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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 A principles-based standard is consistent with a theoretical framework. In contrast, a rules-based standard does not necessarily rely on a consistent theoretical framework. Rather, it contains more specific and prescriptive rules.

Q1-11 Recently, the FASB has taken an asset/liability approach in setting standards. With this approach, a transaction is recorded based on whether an asset or liability is created. Another trend has been the movement toward the use of fair value measurements as an alternative to historical cost. FASB has also focused on the promulgation of principles-based standards instead of rules-based standards.

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

The items below are characteristics of a principles-based (P) or rules-based (R) accounting system:

P Provides a clear discussion of the accounting objective related to the standard

R Contains detailed application guidance

R Contains numerous exceptions to the types of firms and industries that are covered

P Involves no bright-line tests

R Contains numerous bright-line tests

P Involves a significant amount of interpretation in application

P Involves few, if any, exceptions

P Provides insufficient guidance to implement the standard

R Would not rely on extensive use of professional judgment

R Results in inconsistencies between standards

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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

Both U.S. GAAP and IFRS have a system of accounting standards that are based on both principles and rules. When we refer to a principles-based standard, we mean that the standard is consistent with a well-developed theoretical framework. When a standard is purely rules-based, it does not rely on a consistent theoretical framework, but rather contains more specific, prescriptive procedures or rules. In addition to being consistent with a theoretical framework, pure principles-based standards would provide a clear discussion of the accounting objective related to the standard, involve few, if any, exceptions, involve no "bright-line" tests, provide insufficient guidance to implement the standard, and involve a significant amount of interpretation in application. Unlike principles-based standards, rules-based standards may not relate to a consistent theoretical framework. In addition, pure rules-based standards would contain numerous exceptions, contain numerous bright-line tests, result in inconsistencies between standards, contain detailed application guidance, and would not rely on extensive use of professional judgment.

Solution to E1-6

We disagree with the comment. Financial accounting has traditionally emphasized the income statement by focusing on recording revenues. As a result, when accounting standards were issued, the effect on net income was emphasized and the valuation and classification of assets and liabilities were byproducts of proper income measurement. That is, proper asset and liability valuation was traded off for the matching of costs with revenues. There has been a recent shift in focus. Today, many accounting standards are issued in order to properly measure assets and liabilities. A tradeoff between the income statement and the balance sheet exists because the financial statements are interconnected. When an event is reported on the income statement, the transaction typically changes a balance sheet item also. For example, if we report revenue, we also increase the balance in accounts receivable or cash. While the two financial statements are interrelated, there is an issue as to which set of accounts is dominant: revenues and expenses on the income statement, or assets and liabilities on the balance sheet? For example, in a typical sales transaction, if an accountant decides that the transaction should be recorded, we will increase accounts receivable (or cash) and revenue. But how do we decide if the transaction should be recorded? Do we make this decision based on revenue recognition criteria? If so, we would be using an income statement approach. If we base the decision on whether the economic resource meets the definition of an asset, accounts receivable, we would be using an asset/liability (balance sheet) approach. In the FASB's early years, they tended to focus on an income statement approach. However, in recent years we have seen the focus shift to the asset/liability approach.

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Solution to E1-7

Statement: "An accountant will use a particular accounting standard only if…"	Principles-based or Rules-based Accounting Standard
a. …the length of a contract covers substantially all of the useful life of a plant asset.	a. Principles-based standard
b. … the number of new common shares a firm issues is equal to 20% of the previously outstanding shares.	b. Rules-based standard
c. …a corporation owns over 50% of the voting shares of an affiliate company.	c. Rules-based standard
d. …a corporation has the ability to control the operating and financing activities of an affiliate company.	d. Principles-based standard
e. …it is more likely than not that a company's tax position will be sustained upon examination by the Internal Revenue Service.	e. Principles-based standard
f. …the sum of the undiscounted future cash flows from the use of a plant asset is less than its carrying value.	f. Rules-based standard

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1

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.

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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.

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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

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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

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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.

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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.

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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.

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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

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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

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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

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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

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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.

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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.

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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.

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Chapter 1

The Financial Reporting Environment

Directed Reading Guide

LO1. Overview of Financial Reporting

a) What are the four major elements of financial accounting?

i) **Financial information**

ii) **Economic entity**

iii) **User groups**

iv) **Legal, economic, political, and social environment**

b) Published financial statements are called **__general-purpose financial statements__** because they provided information to a wide spectrum of user groups.

c) The body responsible for promulgating U.S. GAAP, which identifies investors, lenders, and other creditors as the primary users of financial information, is called the **____Financial Accounting Standards Board (FASB)____**.

LO2. Role of Standard Setters

a) List at least four reasons it is important for an accountant in the United States to learn international accounting standards.

i) **U.S companies operate outside the United States.**

ii) **Non-U.S. companies operate in the United States and prepare their financial statements using IFRS.**

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iii) **The SEC permits the use of IFRS-based financial statements by international companies with shares trading on U.S. stock exchanges.**

iv) **Many U.S. accountants now spend time working outside the United States.**

(Note: Refer to the textbook for other possible answers.)

LO3. The Standard-Setting Process

a) The **__FASB___** sets accounting standards in the United States, and the **___IASB___** sets global accounting standards.

b) List the FASB seven-step process for issuing a final standard. Give a brief explanation of each step.

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**

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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.

LO4. Trends in Standard Setting

a) Indicate whether the following characteristics indicate principles-based (PB) or rules-based (RB) accounting:

i) Involves few, if any, exceptions. **__PB__**

ii) Provides insufficient guidance to implement the standard. **__PB__**

iii) Contains numerous bright-line tests. **__RB__**

iv) Contains detailed application guidance. **__RB__**

v) Involves no test that require meeting a pre-established numerical threshold. **__PB__**

b) In the following statement, fill in the blanks with *U.S. GAAP* or *IFRS*, as appropriate.

__U.S. GAAP__ tends to be a more pure rules-based approach, while **__IFRS__** tends to be a more pure principles-based approach.

c) **__Fair value__** is the amount at which an asset (or a liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties.

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