CHAPTER 2
What Should Decision Makers Know in Order to Make Good Decisions about an Organization?

1. CREATING A PORTRAIT OF AN ORGANIZATION THAT CAN BE USED BY DECISION MAKERS

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.

1.1— Financial Statements: The Portrait of an Organization [PowerPoint 2-3]

The purpose of a portrait is to capture a likeness of the artist’s model. Similarly, financial accounting attempts to present a portrait of an organization that can be used by interested parties to assess its financial health and future prospects. In accounting, this portrait is most often presented in the form of financial statements. Financial statements are a representation of an organization’s operations, financial position, and cash flows.

1.2— A Likeness Does Not Have to Be Exact [PowerPoint 2-4]

Like a portrait, financial statements are not an exact depiction of its subject. Just as the eyes in a portrait differ from the person’s actual eyes, the numbers in the financial statements are not 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.

Example: the reported cost of constructing a building may be off slightly because of the sheer volume of money being spent on the many different aspects of the project. No one expects the reported cost of a $50 million manufacturing plant to be accurate to the penny.

1.2.1—Usefulness of Financial Statements [PowerPoint 2-4]

If financial information provides a fair representation, an interested party should be able to make use of it to arrive at desired projections such as future stock prices. A potential investor or creditor does not need numbers that are absolutely accurate in order to assert, "Based on the information available in the financial statements, I understand enough about this business to make informed decisions. Even if I could obtain figures that were more accurate, I believe that I would still take the same actions."

1.2.1—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Before class, require students to pull the income statement and balance sheet of a company that interests them, such as Starbucks or Target. These statements can be used to illustrate many of the points of this chapter. To begin, have the students examine the magnitude of the numbers on their financial statements. Many will be in the millions, and some in the billions, of dollars. It should make sense to them immediately that those types of numbers cannot be exact to the penny.

1.2.1—Appropriate In-Class Use

Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√		2 Minutes	Students will need to bring financial statements to class

1.3— Material Misstatements [PowerPoint 2-5]

In financial accounting, the data presented to decision makers by an organization should never contain any misstatements that are deemed to be material. Financial statements must be free of material misstatements in order to be of use to decision makers.

1.3.1—Two Types of Misstatements [PowerPoint 2-6]

The two types of misstatements are *errors* and *fraud*. A misstatement is an error (made accidentally) or fraud (done intentionally) where reported figures or words actually differ from the underlying reality. In simple terms, the information is wrong.

1.3.2—Teaching tip

Before giving students examples of errors and fraud, see if they can come up with example of their own. Ask if they know of any companies or individuals, which have been accused of fraud. They should come up with examples such as Enron or Madoff. This will allow for a good discussion of the difference between an error and fraud.

1.3.3—Material Misstatement [PowerPoint 2-6]

A misstatement is deemed to be material if it is so significant that its presence would impact a decision made by an interested party. A financial accountant never claims that reported information is correct, accurate, or exact. However, the accountant must take all precautions necessary to ensure that reported data contain no material misstatements. All parties need to believe that reported information can be used with confidence because it presents a fair likeness of the organization as a whole.

1.3.3—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Ask the students to look at their financial statements (see 1.2.1 above). Would a $100 misstatement make a difference to them if they were thinking of investing in this company's stock? How about a $100 million misstatement? Call on one or two students to explain their answers.

1.3.3—Appropriate In-Class Use

Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√		2 Minutes	Students will need to bring financial statements to class

2. DEALING WITH UNCERTAINTY

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.

2.1— Uncertainty, the True Challenge for Reporting [PowerPoint 2-8]

Many of the figures reported by an organization do not lend themselves to accuracy. The primary reason that exactness is not a goal can be summed up in a single word: uncertainty.

Financial accounting is a structured attempt to paint a fairly presented portrait of an organization's overall operations, financial condition, and cash flows. This requires the reporting of many events where a final resolution might not occur for months or even years. Uncertainty keeps financial information from being precise. Examples of uncertainty faced by organizations include law suits, bonuses and warranties.

Many of the most important accounting rules have been created to establish requirements for the reporting of uncertain situations. Because of the quantity and variety of such unknowns, exactness simply cannot be an objective of financial reporting.

Whenever an organization encounters a situation of this type, the accountant must come to understand what has happened and then determine a logical method to communicate a fair representation of that information within the framework provided by financial accounting rules. Thus, reporting events in the face of uncertainty is surely one of the major challenges of being a financial accountant.

2.2— Accounting as the Language of Business [PowerPoint 2-9]

Accounting is a language—one that enables an organization to communicate a portrait of its financial health and future prospects to interested parties by using words and numbers rather than oils and watercolors.

2.2.1—An Effective Communication [PowerPoint 2-9]

An effective communication is possible in a language when: 1) set terminology exists and 2) structural rules and principles are applied.

Financial accounting has its own terminology. Many words and terms (such as "LIFO" and "accumulated depreciation") have specific meanings. In addition, a comprehensive set of rules and principles has been established over the decades to provide structure and standardization. They guide the reporting process so that the resulting information will be fairly presented and readily understood by all interested parties, both inside and outside the organization.

For successful communication of financial information, both the terminology and the structural rules must be understood by all parties involved.

2.2.1—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Ask the students to look at their financial statements (see 1.2.1 above). Are there terms they do not understand or recognize, much as if they were looking at foreign language? Ask one or two students to share a term they do not understand. Explain that the terminology will explained over the course of the term. They will be learning the language of business.

2.2.1—Appropriate In-Class Use

Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√		2 Minutes	Students will need to bring financial statements to class

3. THE NEED FOR ACCOUNTING STANDARDS

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.
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.

3.1— The Existence of Formal Accounting Standards [PowerPoint 2-12]

The existence of financial accounting standards is essential to ensure that all communicated information is understood properly. During the past ten years or so, as a truly global economy became a reality, two primary systems of accounting rules emerged. U.S. generally accepted accounting principles (U.S. 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.

Having two bodies of rules causes problems for decision makers. Not surprisingly, many corporate officials and decision makers would prefer to see one universal set of accounting standards. Over the past few years, extensive progress has been made in bringing these two sets of standards into alignment. However, a number of significant differences continue to exist.

3.1.1—How does GAAP keep pace with a changing business world?

Some rules are older, but many have been developed in the last 20 to 30 years. Accounting principles evolve as the business world changes. Significant changes are made to GAAP every year.

3.2— The Development of Accounting Standards [PowerPoint 2-13]

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). Whether U.S. GAAP or IFRS, accounting standards evolve quite quickly as the nature of business changes and new reporting issues, problems, and resolutions arise.

Because standardization exists in most areas of the reporting process, any decision maker with an adequate knowledge of financial accounting—whether located in Phoenix, Arizona or in Portland, Maine—should be able to understand fairly presented information being conveyed by a wide variety of organizations. They all speak the same language. Put simply, the existence of accounting standards enables organizations and other interested parties to communicate successfully.

3.2.1—Teaching Tip: Value of GAAP [PowerPoint 2-14]

Have a few students volunteer what they consider the greatest intellectual achievement of the 20th century. Then present this quote from the Wall Street Journal about the importance of GAAP: "*When the intellectual achievements of the 20th century are tallied, GAAP should be on everyone's Top 10 list.*"

3.3— The Importance of Accounting Standards [PowerPoint 2-14, 15]

3.3.1—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Ask the students to look at their financial statements (see 1.2.1 above). Pair students and ask them to compare their two companies. Tell them that each company is allowed to do their accounting however they wish, that no actual rules exist. Ask what comparisons they can make. They should say none. Now say that in truth, the accounting for these statements is governed by U.S. GAAP, and that while some judgment is allowed, the companies follow the same basic rules for accounting. Now can they make any comparisons? This should demonstrate the value of GAAP.

3.3.1—Appropriate In-Class Use				
Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√	√	3 Minutes	Students will need to bring financial statements to class

The United States has a capitalistic economy, which means that businesses are (for the most part) owned by private citizens and groups rather than by the government. To operate and grow, these companies must convince investors and creditors to contribute huge amounts of their own money voluntarily. Not surprisingly, such financing is only forthcoming if the possible risks and rewards can be assessed and then evaluated with sufficient reliability.

Bring back In-Class Activity 3.3.1 by asking them if they would be more comfortable investing their money in their company knowing that the company must follow certain accounting rules.

Before handing over thousands or even millions of dollars, decision makers must believe that they are using reliable data to make reasonable estimations of future stock prices, cash dividends, and cash flows. Otherwise, buying stocks and granting credit is no more than gambling. 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.

If accounting standards did not exist, the development and expansion of thousands of the businesses that have become a central part of today's society might be limited or impossible simply because of the lack of available resources. An expanding economy requires capital investment. That funding is more likely to be available when financial information can be understood because it is stated in a common language: U.S. GAAP.

3.4— The Evolution of Accounting Standards [PowerPoint 2-16]

As indicated earlier, since 1973, FASB has served as the primary authoritative body in charge of producing U.S. GAAP for nongovernmental entities such as businesses and private not-for-profit organizations.. FASB is an independent group supported by the U.S. government, various accounting organizations, and many private businesses.

Typically, accounting problems arise over time within the various areas of financial reporting. New types of financial events can be created, for example, that are not covered by U.S. GAAP or, perhaps, weaknesses in earlier rules start to become evident. If such concerns grow to be serious, FASB steps in to study the issues and alternatives. After a period of study, the board might pass new rules or make amendments to previous ones.

The FASB and other standard setting bodies will be covered in more detail in Chapter 6.

4. FOUR BASIC TERMS FOUND IN FINANCIAL ACCOUNTING

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.

4.1— Assets, Liabilities, Revenues, and Expenses [PowerPoint 2-18, 19]

Begin with basic terminology. Four fundamental terms will be introduced in this chapter - asset, liability, revenue, and expense. Knowledge of these words is essential in gaining an understanding of accounting because they serve as the foundation for a significant portion of the financial information provided by any organization.

4.2— Definition of the Term "Asset" [PowerPoint 2-18]

An asset is a probable future economic benefit that an organization either owns or controls. Every business has its own particular mix of assets. Virtually all have cash and accounts receivable (money due from customers). Many also have inventory (merchandise held for resale). The size and type of other assets will vary significantly based on the company and the industry in which it operates.

4.2.1—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Ask the students to look at their financial statements (see 1.2.1 above). Point out the left-hand side or top of the balance sheet. Ask volunteers to read off assets listed there. Ask students to determine how that item can be used to benefit the business in the future. For example, if a student names "inventory," its benefit could be that it can be sold for cash.

4.2.1—Appropriate In-Class Use				
Pages	**Discussion**	**Team Activity**	**Class Time**	**Assign Ahead**
	√		3 Minutes	Students will need to bring financial statements to class

4.3— Definition of the Term "Liability" [PowerPoint 2-18]

A more formal definition of a liability is that it is a probable future sacrifice of economic benefits arising from present obligations but, for simplicity sake, liabilities can be viewed as the debts of the organization.

Another term that is often encountered in financial reporting is "net assets." The net asset total for an organization is simply its assets (future benefits) less its liabilities (debts). This balance is also known as "equity" in reference to the owners' rights to all assets in excess of the amount owed on liabilities. A business's net assets will increase if assets go up or if liabilities decrease. Changes in net assets show growth (or shrinkage) in the size of the organization over time.

4.3.1—IN-CLASS ACTIVITY

Using Actual Financial Statements

Description: Ask the students to look at their financial statements (see 1.2.1 above). Point out the right-hand side or middle of the balance sheet. Ask volunteers to read off liabilities listed there. Ask students if it makes sense that that item is seen as a debt of the organization. For example, if a student names "accounts payable," this makes sense because these are amounts owed to suppliers.

4.3.1—Appropriate In-Class Use				
Pages	**Discussion**	**Team Activity**	**Class Time**	**Assign Ahead**
	√		3 Minutes	Students will need to bring financial statements to class

4.4— Definition of the Term “Revenue” [PowerPoint 2-19]

The term “revenue” is a measure of the financial impact on an organization that results from a particular process. This process is a sale.

For timing purposes, revenue is recognized when the earning process takes place. That is normally when the goods or services are delivered.

4.4.1—IN-CLASS ACTIVITY
Using Actual Financial Statements
Description: Ask the students to look at their financial statements (see 1.2.1 above). Point out the income statement. Point out that the top line is revenue.

4.4.1—Appropriate In-Class Use

Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√		1 Minute	Students will need to bring financial statements to class

4.5— Definition of the Term “Expense” [PowerPoint 2-19]

An expense is an outflow or reduction in net assets that was incurred by an organization in hopes of generating revenues.

In some ways, expenses are the opposite of revenues that measure the inflows or increases in net assets that are created by sales. Expense figures reflect outflows or decreases in net assets incurred in hopes of generating revenues.

4.5.1—IN-CLASS ACTIVITY
Using Actual Financial Statements
Description: Ask the students to look at their financial statements (see 1.2.1 above). Point out the income statement. Ask volunteers to read off some of the expenses listed. Many of these will not be familiar to students, i.e., cost of goods sold and depreciation. Inform them that they will be learning the meanings of all of these terms as they learn the “language of accounting.”

4.5.1—Appropriate In-Class Use				
Pages	Discussion	Team Activity	Class Time	Assign Ahead
	√		1 Minute	Students will need to bring financial statements to class