done during class time or as an external assignment.

Guidance on Incorporating IFRS Material

1. Students will be curious about the trend toward IFRS. Most students have heard of IFRS but have not had an opportunity to learn about it. In Chapter 1, the students will be introduced to the ground level of IFRS. This chapter is a great place on which to build the students' understanding. As noted in the chapter material, there is a need to learn about IFRS. Students must recognize their need to learn about IFRS. Having a discussion about the topic will open up lines of communication. Begin the discussion by asking questions such as:
 - What have you heard about IFRS, if anything? This is an opportunity to clear up any inaccurate thoughts the students may have about IFRS. Students may have heard bits and pieces of the purpose and the process involved in IFRS. Explain to the students that IFRS learning will be implemented as a part of every chapter to ensure that the student receives accurate knowledge on the topic.
 - What is the future of IFRS in the United States? This is an opportunity to discuss the impact that IFRS is having or will have on the U.S. reporting purpose.
 - What is your role in learning about IFRS as a student seeking to have a career in accounting? Students will acknowledge the need to learn about IFRS and may comment on their future goals in accounting. Explain how IFRS will be part of our future.
2. Be sure to recognize components of IFRS throughout the course. Just addressing IFRS in Chapter 1 and never addressing it again will leave the students with only a partial understanding of the topic. Assign students the responsibility to complete and report on their own research of the topic on a chapter-by-chapter basis. As Chapter 1 introduces the standard-setting bodies and processes, encourage students to seek out professional journals that may report on the latest developments of IFRS.
3. Provide links to credible online tools the students can use to learn more about IFRS. Links to the various professional organizations' websites will ensure that students are learning from dependable sources. Assign students the task of becoming student members of associations such as the AIPCA, where they can obtain credible and up-to-date information about IFRS.

Interview Discussion Questions

1. Discuss the role that the AICPA will play in your accounting career as a student and when you join the profession.

Suggested discussion points: The AICPA offers several options for accounting students, including affiliate membership and leadership conferences. The *Journal of Accountancy* will assist in staying current and can be used as a source of information for research papers. The AICPA offers a wide variety of services, including professional development, career services, professional guidance, and a large number of publications covering accounting standards, taxes, and auditing.

2. How would you characterize the current relationship between the FASB and the AICPA?

Suggested discussion points: The current relationship between the FASB and the AICPA can be characterized as one of professional cooperation. The AICPA is no longer responsible for promulgating standards with authoritative support, as is the case with the FASB. However, the AICPA continues to issue many position papers and documents that are used to guide the FASB and SEC deliberations on new and emerging accounting issues. The AICPA issues the ethical standards for the profession, is responsible for ethics enforcement, and practices quality control for certain CPA firms.