**CHAPTER 1: Environment and Theoretical Structure of Financial Accounting**

**Overview**

The primary function of financial accounting is to provide useful financial information to users who are external to the business enterprise, particularly investors and creditors. These users make critical resource allocation decisions that affect the global economy. The primary means of conveying financial information to external users is through financial statements and related notes.

In this chapter, you explore important topics, such as the reason why financial accounting is useful, the process by which accounting standards are produced, and the conceptual framework that underlies financial accounting. The perspective you gain in this chapter serves as a foundation for a more detailed study of financial statements, the way the statement elements are measured, and the concepts underlying these measurements and related disclosures.

**Learning Objectives**

* **LO1–1** Describe the function and primary focus of financial accounting.
* **LO1–2** Explain the difference between cash and accrual accounting.
* **LO1–3** Define accounting standards and discuss the historical development of accounting standards, including convergence between US and international standards.
* **LO1–4** Explain why the establishment of accounting standards is characterized as a political process.
* **LO1–5** Explain the purpose of the IASB’s conceptual framework.
* **LO1–6** Describe the objective and qualitative characteristics of financial reporting information.
* **LO1–7** Describe the elements of financial statements and the four basic financial statements.
* **LO1–8** Describe the basic assumptions underlying the measurement and reporting of financial statement information.
* **LO1–9** Describe the recognition, measurement, and presentation and disclosure concepts that guide accounting practice.

**Lecture Outline**

**Part A: Financial Accounting Environment**

**I. The Function and Primary Purpose of Financial Accounting**

A. There are a number of financial information supplier groups as well as several external user groups.

B. The primary focus of financial accounting is on the information needs of investors and creditors.

C. Financial statements and disclosure notes convey financial information to external users.

**II. The Economic Environment and Financial Reporting**

A. The capital markets provide a mechanism to help our economy allocate resources efficiently.

B. Corporations, the dominant form of business organization in many countries around the world in terms of the ownership of productive resources, acquire capital from investors in exchange for ownership interest and by borrowing from creditors.

C. The investment-credit decision—a cash flow perspective

1. A company will be able to provide a return to investors and creditors only if it can generate cash receipts from selling a product or service that exceeds the cash disbursements necessary to provide that product or service.

2. The objective of financial accounting is to provide information to investors and creditors to help them predict future cash flows.

D. Cash versus accrual accounting

1. Over short periods of time, operating cash flow may not be an accurate predictor of future operating cash flows.

2. The accrual accounting model provides a measure of periodic performance called net profit.

3. Net profit is considered a better indicator of future operating cash flows than is current net operating cash flows.

**III. The Development of Financial Accounting and Reporting Standards**

A. International Standard Setting and International Financial Reporting Standards (IFRS)

1. Financial accounting and reporting standards provide guidelines that companies follow when measuring and reporting financial information and are set by standard setting organizations which may be private-sector professional accounting bodies in some countries and governmental bodies in other countries.

2. Differences among national accounting standards cause problems for multinational

corporations and investors.

3. The International Accounting Standards Committee (IASC) was formed in 1973 to develop global accounting standards. The IASC reorganized itself and created a new standard setting body called the International Accounting Standards Board (IASB).

4. The IASB’s objectives are to develop a single set of high-quality, understandable, and enforceable global accounting standards.

5. The IFRS refer to all the standards issued by the IASB, including the Conceptual Framework and the old International Accounting Standards (IAS) issued by the IASC.

6. By 2018, over 140 jurisdictions, including Australia, Canada, Egypt, and Hong Kong and the countries in the European Union, require or permit the use of IFRS or a local variant of IFRS.

B. Standard setting in the United States and Convergence between IFRS and US GAAP

1. In the United States, the Financial Accounting Standards Board (FASB) currently sets accounting standards.

2. The Securities and Exchange Commission (SEC) has the authority to set accounting standards for companies that are publicly traded in the United States, but has always delegated the task to the accounting profession.

3. In 2009, the FASB Accounting Standards Codification (consisting of nine main topics and approximately 90 subtopics) became effective and now represents the single source of authoritative nongovernmental US GAAP, except for rules and interpretive releases of the SEC, which remain also as sources of authoritative GAAP.

4. In 2002, the FASB and IASB signed the Norwalk Agreement, pledging to remove existing differences between standards. In April 2008, the two boards agreed to accelerate the convergence process and issued several converged new and revised standards. In November 2008, the SEC proposed a Roadmap that sets forth several milestones for the potential use of IFRS by US publicly traded companies. In July 2012, the SEC staff conclude in its Final Staff Report that it is not feasible for the United States to adopt IFRS. At the date this book was written, it appears that full convergence will not be achieved in the foreseeable future.

C. The establishment of accounting standards—a political process

1. The standards setting board must consider potential economic consequences of accounting standards.

2. The standards setting board undertakes a series of information gathering steps before issuing a new or revised accounting standard.

3. The standards setting board faces political pressure by various interest groups who want to put in place an accounting treatment that best serves their economic interests.

**IV. Encouraging High-Quality Financial Reporting**

A. Auditors offer credibility to financial statements by expressing an opinion that financial statements are presented fairly and comply with accounting standards.

B. In the United States, the *Public Company Accounting Reform and Investor Protection Act of 2002*, commonly referred to as the *Sarbanes-Oxley Act*, provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators.

C. Recent accounting scandals have rekindled the debate over *principles-based*, or more recently termed, *objectives-oriented*, versus *rules-based* accounting standards. A principles-based approach to standard setting stresses professional judgment to apply broad principles to various situations, as opposed to following a list of rules. IFRS is more principles-based and provides less precise guidance, whereas US GAAP is more rules-based and contains an extremely large amount of detailed and precise guidance.

**V. Ethics in Accounting**

A. Ethical judgment is critical in accounting, particularly if decisions are not specified by rules.

B. Ethics deal with the ability to distinguish right from wrong.

C. Many professions have articulated ethical standards in a code of ethics.

D. There are a number of steps that provide a framework for analyzing ethical issues.

**Part B: The Conceptual Framework**

**I. Purpose of the Conceptual Framework**

A. The conceptual framework does not prescribe the accounting standards.

B. It provides an underlying foundation for accounting standards.

C. The IASB’s conceptual framework was revised in March 2018. Its purpose is to provide the board guidance in developing accounting standards, provide preparers of financial statements guidance in formulating accounting policies when no accounting standards exist or when accounting standards allow an accounting choice, and help users to better understand and apply accounting standards.

D. The framework consists of a financial reporting objective, qualitative characteristics of information, financial statement elements, recognition, measurement, presentation and disclosure concepts, constraints, and concepts of capital and capital maintenance.

**II. Objective of Financial Reporting**

To provide financial information that is useful to capital providers.

**III. Qualitative Characteristics of Financial Reporting Information**

A. Overriding objective is decision usefulness.

B. Fundamental qualities of useful information are relevance and faithful representation.

C. Components of relevance are:

1. predictive value,

2. confirmatory value, and

3. materiality—an aspect of relevance that is based on nature and relative magnitude.

D. Components of faithful representation are:

1. completeness,

2. neutrality, and

3. free from error.

E. Enhancing qualities are comparability (including consistency), verifiability, timeliness, and understandability.

F. A constraint is cost-effectiveness.

**IV. Elements of Financial Statements**

A. Statement of financial position elements:

1. Assets

2. Liabilities

3. Equity

B. Statement of profit or loss elements:

1. Income (revenues and gains)

2. Expenses (expenses and losses)

**V. Financial Statements**

A. The statement of financial position presents an organized list of assets, liabilities, and equity at a particular point in time.

B. The statement of profit or loss and other comprehensive income

1. The purpose of the statement of profit or loss and other comprehensive income is to summarize the income-generating transactions that caused shareholders’ equity (retained earnings and other reserves) to change during the period.

2. Presented as either:

(a) a single, continuous statement of profit or loss and other comprehensive income, or

(b) a separate statement of comprehensive income immediately following a separate statement of profit or loss.

C. The statement of cash flows summarizes the transactions that caused cash to change during the period.

D. The statement of changes in equity discloses the events that caused the various shareholders’ equity accounts to change during the period.

E. The underlying assumption for the preparation and presentation of financial statements is the going concern assumption.

F. There are three other assumptions that are useful in guiding the measurement and reporting of financial statement information.

1. Economic entity assumption

2. Periodicity assumption

3. Monetary unit assumption

G. A reporting entity is defined as an entity that prepares financial statements and need not be a legal entity.

**VI. Recognition, Measurement, and Presentation and Disclosure Concepts**

1. Recognition
2. An item should be recognized in the basic financial statements if it meets the definition of the item and the following two conditions:

- Recognition provides relevant information about the item.

- Recognition provides faithful representation of the item.

2. Uncertainty in the existence and measurement of assets and liabilities and low probability of inflow or outflow of benefits are some factors that indicate that recognition does not result in relevant information.

3. Revenue recognition recently changed due to the issuance of IFRS 15, which requires that revenue be recognized at a point in time or over a period of time, depending on when a seller fulfills its performance obligations of transferring the control of goods or services to customers for the amount the seller expects to be entitled to receive in exchange for those goods or services. No revenue is recognized if it is not probable that the seller will collect the amounts it is entitled to receive.

4. Expense recognition typically occurs in the period in which expenses are incurred to produce revenues.

B. Measurement

1. There are two main categories of measurement bases: historical cost and current value.

2. Current value is further categorized into value in use (for assets), fulfillment value (for liabilities), and fair value.

3. Value in use and fulfillment value are based on the present value of future cash flows discounted for the time value of money.

4. Fair value is based on the price that would be received to sell assets or transfer liabilities.

5. Fair value can be measured using market, income, or cost approaches.

6. The IASB provides a framework for measuring fair value that is based on a hierarchy that prioritizes the inputs of fair value measurement according to levels.

7. IFRSgives a company the option to report some or all of its *financial* assets at fair value.

C. Presentation and Disclosure

1. Financial reports should include any information that could affect the decisions made by external users, subject to the cost-effectiveness constraint.

2. Such information is disclosed using modifying comments, disclosure notes, and supplemental schedules and tables.

3. The use of presentation and disclosure tools such as classification and aggregation can improve relevance and faithful representation.

4. Income and expenses are included as part of profit or loss, except if relevance and faithful representation are improved by including them as part of other comprehensive income.

5. Recycling of other comprehensive items to profit or loss is done only if relevance and faithful representation of the statement of profit or loss is improved.

**VII. Capital and Capital Maintenance Concepts**

A. Capital

1. A financial capital concept focuses on an entity’s invested money, and capital is defined as the entity’s net assets (assets minus liabilities) or equity.

2. A physical capital concept focuses on the entity’s operating capability, and hence, capital is defined as the entity’s productive capacity or units of output.

B. Capital Maintenance and Profit

1. Under a financial capital maintenance concept, profit is represented by an increase in the monetary units of net assets, and price increases in net assets are treated as profits.

2. Under a physical capital maintenance concept, profit is represented by an increase in physical productive capacity or operating capability during the period. Price changes in net assets are treated as changes in physical productive capacity and are therefore treated as capital maintenance adjustments (equity) and not profits.

**VIII. Evolving Accounting Standards**

1. Two competing approaches for the recognition of revenues and expenses are (1) the revenue/expense approach and (2) the asset/liability approach.
2. Under the revenue/expense approach, principles for recognizing revenues and expenses are emphasized, with assets and liabilities recognized as necessary to make the statement of financial position reconcile with the statement of profit or loss.
3. Under the asset/liability approach, principles for asset and liability measurement are emphasized, and revenues, expenses, gains, and losses are recognized as necessary to make the statement of financial position reconcile with the statement of profit or loss.

**Suggestions for Class Activities**

**1. Real World Scenario**

America Online (AOL) is a leader in the Internet access provider industry. In 1996, the company changed a controversial accounting method involving the treatment of the cost of advertising and free trials. The following is an excerpt from a May 15, 2000, *CNET News.com* article:

America Online will pay a civil penalty of $3.5 million as part of a settlement with the Securities and Exchange Commission over the accounting of advertising costs. According to the SEC, the Internet and media giant improperly reported most of the costs of acquiring new subscribers—such as the expense of sending computer disks to potential customers—as an asset. As a result, the SEC said AOL posted a profit for six of eight quarters in 1995 and 1996 but would have recorded a loss if the company followed recommended accounting practices.

AOL, backed by its auditor, defended the accounting method of capitalizing these costs arguing that spreading the costs over two years was a justifiable way to match expenses against revenue flows that would emerge later. In 1996, AOL switched to expensing these costs in the period incurred.

**Suggestions:**

Have the class consider the general treatment of advertising and promotion costs. Why are these costs normally expensed in the period incurred even though they are incurred with the intention of generating future revenues? Why did they expense these costs over a two-year period? Then discuss the possible reasons why AOL chose a different approach followed by a discussion of the possible reasons why the company decided to change its method. Another interesting discussion is the civil penalty of $3.5 million leveled by the SEC four years after AOL changed its method. This could lead to a general discussion of the SEC’s role in the financial reporting process for US-listed companies.

**Points to note:**

Perhaps an important factor prompting the switch was the increased competition in the industry and the loss of customers that prompted AOL to implement a new pricing scheme. The loss of customers creates significant uncertainty with respect to the realization of deferred advertising and promotion costs. Another reason is pressure exerted by the SEC to make the switch and another is that AOL’s competitors all expensed these costs.

**2. Singapore Telecommunications Analysis**

Have students, individually or in groups, download the most recent annual report of Singapore Telecommunications Limited from the company’s website at [www.singtel.com](http://www.singtel.com). Ask them to:

1. Compare revenues, total costs and expenses, net profit, total assets, and total shareholders’ equity of the most recent financial year with those in the previous financial year. Are there any discernible trends? How might they be interpreted?

1. Use the Internet to locate the most recent annual report information for Telstra Corporation Limited, one of Singapore Telecommunications’ competitors. Using the most recent annual report information for both companies, compare:
2. growth rates in revenues and net profit and
3. the relationship between revenues and net profit (profit margin).

What could account for any differences you identify?

**3. Group/Research Activity**

The debate over principles-based versus rules-based accounting standards provides an excellent opportunity for class discussion, in-class debate, or for a writing assignment. One suggestion is to form groups of four or five students to research the issue. Assign half of the groups to defend a principles-based approach and the other half to defend the rules-based approach. There are numerous articles written on the subject. A google search will find many hits. For example, a link to an article entitled “The Case for Principle-Based Accounting” appears below.

<http://archive.ifrs.org/Features/Pages/The-case-for-principle-based-accounting-.aspx>

**4. International Accounting Activity**

What are the advantages and disadvantages to accounting convergence? Two recent articles in Accounting Horizons provide an excellent overview of the research evidence:

* Luzi Hail, Christian Leuz, and Peter Wysocki (2010) Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part I): Conceptual Underpinnings and Economic Analysis. *Accounting Horizons*: September 2010, Vol. 24, No. 3, pp. 355–394.
* Luzi Hail, Christian Leuz, and Peter Wysocki (2010) Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Future Scenarios for U.S. Accounting Standards. *Accounting Horizons*: December 2010, Vol. 24, No. 4, pp. 567–588.

**Suggestions:**

Have your students write a paper summarizing the issue and the papers’ results. Alternatively, have a debate in which different groups of students take pro- versus con-convergence positions.

**5. Professional Skills Development Activities**

The following are suggested assignments from the end-of-chapter material that will help your students develop their communication, research, analysis, and judgment skills.

**Communication Skills.** In addition to Communication Case 1-7, Judgment Case 1-12 can be adapted to ask students to write a letter to the client. Communication Case 1-6 does well as a group assignment. Ethics Case 1-8 and Judgment Cases 1-9 and 1-10 create good class discussions. Judgment Cases 1-11 and 1-14 are suitable for student presentation(s).

**Research Skills.** In their careers, our graduates will be required to locate and extract relevant information from available resource material to determine the correct accounting practice, perhaps identifying the appropriate authoritative literature to support a decision. Research Cases 1-3 and 1-4 provide excellent opportunities to help students develop this skill by introducing them to some important resources available on the Internet.

**Analysis Skills.** The “Broaden Your Perspective” section includes Analysis Cases that direct students to gather, assemble, organize, process, or interpret data to provide options for making business and investment decisions. In addition to Analysis Case 1-13, Brief Exercise 1-1, and Exercises 1-1 and 1-2 also provide opportunities to develop and sharpen analytical skills.

**Judgment Skills.** The “Broaden Your Perspective” section includes Judgment Cases that require students to critically analyze issues to apply concepts learned to business situations in order to evaluate options for decision-making and provide an appropriate conclusion. This chapter includes Judgment Cases 1-9, 1-10, 1-11, 1-12, and 1-14.

**6. Ethical Dilemma**

The chapter contains the following ethical dilemma:

**Ethical Dilemma**

You have recently been employed by a large retail chain that sells sporting goods. One of your tasks is to help prepare periodic financial statements for external distribution. The chain's largest creditor, National Savings & Loan, requires quarterly financial statements, and you are currently working on the statements for the three-month period ended June 30, 2023.

During the months of May and June, the company spent $1,200,000 on a hefty radio and TV advertising campaign. The $1,200,000 included the costs of producing the commercials as well as the radio and TV time purchased to run the commercials. All of the costs were charged to advertising expense. The company’s chief financial officer (CFO) has asked you to prepare a June 30 adjusting entry to remove the costs from advertising expense and to set up an asset called *prepaid advertising* that will be expensed in July. The CFO explained that “This advertising campaign has produced significant sales in May and June and I think it will continue to bring in customers through the month of July. By recording the ad costs as an asset, we can match the cost of the advertising with the additional July sales. Besides, if we expense the advertising in May and June, we will show an operating loss on our statement of profit or loss for the quarter. The bank requires that we continue to show quarterly profits in order to maintain our loan in good standing.”

You may wish to discuss this in class. If so, discussion should include these elements.

**Step 1—The Facts**

One of your tasks as an employee of a large sporting goods chain is to prepare financial statements for external use. You are currently preparing quarterly statements for the quarter ended June 30, 2023, which will be given to the chain's largest creditor, National Savings & Loan. The CFO has asked you to capitalize (charge to a prepaid asset) the $1,200,000 cost for an advertising campaign conducted in May and June of 2023. The capitalization of advertising will prevent an operating loss for the quarter and maintain the company's good standing with the creditor. The CFO believes that the commercials improved sales in May and June and expects the advertising effect to continue in July. The matching principle states that expenses are recognized in the same period as the related revenue. In some situations, it is impossible to determine in which periods revenues will be earned from expenses such as advertising. Because of the difficulty in estimating the effect of advertising expenditures, accounting principles dictate that advertising should be recognized as an expense in the period incurred.

**Step 2—The Ethical Issue and the Stakeholders**

The ethical issue or dilemma is whether your obligation to challenge the CFO's request for capitalization of the advertising expense is stronger than your obligation to your employer's financial interests.

Stakeholders include you, the accountant, the CFO, other corporate managers, company employees, the bank and other creditors, and current and future investors.

**Step 3—Values**

Values include competence, honesty, integrity, objectivity, loyalty to your employer, and responsibility to users of financial statements.

**Step 4—Alternatives**

1. Follow the suggestion of the CFO to record the advertising costs as a prepaid asset.

2. Record the advertising costs as an expense in the quarter ended June 30, 2023.

3. Report the CFO's request to a higher level of management, the audit committee, or the auditors.

4. Resign from the company and seek employment elsewhere.

**Step 5—Evaluation of Alternatives in Terms of Values**

1. Alternative 1 illustrates loyalty to the employer.

2. Alternative 2 exhibits the values of competence, honesty, integrity, objectivity, and responsibility to users of the financial statements.

3. Alternative 3 illustrates loyalty to the employer at a level higher than that of the CFO but also includes the values of honesty, integrity, and objectivity on the part of the accountant.

4. Alternative 4 supports the values of honesty and integrity, but does not reflect competence or responsibility to financial statement users.

**Step 6—Consequences**

*Alternative 1*

Positive consequences: You would keep your job and please the CFO. The company would remain in good standing with the bank.

Negative consequences: Users of the financial statements would be misinformed. Users of financial statements may sue the company upon learning the truth if the amount of advertising is material and affects their financial decisions. You may lose your self-respect and the respect of coworkers.

*Alternative 2*

Positive consequences: Users of financial statements would receive more conservative information concerning advertising costs. You would maintain your integrity.

Negative consequences: You may incur disfavor with the CFO and other top management, resulting in a loss of future promotions or your job. You also may lose the trust of other employees.

*Alternative 3*

Positive consequences: You would maintain your integrity. Users may receive more conservative information concerning advertising costs if upper management levels or the audit committee compel fair presentation in the financial statements.

Negative consequences: You may incur disfavor with the CFO and other top management, resulting in a loss of future promotions or your job. You also may lose the trust of other employees. Whistle blowers are often not rewarded.

*Alternative 4*

Positive consequences: You maintain your integrity and avoid conflict with management and other employees.

Negative consequences: You have no job and you may have difficulty getting references for a new job. Users of financial statements still do not receive correct information regarding advertising costs.

**Step 7—Decision**

Student(s) must decide their course of action.