Financial Reporting and Analysis 1

Chapter 1: Environment and Theoretical Structure of Financial Accounting

- Primary focus of financial accounting
  - Providing financial information to various external users
    - Creditors
    - Investors
    - Other external users
- Financial accounting
  - Financial information is conveyed through financial statements and related disclosure notes
    - Balance sheet
    - Income statement
    - Statement of cash flows
    - Statement of shareholders' equity
- The economic environment and financial reporting
  - *Capital markets* provide a mechanism to help the economy allocate resources efficiently
  - *Initial market transactions* involve issuance of stocks and bonds by the corporation
    - Corporations receive new cash
  - *Secondary market transactions* involve the transfer of stocks and bonds between individuals and institutions
    - Corporations receive no new cash
  - *Corporations* acquire capital from investors in exchange for ownership interest and from creditors borrowing
- Cash versus accrual accounting
  - **Cash basis accounting: cash receipts – cash payments = net operating cash flow**
  - **Accrual basis accounting: revenues - expenses = net income**
- The development of financial accounting and reporting standards
  - Generally Accepted Accounting Principles (GAAP)
    - Broad and specific guidelines
    - Comparability
- Accounting standard setting – hierarchy
  - Congress -> SEC -> private sector
    - Private sector:
      - 1938-1959: CAP
      - 1959-1973 APB
      - 1973-present: FASB
- Historical perspective and standards
  - Securities and Exchange Commission (SEC)
    - Created by congress in response to the stock market crash of 1929
      - Goal: to restore investor confidence
      - Has the statutory authority to set accounting standards
  - 1933 Securities Act
    - Applies to initial offerings of securities (stocks and bonds)

- 1934 Securities Exchange Act
  - Applies to secondary market transactions
  - Mandates reporting requirements for companies whose securities are publicly traded

- Codification
  - FASB Accounting Standards Codification (www.fasb.org)
    - Only source of authoritative nongovernmental U.S. GAAP
      - Organizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics
      - Also includes portions of SEC accounting guidance
      - Accounting Standards Update (ASU): any new standard issued by FASB

FASB Accounting Standards Codification Topics

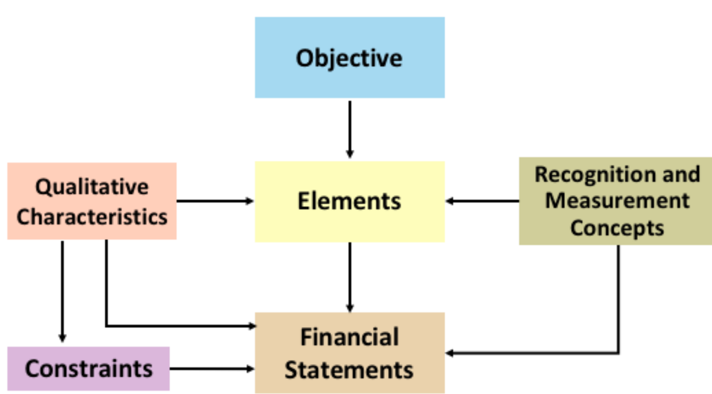
Topic	Numbered
General Principles	100–199
Presentation	200–299
Assets	300–399
Liabilities	400–499
Equity	500–599
Revenues	600–699
Expenses	700–799
Broad Transactions	800–899
Industry	900–999

- International Standard Setting
  - International Accounting Standards Committee (IASC)
    - Formed in 1973 to develop global accounting standards
    - Created a new standard-setting body called the International Accounting Standards Board (IASB) in 2001
      - To develop a single set of high-quality, understandable, and enforceable global accounting standards
        - Issued and endorsed 41 International Accounting Standards (IASs)
        - Issued new standards of its own called International Financial Reporting Standards (IFRSs)
  - Efforts to converge U.S. and International Standards
    - U.S. GAAP + IFRS = Converged Standards

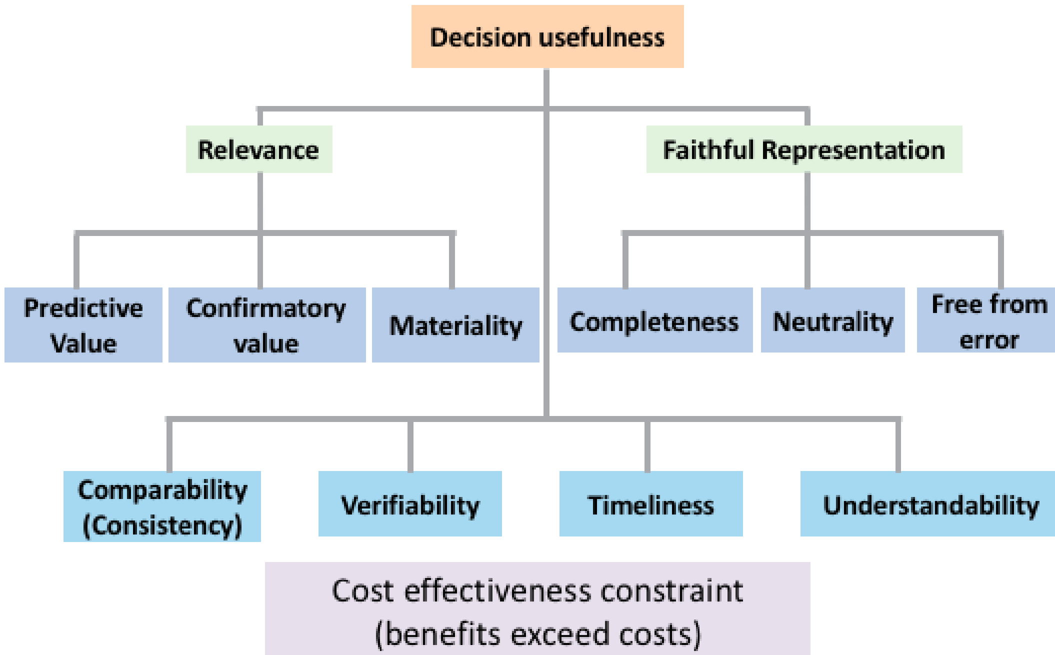
- The FASB's standard-setting process

Step	Explanation
1.	The Board identifies financial reporting issues based on requests/recommendations from stakeholders or through other means.
2.	The Board decides whether to add a project to the technical agenda based on a staff-prepared analysis of the issues.
3.	The Board deliberates at one or more public meetings the various issues identified and analyzed by the staff.
4.	The Board issues an Exposure Draft. (In some projects, a Discussion Paper may be issued to obtain input at an early stage that is used to develop an Exposure Draft.)
5.	The Board holds a public roundtable meeting on the Exposure Draft, if necessary.
6.	The staff analyzes comment letters, public roundtable discussion, and any other information. The Board redeliberates the proposed provisions at public meetings.
7.	The Board issues an Accounting Standards Update describing amendments to the Accounting Standards Codification.

- Encouraging high-quality financial reporting
  - Role of an auditor
    - Offer credibility to financial statements
    - Express an opinion on the compliance of financial statements with GAAP
    - Licensed by states to provide audit services – Certified Public Accountants (CPAs)
- Sarbanes-Oxley Act
  - Oversight board
  - Corporate executive accountability
  - Non-audit services
  - Retention of work papers
  - Auditor rotation
  - Conflicts of interest
  - Hiring an auditor
  - Internal control
- The conceptual framework



- Hierarchy of qualitative characteristics of financial information



- Elements of financial statements
  - Assets
  - Liabilities
  - Equity (or net assets)
  - Investments by owners
  - Distribution by owners
  - Comprehensive income
  - Revenues
  - Expenses
  - Gains
  - Losses
- Underlying assumptions
  - The <u>economic entity assumption</u> presumes that economic events can be identified specifically with an economic entity
  - The <u>going concern assumption</u> anticipates that a business entity will continue to operate indefinitely
  - The <u>periodicity assumption</u> allows the life of a company to be divided into artificial time periods to provide timely information
  - The monetary unit used in U.S. financial statements is the U.S. dollar
- Recognition, measurement, and disclosure concepts
  - <u>Recognition</u> refers to the process of admitting information into the financial statements
    - *Revenue recognition*
      - **Revenue:** inflow of assets or settlements of liabilities resulting from providing a product or a service to a customer

        - FASB recently issued ASU No. 2014-09, which requires that we recognize revenue when goods or services are transferred to customers for the amount the company expects to be entitled to receive in exchange for those goods or service
  - *Expense recognition*
    - Often matches revenues and expenses that arise from the same transactions or other events
    - Four approaches:
      - Exact cause-and-effect relationship
      - Associating an expense with the revenues
      - Systematic and rational allocation
      - In the period incurred, without regard to related revenue
- <u>Measurement</u> is the process of associating numerical amounts with the elements
  - GAAP currently employs a “mixed attribute” measurement model
  - The 5 measurement attributes are:
    - Historical cost
      - Original transaction value adjusted for depreciation and amortization
    - Net realizable value
      - The amount of cash into which an asset is expected to be converted in the ordinary course of business
    - Current cost
      - The cost that would be incurred to purchase or reproduce the asset
    - Present (or discounted) value
      - Calculated by removing the time value of money from future cash flows
    - Fair value
      - The price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement dat
- <u>Disclosure</u> refers to the process of including additional pertinent information in the financial statements and accompanying notes

Chapter 2: Review of the Accounting Process

- Steps of the accounting processing cycle

During the accounting period	Step 1	**Source documents**
	Step 2	**Transaction analysis**
	Step 3	**Journal**
	Step 4	**General ledger**
At the end of the accounting period	Step 5	**Unadjusted trial balance**
	Step 6	**Adjusting entries**
	Step 7	**Adjusted trial balance**
	Step 8	**Financial statements**
At the end of the year	Step 9	**Closing process**
	Step 10	**Post-closing trial balance**

- Accounting equation
  - Underlies the process used to capture the effect of economic events
  - **Assets = Liabilities + Owner's Equity**
    - Owner's equity is made up of:
      - Retained earnings
        - Revenues/gains + expenses + dividends
      - Paid-in capital
- T-accounts
  - Account title at the top
  - Two sides for recording increases and decreases
    - Debits represent the left side
    - Credits represent the right side
  - Assets
    - Up = debits
    - Down = credits
  - Liabilities and shareholder's equity
    - Up = credits
    - Down = debits
- Journals
  - Provide a chronological record of all economic events affecting a company
  - Each entry: debits = credits
  - Special journal
    - Records a repetitive type of transaction
      - Ex) sales
  - General journal
    - Any transaction not recorded in a special journal
- Unadjusted Trial Balance
  - List of the balances of the general ledger accounts

        - Facilitates the preparation of adjusting entries
- Adjusting entries
    - Objective: to implement the accrual accounting model
        - To ensure that all revenues are recognized in the period goods or services are transferred to customers, and that all expenses are recognized in the period incurred
        - Cash payments or receipts happened either before or after the current accounting period, but revenue is earned, or expense incurred in the current period
    - Necessary for three situations:
        - Prepayments
            - Sometimes referred to as deferrals
            - Transactions in which the cash flow precedes expense or revenue recognition
            - Includes prepaid expenses and deferred revenues
                - Deferred revenues: cash received from customers in advance of providing a good or service
                    - Adjust the entry when revenue is earned
                        - Revenue goes up and deferred revenue liability goes down
                        - Makes the income on the income statement go up and the liabilities on the balance sheet go down
        - Accruals
            - Involve transactions where the cash outflow or inflow takes place in a period subsequent to expense or revenue recognition
            - Accruals include accrued liabilities and accrued receivables
                - Accrued liabilities represent liabilities recorded when an expense has been incurred prior to cash payment
                    - Debit expenses and credit liabilities
                    - Income on the income statement goes down and liabilities on the balance sheet go up
                - Accrued receivables involve situations when revenue is recognized in a period prior to the cash receipt
                    - Debit assets and credit revenues
                    - Income on the income statement goes up and assets on the balance sheet goes up
        - Estimates
            - When accountants make estimates of future events in order to comply with the accrual accounting model
- Adjusted trial balance: trial balance after adjusting entries have been recorded
- Preparation of financial statements
    - Financial statements: primary means of communicating financial information to external parties
    - Income statement