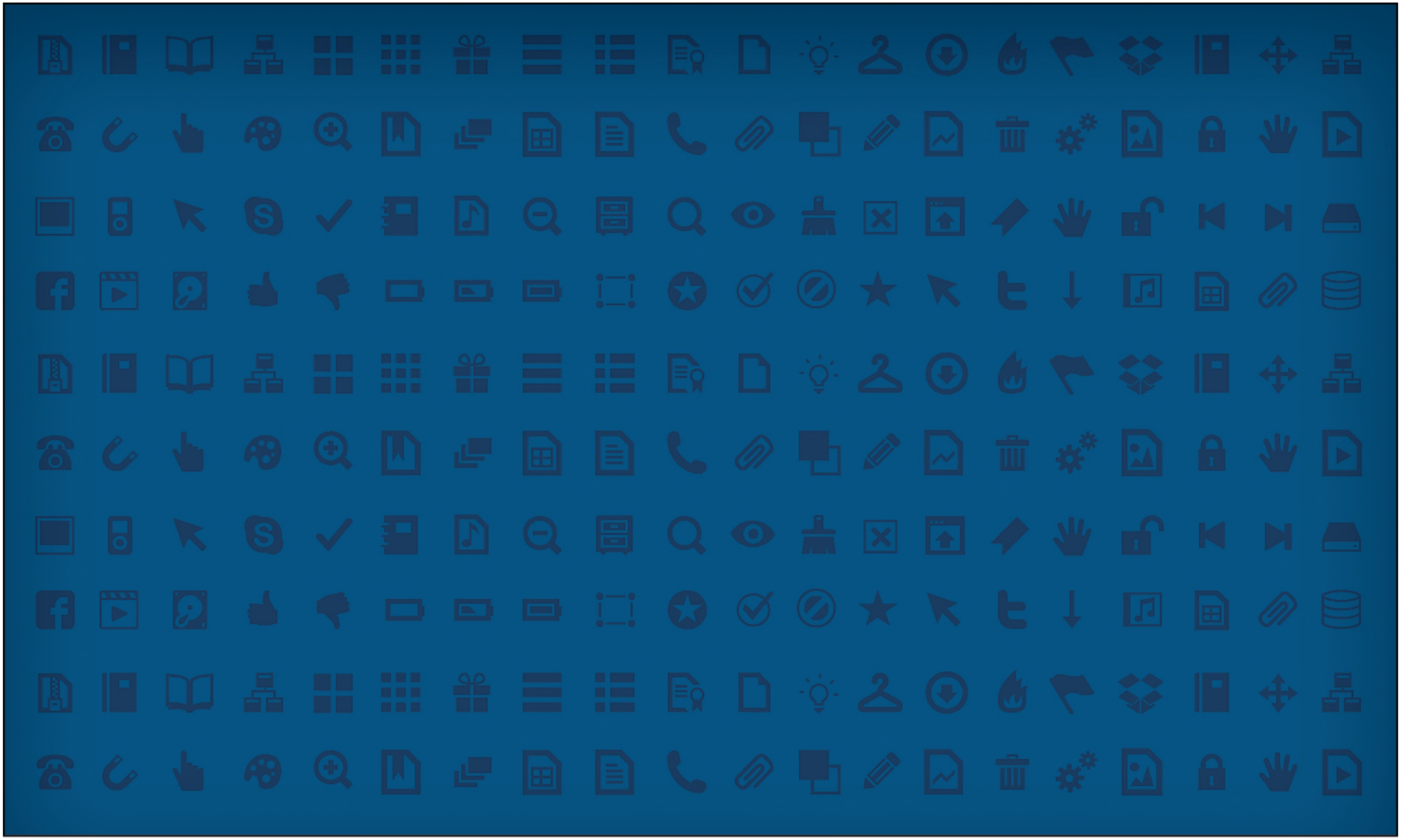

Financial Accounting

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Chapter 2

What Should Decision Makers Know in Order to Make Good Decisions about an Organization?

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Section 1—Learning Objectives

1. Explain the comparison of financial accounting to the painting of a portrait
2. Understand the reasons why financial accounting information does not need to be exact
3. Define the term “material” and describe its fundamental role in financial accounting
4. Define the term “misstatement” and differentiate between the two types of misstatements: errors and fraud

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Financial Statements: The Portrait of an Organization

- Like a portrait, financial accounting attempts to present a portrait of an organization that can be used by interested parties
- In accounting, this portrait is most often presented in the form of financial statements

A Likeness Does Not Have to Be Exact

- Financial accounting information is rarely an exactly accurate portrait
  - The accountant's goal is to create financial statements that present a likeness of an organization that can be used to make decisions
- Financial statements are still useful for decision making, even though they are not exact

Material Misstatements

- The data presented to decision makers by an organization should never contain any misstatements that are deemed to be material
- Financial statements do not need exact accuracy
  - They must be free of material misstatements in order to be of use to decision makers

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Material Misstatements

- The two types of misstatements are:
  - An error (made accidently)
  - A fraud (done intentionally)
- A misstatement is deemed to be material if it is so significant that its presence would impact a decision made by an interested party

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Section 2—Learning Objectives

1. Discuss the challenge created for financial accountants by the presence of uncertainty
2. List examples of uncertainty that an accountant might face in reporting financial information about an organization
3. Explain how financial accounting resembles a language such as Spanish or Japanese

Uncertainty, the True Challenge for Reporting

- Uncertainty keeps financial information from being precise
- Examples of uncertainty are:
  - Law suits
  - Bonuses
  - Warranties

Accounting as the Language of Business

- Accounting enables an organization to communicate
  - Uses words and numbers
- An effective communication is possible when:
  - Set terminology exists
  - Structural rules and principles are applied

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Section 3—Learning Objectives

1. Describe the purpose of accounting standards such as U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) and the benefits that these rules provide
2. Explain the importance of accounting standards to the development of a capitalistic economy

Section 3—Learning Objectives

3. Understand the role played by the Financial Accounting Standards Board (FASB) in the ongoing evolution of accounting standards in the United States
4. Discuss the advantages and the possibility that financial reporting will switch from U.S. GAAP to IFRS

The Existence of Formal Accounting Standards

- The existence of financial accounting standards is essential to ensure that all communicated information is understood properly
  - U.S. Generally Accepted Accounting Principles (GAAP) are applied to most financial information presented within the United States
  - International Financial Reporting Standards (IFRS) are now used almost exclusively in the rest of the world

The Development of Accounting Standards

- The Financial Accounting Standards Board (FASB) has held the authority to develop U.S. GAAP since 1973
  - IFRS are produced by the London-based International Accounting Standards Board (IASB)
- Because of standardization, any decision maker with adequate knowledge of financial accounting should be able to understand financial statements

The Importance of Accounting Standards

- "When the intellectual achievements of the 20th century are tallied, GAAP should be on everyone's Top 10 list."
  - Wall Street Journal
- The United States has a capitalistic economy
  - Need to attract investor capital to operate and grow

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The Importance of Accounting Standards

- U.S. GAAP enables outside parties to obtain the financial information they need to reduce their perceived risk to acceptable levels
  - Thus, money can be raised, and businesses can grow and prosper
- Funding is more likely to be available when financial information can be understood because it is stated in a common language: U.S. GAAP

The Evolution of Accounting Standards

- The Financial Accounting Standards Board (FASB) has served as the primary authoritative body in charge of producing U.S. GAAP
- Typically, accounting problems arise over time within the various areas of financial reporting
    - If such concerns grow to be serious, FASB steps in to study the issues and alternatives
  - Pass new rules or make amendments to previous ones

Section 4—Learning Objectives

1. Define “asset” and provide examples found in financial reporting
2. Define “liability” and provide examples found in financial reporting
3. Define “revenue” and provide examples found in financial reporting
4. Define “expense” and provide examples found in financial reporting

Assets, Liabilities, Revenues, and Expenses

- An asset is a probable future economic benefit that an organization either owns or controls
  - Examples: cash, accounts receivable, inventory, buildings, intangible assets, furniture, fixtures, and equipment etc.
- A liability is a probable future sacrifice of economic benefits arising from present obligations
  - Examples: accounts payable, notes payable, income tax obligations, outstanding expenses etc.

Assets, Liabilities, Revenues, and Expenses

- The term "revenue" is a measure of the financial impact on an organization that results from a particular process
  - This process is a sale
- An expense is an outflow or reduction in net assets that was incurred by an organization in hopes of generating revenues
  - Examples: insurance expense, rent expense, advertising expense, utility expense (such as for electricity and water) etc.

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