# CHAPTER 1

**THE ECONOMIC AND INSTITUTIONAL SETTING FOR FINANCIAL REPORTING**

###### CHAPTER OVERVIEW

Financial statements are an extremely important source of information about a company, its economic health, and its prospects. They help improve decision making and make it possible to monitor managers’ activities.

* Equity investors use financial statements to form opinions about the value of a company and its stock.
* Creditors use statement information to gauge a company’s ability to repay its debt and to check whether the company is complying with loan covenants.
* Stock analysts, brokers, and portfolio managers use financial statements as the basis for their recommendations to investors and creditors.
* Auditors use financial statements to help design more effective audits by spotting areas of potential reporting abuses.

Investors, creditors, and other interested parties demand financial statements because the information is useful. But what governs the supply of financial information?

* Mandatory reporting is a partial answer. Most companies in the United States and other developed countries are required to compile and distribute financial statements to shareholders and to file a copy with a government agency (in the United States, that agency is the SEC). This requirement allows all interested parties to view the statements.
* The advantages of voluntary disclosure are the rest of the answer. Financial information that goes beyond the minimum requirements can benefit the company, its managers, and its owners. For example, voluntary financial disclosures can help the company obtain capital more cheaply or negotiate better terms from suppliers. But benefits like these come with potential costs: information collection, processing, and dissemination costs; competitive disadvantage costs; litigation costs; and political costs. This means that two companies with different financial reporting benefits and costs are likely to choose different accounting policies and reporting strategies.

Different companies choose different accounting policies and reporting strategies because financial reporting standards are often imprecise and open to interpretation. This imprecision gives managers an opportunity to shape financial statements in ways that allow them to achieve specific reporting goals.

* Most managers use their accounting flexibility to paint a truthful economic picture of the company.
* Other managers mold the financial statements to mask weaknesses and to hide problems.
* Analysts who understand financial reporting, managers’ incentives, and the accounting flexibility available to managers will maintain a healthy skepticism about the numbers and recognize that financial statements sometimes conceal more than they reveal.

The accountant’s and analyst’s job is made more difficult when financial reporting measurement and disclosure rules differ across national boundaries. Reporting rules in some countries such as Canada, the United Kingdom, and the United States evolved to reflect firms’ underlying economic performance. But reporting rules in many other countries—France, Germany, and Japan, for example—merely complied with taxation or other statutory requirements.

* Globalization forced many firms in countries using a commercial or tax law approach to seek foreign capital. In turn, this has led countries around the world to move to IFRS, making it easier for firms in their countries to raise capital in domestic and foreign financial markets.
* The FASB and IASB have worked to converge the guidance for numerous accounting issues. However, in many cases, the boards have issued substantially different standards after having worked together originally.

**CHAPTER OUTLINE**

1. Why Financial Statements Are Important

***Teaching Tip:*** While financial statements are not as timely as press releases, they do provide an economic history and are indispensable in developing an accurate profile of ongoing performance and prospects.

***Teaching Tip:*** This text does not focus on assisting readers of financial statements in detecting fraud, which is rare. Rather, the purpose of this text is to assist readers in understanding the financial flexibility and discretion inherent in financial accounting rules in order that they may make more informed decisions.

1. **Economics of Accounting Information**
   1. Demand for Financial Statements
   2. Disclosure Incentives and the Supply of Financial Information
2. **A Closer Look at Professional Analysts**
   1. Analysts’ Decisions
3. **Fundamental Concepts of Financial Reporting**
   1. Generally Accepted Accounting Principles
   2. Who Determines the Standards?
   3. The Politics of Accounting Standards
   4. FASB Accounting Standards Codification™

***Teaching Tip:*** It may be a good idea to access the FASB Codification and provide an overview of how to use the system and reinforce that everything in the Codification is a Generally Accepted Accounting Principle.

1. **Incentive Conflicts and Financial Reporting**

***Teaching Tip:*** For example, the choice to capitalize, rather than expense amounts, will make firms appear to be larger, more profitable, and less risky. Therefore, naive acceptance of financial statement data may be dangerous. Much of the book is devoted to providing students with the skills necessary to become more informed readers of financial statements by making meaningful comparisons between companies and gaining insight into managers’ incentives.

1. **An International Perspective**
   1. International Financial Reporting
2. **APPENDIX 1A: GAAP in the United States**
   1. Early Developments
   2. Emergence of GAAP
   3. Current Institutional Structure in the United States

CHAPTER QUIZ

1. A company’s financial statements reflect information about

1. product information and competitive positions.
2. future projections of sales, expenses, and other future economic events.
3. the general economy of the industry in which the company operates.
4. economic events that affect a company that can be translated into accounting numbers.

2. Creditors assess credit risk by comparing a firm’s required principal and interest payments to estimates of the firm’s current and future

1. cash flows
2. net assets.
3. revenue.
4. net income.

3. Which is not correct regarding Regulation Fair Disclosure (Reg FD)?

1. It limits what management can say in private conversations with analysts and investors.
2. It does not limit what management can say in private conversations with analysts or investors.
3. It was passed by the SEC.
4. It helps level the playing field between individual and institutional investors.

4. Being verifiable and neutral is part of what makes financial information

1. consistent.
2. comparable.
3. relevant.
4. useful

5. Financial information capable of making a difference in a decision is

1. relevant.
2. reliable.
3. consistent.
4. verifiable.

6. Factors that may influence a decision maker’s judgment as to what accounting information is useful include:

1. The decision to be made.
2. The information already possessed.
3. The decision maker’s capacity to process the information.
4. All of the above answers are correct.

7. Which one of the following types of disclosure costs is the cost of disclosing the company’s pricing strategies?

1. Political cost
2. Litigation cost
3. Competitive disadvantage cost
4. Information collection, processing, and dissemination cost

8. Employees demand financial statement information because the firm’s performance is often linked to

1. Employee stock ownership plans.
2. Social security benefits.
3. Disability plan benefits.
4. Workmen’s compensation benefits.

9. The primary current source of generally accepted accounting principles for publicly traded companies in the United States rests with the:

1. Securities and Exchange Commission.
2. New York Stock Exchange.
3. Financial Accounting Standards Board.
4. American Institute of Certified Public Accountants.

10. International accounting standards are established by the

1. Securities Exchange Commission
2. London Stock Exchange
3. International Accounting Standards Board
4. Institute of Chartered Accountants

**Essay Questions**

1. Define the expanded role of the PCAOB in the preparation of consistent and transparent financial statements.

2. Why would it be beneficial to narrow international differences in accounting rules for accounting and reporting?

**QUIZ ANSWERS:**

1. *D*. The financial statements present historical information about what has happened to the company in the past.
2. *A*. Creditors are concerned with a firm’s ability to replay principal and interest by projecting cash flows.
3. *B*. Reg FD was passed to limit what management can say in private to analysts and investors.
4. *D*. Useful information is verifiable and neutral.
5. *A*. Relevant information is capable of making a difference in decision making.
6. *D*. The judgment by a decision maker as to what accounting information can be useful includes the decision to be made, the information already possessed, and the decision maker’s capacity to process the information.
7. *C*. Competitive disadvantage cost is the cost of disclosing the company’s pricing strategies
8. *A*. Managers and employees use financial information to monitor employee contracts such as bonus plans, profit–sharing plans, and pension plans.
9. *C*. The FASB is charged with the responsibility of establishing financial accounting standards.
10. *C*. The IASB is responsible for establishing IFRS.

**RECOMMENDED FIGURES AND EXHIBITS**

1. Figure 1.1—Desirable Characteristics of Accounting Information