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SKU: 9780135343258-SOLUTIONS

CHAPTER 1
The Financial Reporting Environment

Solutions

Questions

Q1-1 Financial information is a much broader concept than simply the financial statements and footnotes to the financial statements. Financial information includes items such as the President's letter to the owners, management's discussion and analysis, the auditors' report, the management report and press releases. Of course, the basic financial statements and footnotes are included in the term financial information. The basic financial statements are: the balance sheet (also referred to as the statement of financial position), the statement of comprehensive income (also referred to as the statement of net income and the statement of comprehensive income), the statement of cash flows, and the statement of shareholders' equity. Financial information is not synonymous with the term financial statements because the financial statements are a subset of the different types of financial information provided.

Q1-2 The purpose of generating financial statements is to provide useful information to users to evaluate economic entities and make efficient resource allocation decisions based on the risks and returns of a particular investment. The Financial Accounting Standards Board (FASB) identifies investors, lenders and other creditors as the primary users of the financial statements. The financial statements are the culmination of the financial reporting process.

Q1-3 Capital is a scarce resource. Investors and creditors have to make decisions as to how much capital to invest in any given entity; therefore, they demand relevant and faithfully representative information about the economic performance and financial position of a company. This information is provided in the financial statements.

Q1-4 External auditors ensure that the management of a company has prepared financial statements in accordance with Generally Accepted Accounting Principles and fairly present the financial position and economic performance of a company. In addition, external auditors must be an independent party and cannot be employees of the company they are auditing. External auditors provide a significant amount of credibility to the financial statements.

Q1-5 Data analytics is the process of analyzing large data sets in order to draw useful conclusions. It involves converting raw data into useful knowledge. In financial reporting, data analytics can be used to improve the quality of estimates and valuations.

Q1-6 Standard setters create accounting concepts, rules, and guidelines to ensure that financial statements accurately present the economic performance and financial position of a firm. The standards encourage transparent and truthful reporting.

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Q1-7 U.S. companies listed on U.S. stock exchanges do not have the option to report under IFRS. However, foreign companies that trade in the U.S. exchanges can report under IFRS. The SEC permits the use of IFRS-based financial statements by international companies with shares trading on U.S. stock exchanges.

Q1-8 The FASB seeks and welcomes comments from all parties in the financial reporting process including managers, investors, accountants, preparers, creditors, lenders, financial statement users, governmental agencies, financial analysts, industry groups, and auditors. FASB also receives feedback from public roundtable discussions, public meetings, the FASAC, the Private Company Council, and EITF.

Q1-9 Yes, the promulgation of financial accounting standards is a political process. There are several groups that influence the standard setting process. The standard setting process is a political process that is affected by the impact of several lobbying groups. The government, through the SEC, influences accounting standards. The SEC has the authority to issue accounting standards but has assigned this responsibility to the private sector. Nonetheless, the SEC can exert pressure on the FASB to issue accounting standards and veto the standards promulgated by the FASB. Auditing firms, the corporate sector, creditors, financial analysts, the financial community, accounting organizations, industry groups, and investors can influence the FASB by written comments about Exposure Drafts and participation in public meetings and public roundtables regarding a proposed financial reporting standard.

Q1-10 Investors use ESG information to assess the sustainability and ethical impact of their investments and to identify potential risks and opportunities that might not be evident from traditional financial analysis alone

Q1-11 AI algorithms handle vast amounts of data with minimal errors, enhancing the accuracy of financial reports.

Q1-12 Companies need to adapt to new reporting standards and integrate complex technologies.

Brief Exercises

Solution to BE1-1

General-purpose financial statements provide general financial information about an entity that will be useful to many types of users. General-purpose financial statements provide information to a wide spectrum of user groups: investors, creditors, financial analysts, customers, employees, competitors, suppliers, unions, and government agencies. Most financial information in general purpose financial statements is provided to satisfy users with limited ability or authority to obtain additional information, which includes investors and creditors. The Financial Accounting Standards Board (FASB) identifies investors, lenders, and other creditors as the primary users of the financial statements.

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Solution to BE1-2

Financial accounting 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. This definition contains four major elements: 1. Financial information; 2.Economic entity; 3. User groups and 4. Legal, economic, political, and social environment

Solution to BE1-3

Financial Statement Users and Other Parties	Role
10 Equity Investors	10. Are shareholders of the company.
1 Creditors	1. Are banks and other financial institutions that lend money to the company.
5 Financial Analysts	5. Use financial information to review and analyze reported results of the companies they cover and make investment recommendations.
8 Employees and Labor Unions	8. Use financial information during negotiation of new labor agreements and compensation contracts.
2 Suppliers and Customers	2. Use financial statements to determine whether to conduct business or purchase products from a company.
7 Government Agencies	7. Review the financial statements of publicly traded companies for a variety of reasons that are in the public interest.
3 Competitors	3. Use financial information to determine their market position relative to the reporting entity and to attempt to identify future strategies of the reporting entity.
4 External Auditors	4. Are independent of the company and responsible for ensuring that management prepares and issues financial statements that comply with accounting standards and fairly present the financial position and economic performance of the company.
6 Internal Auditors	6. Are employees of the company serving in an advisory role to management. They provide information to management regarding the company's operations and proper functioning of its internal controls.
11 Regulatory Bodies	11. Protect investors and oversee the accounting and auditing standard setting processes.
9 Professional Organizations	

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	9. Support accounting professionals throughout their careers by providing training, professional skills development, and other resources.

Solution to BE1-4

Financial statement users and why each would use the financial statements are summarized below:

1. Equity investors - Equity investors buy stock in the company, that is, they purchase a percentage of the company itself. The financial statements help them make investment decisions.
2. Creditors - Creditors loan money to the company. The financial statements help them assess the creditworthiness of the company, and whether principal and interest will be repaid.
3. Competitors - Competitors use financial statements to determine their market position relative to the reporting entity.

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4. Financial analysts - Financial analysts use financial statements to perform financial analyses. Their analyses often result in a recommendation as to whether investors should buy or sell the stock of that company. These analysts act as market intermediaries.
5. Employees and labor unions - Employees and labor unions use the financial statements to assess the company's economic performance and liquidity, which are important information in wage negotiations.
6. Suppliers and customers - Suppliers and customers can use the financial statements to determine a company's financial position and whether they want to do business with the company. For suppliers, it is important to assess the company's ability to pay for goods and services. For customers, it is important to assess the company's ability to honor warranties.

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Solution to BE1-5

Parties in the financial reporting process and why each would be interested in the financial statements:

1. Auditors – External auditors are important players in the financial reporting process. It is their job to ensure that the management of the company has prepared financial statements that follow the accounting rules and fairly present the financial position and economic performance of the company. Because auditors are an independent party, they lend a significant amount of credibility to the financial statements. External auditors will carefully examine the financial statements.
2. Accounting standard setters such as the Financial Accounting Standards Board and the International Accounting Standards Board - Standard setters create accounting concepts, rules, and guidelines that will result in financial statements that provide financial information that is relevant and that faithfully represents the financial performance and position of the reporting entity.
3. Regulatory bodies such as the Securities and Exchange Commission and the Public Company Accounting Oversight Board - The Securities and Exchange Commission's role is to protect investors. They oversee the accounting standard setting process, including giving the FASB the authority to determine U.S. GAAP. They also review the filings of public companies in the U.S., which includes the financial statements and footnotes. The Public Company Accounting Oversight Board (PCAOB) sets auditing standards and oversees the audits of public companies in the U.S. External auditors focus on the financial statements.

Solution to BE1-6

The second element in the definition of financial accounting involves the *economic entity* for which the financial statements and other financial information are presented. An **economic entity** is an organization or unit with activities that are separate from those of its owners and other entities. Financial information always relates to a particular economic entity. Economic entities can be corporations, partnerships, sole proprietorships, or governmental organizations. Also, economic entities may be privately held or publicly held. If the entity is publicly held, then its equity can be bought and sold by external parties on stock exchanges.

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Solution to BE1-7

Accounting standard setters follow a process to set accounting standards that involves financial statement preparers, users and other interested parties at several stages.

- In identifying issues to consider by the FASB, standard setters consider input from these parties.
- Once an issue is added to the technical agenda, standard setters usually have public meetings where they seek comments from these interested parties.
- When an exposure draft is issued, interested parties are invited to prepare comment letters.
- After an exposure draft is issued, standard setters sometimes hold roundtables, or public forums, which include these various parties.
- When deliberating on an issue before publishing a final standard, the standard setters consider the inputs obtained from outside parties at the various stages in the standard setting process.

The IASB uses a similar process.

Solution to BE1-8

The FASB follows a seven-step process to issue a final standard.

Step 1: **Identification of an issue.** FASB identifies a financial reporting issue based on recommendations from analysts, government agencies, or other market participants.

Step 2: **Decision to pursue.** After consultation with FASB members and others as appropriate, the FASB Chairperson decides whether to add the issue to the technical agenda.

Step 3: **Public meetings.** Once added to the technical agenda, the Board holds public meetings where it deliberates the various issues identified by the FASB staff.

Step 4: **Exposure Draft.** The Board issues an Exposure Draft (ED), which is intended to solicit input from financial statement preparers, auditors, and users of the financial statements.

Step 5: **Public roundtables.** The Board may hold public roundtables to discuss the ED, if needed.

Step 6: **Redeliberation.** The FASB staff analyzes the comment letters received from preparers, financial statement users and auditors, public roundtable discussions, and any other information. The Board then redeliberates the issue.

Step 7: **Publication of the final standard.** The Board issues an Accounting Standards Update (ASU), which is the final standard. It requires a majority vote of the Board to issue a new standard. The ASU will then be incorporated into the body of the Accounting Standards Codification that makes up U.S. GAAP.

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Solution to BE1-9

The steps in the Financial Accounting Standards Board's standard setting process in the correct order from 1 to 7.

4 The Board issues an Exposure Draft (ED), which is intended to solicit input.

2 After consultation with FASB members and others as appropriate, the FASB Chairperson decides whether to add the issue to the technical agenda.

6 The FASB staff analyzes the comment letters received, public roundtable discussions and any other information. The Board then redeliberates the issue.

5 The Board may hold public roundtables to discuss the ED, if needed.

7 The Board issues an Accounting Standards Update (ASU), which is the final standard. It then incorporates the ASU into the Accounting Standards Codification that makes up U.S. GAAP.

1 A financial reporting issue is identified either by requests of financial statement users or by some other means.

3 The Board holds public meetings where it deliberates the various issues identified by the FASB staff.

Solution to BE1-10

The IASB is comprised of 14 members who are appointed by the IFRS Foundation's board of trustees. At least 11 members serve full time, and not more than three can be part-time members. To ensure broad and diverse international representation, the IASB is composed of:

- Four members from the Asia/Oceania region.
- Four members from Europe.
- Four members from the Americas.
- One member from Africa.
- One member appointed from any area, subject to maintaining overall geographical balance.

Solution to BE1-11

U.S. financial reporting standard setting began with the 1934 Securities Exchange Act, which gave the SEC the power to promulgate accounting standards for all publicly traded firms. The SEC delegated its standard-setting power to the private sector, prompting the accounting profession to establish the first U.S. standard-setting board. Currently, the SEC issues standards and continues in an oversight function over the US standards-setting bodies such as the FASB.

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Solution to BE1-12

D	ESG stands for…?	A. SEC
E	Significantly impacted financial reporting and disclosure requirements in the U.S.	B. EDGAR
B	System used by the SEC to make corporate filings more accessible	C. Quantum Computing
A	A regulatory body that plays a crucial role in setting financial disclosure standards in the U.S.	D. Environmental, Social, and Governance
C	A technology that is NOT part of the digital transformation in accounting?	E. Dodd-Frank Act

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Exercises

Solution to E1-1

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

This definition contains four major elements. These elements are:

1. Financial information - Financial information includes items such as the financial statements, footnotes to the financial statements, the letter to the owners, management's discussion and analysis, the auditors' report, the management report, and press releases.
2. Economic entities - An economic entity is an organization or unit with activities that are separate from those of its owners and other entities. Economic entities can, for example, be corporations, partnerships, sole proprietorships, or governmental organizations. Also, economic entities may be privately held or publicly held.
3. User groups – User groups demand financial information about an economic entity. Users include equity investors, debt investors, creditors, competitors, financial analysts, employees and labor unions, suppliers, customers, and government agencies.
4. Environment – The environment includes the legal, economic, political, and social factors that shape and influence the financial reporting process.

Solution E1-2

Accounting and financial reporting are far from isolated from society. Accounting and financial reporting interact with environmental factors - legal, economic, political, and social – that shape and influence the financial reporting process. The information needs of financial statement users change as business evolves. So, it is natural that financial accounting interacts with its environment in both a reactive and a proactive fashion.

In a reactive fashion, financial accounting reacts to pressure (lobbying) from various groups and changes in its environment. Accounting theories and procedures evolve to meet the dynamic changes and demands from the environment. The development of accounting standards is also a political process that is heavily influenced by the various groups within the reporting environment. Lobby or pressure groups include investors, creditors, financial analysts, the financial community, academics, accounting organizations, and industry associations.

Financial accounting is also proactive. That is, it can change or influence its environment by providing feedback information that is used by organizations and individuals to reshape the economy. Accounting standards can also influence managerial behavior.

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Solution to E1-3

There are several reasons to study IFRS

- U.S. companies operate subsidiaries outside of the U.S. Many of these subsidiaries report under IFRS in their home countries. Accountants must convert the subsidiaries' financial statements to U.S. GAAP when preparing consolidated financial statements. So, if I am the accountant or auditor of a company with international subsidiaries, I will need to understand IFRS.
- Non-U.S. companies operate in the U.S. and prepare their financial statements using IFRS. If I am working at or auditing an international firm, I am likely to see IFRS.
- The SEC permits the use of IFRS-based financial statements by international companies with shares trading on U.S. stock exchanges. As an accountant and auditor in the U.S., I may be asked to assist these non-U.S. companies in preparing U.S. regulatory reports.
- The SEC promotes high-quality, globally accepted accounting standards. U.S. accountants and auditors will need a working knowledge of IFRS to implement these standards in companies and perform audits.
- I may want to work outside of the U.S. at some time in my career. As of 2019, IFRS is required or permitted in 144 countries worldwide.
- I'll be taking the CPA exam and IFRS is tested on it. The accounting profession has determined that a working knowledge of IFRS is important for today's accountant.

Solution to E1-4

a. Financial reporting standard setting began in the United States in 1934 with the 1934 Securities Exchange Act.

b. The 1934 Securities Exchange Act gave the SEC the power to promulgate accounting standards that all publicly traded firms must follow. However, the SEC delegated this power to the private sector.

c. After the authority to promulgate accounting standards was shifted to the private sector, the accounting profession established the first standard setting board in the United States. The Committee on Accounting Procedures (CAP) was formed in 1939 and was a subcommittee of the AICPA. The committee's purpose was to reduce the number of accounting methods used in practice. Prior to the formation of the CAP, there were significant inconsistencies in the form and content of financial statements. For example, some companies would only provide a balance sheet while others would only report an income statement. During its tenure, the CAP produced 51 standards, referred to as Accounting Research Bulletins (ARBs). The CAP accomplished its goal of reducing accounting alternatives and was replaced in 1959 by the Accounting Principles Board (APB).

   The APB was also a subcommittee of the AICPA. The purpose of the APB was to issue pronouncements on accounting standards needed to meet existing and emerging problems in financial reporting. The pronouncements of the APB were known as Opinions. The APB issued 31 APB Opinions and four APB Statements. The APB was criticized for two reasons. First, the board members were part-time, were CPAs and were still affiliated with their

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employers. As a result, board members were not viewed as independent. The part-time commitment and the lack of independence of board members were cited as causes of the slow development of accounting standards and inaction on several controversial issues. Second, the APB did not develop standards in anticipation of changes in the accounting environment. Rather, the Board simply responded to long existing, controversial accounting issues.

d. The Financial Accounting Standards Board (FASB) replaced the APB in 1973, and currently develops accounting standards in the United States. The FASB is a more independent board than the APB. All members are employed as board members full-time and must sever all relationships with outside entities. In addition, FASB board members do not have to be accountants or CPAs. The members can join the board from industry, education and public service. In addition, the FASB is not a subcommittee of the AICPA and is not affiliated with any professional organization. The Financial Accounting Foundation is responsible for the oversight, administration and finances of the FASB. The Financial Accounting Standards Advisory Council advises FASB on technical issues. The Emerging Issues Task Force and the Private Company Council also assist FASB. The FASB currently issues Accounting Standards Updates (ASUs) as part of the Accounting Standards Codification.

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Solution to E1-5

E	What role does AI play in financial accounting?	A. Elevates them to more strategic business roles
A	How does digital transformation affect accountants' roles?	B. Enables predictive analytics and trend analysis
C	Which aspect is NOT directly related to AI's impact on accounting?	C. Increased manual data processing
B	A way in which AI transforms financial accounting.	D. It automates many traditional accounting tasks, such as data entry and transaction processing.
D	An example of how digital transformation enhances efficiency in accounting	E. Facilitates predictive analytics and trend analysis

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