

## Chapter 1

# Seeing the Big Picture of Financial Accounting

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### *In This Chapter*

- ▶ Getting to know financial accounting
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**M**ost people don't buy a title like *Intermediate Accounting For Dummies* on a whim in the bookstore, so I assume you have good reason for picking up this book. Most likely, you're preparing for or in the midst of starting your series of classes on intermediate accounting. Or perhaps you're gearing up to take the certified public accountant (CPA) exam and are looking for a plain-talk explanation of some tested topics. Maybe you're a business owner wanting to get a better handle on financial statement preparation. Then again, maybe you're just curious about the inner workings of the wonderful world of accounting. Whatever brought you here, welcome.

In this chapter, I talk about the background of financial accounting including key challenges to preparing financial statements. I also introduce you to the alphabet soup that is the three financial accounting standard-setting bodies: the SEC, FASB, and AICPA.

This chapter also introduces generally accepted accounting principles (GAAP), which defines for financial accountants the acceptable practices in the preparation of financial statements in the United States and addresses the recent Codification, which restructures GAAP into a more user-friendly format.

This chapter provides an overview of the financial accounting code of professional conduct and rules and regulations that set the standards for professionalism for financial accountants and certified public accountants. These standards give you a roadmap to follow when you're trying to figure out how to handle various accounting transactions taking place during day-to-day business operations. In particular, I explain integrity, objectivity, independence, and due care.

Ready to jump into the pool of financial accounting? Time to go back to the beginning, to the early days of financial accounting.

## *Financial Accounting: Seeing Where It All Began*

*Financial accounting* involves the process of preparing financial statements for a business. This extravaganza involves three major components: accounting information, type of business entity, and user of the financial statements.

The three financial statements are the income statement, balance sheet, and statement of cash flows.

Following is a brief description of each:

- ✔ **Information:** Any accounting transactions the business completes during the accounting period. These transactions include generating revenue from the sales of company goods or services, paying business-related expenses, buying company assets, and incurring debt to run the company.
- ✔ **Business entity:** The company incurring the accounting transactions. Important in this consideration is the type of business entity; some accounting transactions require different treatment, depending on the type of entity.  
  
The three types of business entities are sole proprietorships (one owner), corporations, and flow-through entities, like a partnership.
- ✔ **User:** The persons or businesses that need to see the accounting transactions organized into financial statements to make educated decisions of their own. More about these users comes in the “Providing results for the users of the financial statements” section of this chapter.

The next few sections give you more information about the three different financial statements and various users of the financial statements.



This book and your intermediate accounting textbook home in on the corporate business entity. Corporations are separate legal entities, with oversight by a board of directors and owned by its shareholders.

## Preparing financial statements

The number one objective of financial accounting is to prepare financial statements that accurately reflect business operations and are understandable by those using the financial statements. You've taken your prerequisites to intermediate accounting, so you're well aware of the fact that accountants can't just throw accounting transaction data on the statements.

Rules govern how the accounting must be done, and they're called *generally accepted accounting principles (GAAP)*. I discuss them later in this chapter, in both the "Developing financial standards" and "Explaining Codification" sections. These rules pertain to both how the financial accountant shows the accounting transactions and on which financial statement the transactions appear.

But first, you get a mini-refresher on each of the financial statements:

✓ **Income statement:** This financial statement shows the results of business operations consisting of revenue, expenses, gains, and losses. The end product is net income or loss. I talk about the income statement again in Chapter 5. Here are just the basic facts on the four different income statement components:

- **Revenue:** Gross receipts the company earned by selling its goods or services. More information about recognizing revenue comes in Chapter 20.
- **Expenses:** The costs to the company to earn the gross receipts. Part V of this book contains more information on various expenses.
- **Gains:** Income from non-business-related transactions, such as the sale of a company asset. Chapter 11 gives more information on the sale of assets, which can lead to gains and losses.
- **Losses:** The flip side of gains — for example, losing money when selling the company car.

The income statement is finite in what it reflects. For example, it may report net income for the 12-month period ending December 31, 2012. Any accounting transactions that take place before or after this 12-month window do not show up on the report.

✓ **Balance sheet:** The balance sheet has three sections: assets, liabilities, and equity. Standing on their own, they contain valuable information about a company. However, a user has to see all three interacting together on the balance sheet to form an opinion approaching reliability





about the company. Chapter 6 gives you more information on preparing the balance sheet.

The balance sheet shows results from the first day the company opens to the date on the balance sheet.

Consider the basics about each balance sheet component:

- **Assets:** Resources a company owns, such as cash, equipment, and buildings. Part III of this book discusses current and long-term assets.
- **Liabilities:** Debt the business incurs for operating and expansion purposes. Chapters 14 and 15 discuss current and long-term liabilities.
- **Equity:** The amount of ownership left in the business after deducting total liabilities from total assets. See Chapter 16 for more information on equity.

Since your intermediate accounting textbook is all about the corporation, your main areas of equity focus are stock, retained earnings, and additional paid-in capital.

- ✓ **Statement of cash flows:** The statement of cash flows contains certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show cash sources and uses during a specific period of time — in other words, how a company brings in cash and for what costs the cash goes back out the door.

The statement of cash flows combines both the income statement and the balance sheet, but it's finite in nature, showing cash ins and outs for only the reporting period.



## *Developing financial standards*

I'm certainly not implying that preparing financial statements is a frivolous pursuit (quite the opposite!), but for now, I want you to liken preparing financial statements to a game. As in any game you play, whether it be athletics, board games like Monopoly, or computer games, without clear-cut, unambiguous rules, players in the game have no idea of their standing. Are they winning or losing?

Well, the same is true of accounting for financial transactions. And the rule-book defining acceptable practices in the preparation of financial statements in the United States is GAAP.

GAAP is the result of a witch's brew of more than 2,000 accounting documents forged during the last 60 years. In the past, generally accepted accounting principles were a collaborative effort among several standard-setting bodies — for example, the Financial Accounting Standards Board (FASB), the Emerging Issues Task Forces (EITF), and the American Institute of Certified Public Accountants (AICPA). At the AICPA, this is the specific task of the Accounting Standards Executive Committee (AcSEC), which is a senior technical committee composed of 15 CPA members of the AICPA.

Just to add a little excitement to the mix, how financial accountants view GAAP changed in 2009 with the adoption of FASB Accounting Standards Codification. You find more information on these standard setters and Codification in the “Getting to Know Key Financial Accounting Players” section of this chapter.

## ***Providing results for the users of the financial statements***

The information in the financial statements enables users to evaluate whether they want to become financially involved with the company. Involving the use of ratios and measurements, a topic I cover in Chapter 22, users of the financial statements evaluate the relative merit of one company over another by analyzing the company's historic performance.

Okay, so just who are these much-ballyhooed users of the financial statements? Users fall into three categories: existing or potential investors in the company, individuals or businesses thinking about extending credit terms to the company, and governmental agencies such as the Securities and Exchange Commission (SEC) that want to make sure the company is fairly presenting its financial position.

Although each user is different, they have a common need: assurance that the information they're looking at is both materially correct and useful. *Materially correct* means the financial statements don't contain any serious or substantial misstatement. To be useful, the information must be understandable to anyone not privy to the day-to-day activities of the company.

Investors and creditors sit at different ends of the table, but they share one characteristic: They're looking for a return in exchange for allowing the business to use their cash. Government agencies don't have a profit motive. Depending on the agency, it just wants to make sure the company is abiding by all tax codes, regulations, and GAAP.

Investors buy stock in the company. Examples of creditors are banks, automobile financing companies, and the vendors from which a company purchases its inventory or office supplies.

## *Identifying reporting challenges*

The biggie reporting challenge is producing financial statements that are both materially correct and timely. *Materially correct* means the financial statements don't contain any serious or substantial understatement or omission. *Timeliness* relates to the users having the financial information while it's still relevant. After all, what good is financial information to investors if it's reported so far after the date of the statements that it's no longer true?

Timeliness is so important that the Securities and Exchange Commission (SEC) requires publicly traded companies to issue certain financial reports as soon as 60 days after the end of the financial period.



See Chapter 19 for more information on correcting financial statement errors.

Another reporting challenge is accounting for and determining *fair value*, which means companies record or disclose. See Chapter 11 for what assets are worth in an open marketplace instead of at historic cost.

This topic has been the subject of heated debate, as some argue that using historic cost doesn't show the true economic impact of the assets on the financial statements. Others counter by saying that fair value reporting can adversely affect the economy. Find out more about this contentious topic in Chapter 3.

## *Getting to Know Key Financial Accounting Players*

This section discusses the three primary players in the financial accounting game. I also discuss GAAP, which defines the acceptable practices in the preparation of financial statements in the United States. In addition, I give you some information on the recent Codification, which restructured GAAP into a more user-friendly format.

First up, you get to find out about the standard setters.

## *Identifying standard-setting organizations*

The three organizations primarily in charge of setting U.S. GAAP are the Securities and Exchange Commission (SEC), the American Institute of Certified Public Accountants (AICPA), and the Financial Accounting Standards Board (FASB).

### **SEC**

In response to the stock market crash of 1929 and the ensuing Great Depression, the Securities Exchange Act of 1934 created the SEC. The SEC's mission is to make sure publicly traded companies tell the truth about their businesses and treat investors fairly by putting the needs of the investors before the needs of the company.



Publicly traded companies are those whose stock is available for sale in an open marketplace, such as the New York Stock Exchange.

The SEC is run by five commissioners, who are appointed to five-year terms by the President of the United States. Their terms are staggered, and no more than three commissioners can be from the same political party at the same time. These commissioners ride herd over the SEC's power to license and regulate stock exchanges, the companies whose securities trade on them, and the brokers and dealers who conduct the trading.

The enforcement authority given by Congress allows the SEC to bring civil enforcement against individuals or companies alleged to have committed accounting fraud, provided false information, or engaged in insider trading or other violations of the securities law. The SEC also works with criminal law enforcement agencies to prosecute individuals and companies alike for offenses, which include a criminal violation.

### **AICPA**

After reading about the SEC's enforcement over publicly traded companies, you may be wondering who's making sure privately traded companies toe the line. Well, look no further! This responsibility goes to the AICPA.

Through the AICPA's senior technical committee, the Auditing Standards Board (ASB), the organization is responsible for establishing auditing and attestation standards for nonpublic companies in the United States. The purpose of a financial statement *audit* is to gather enough evidence about a company's documents to be able to issue an opinion on whether the financial statements are free of material misstatements.



The ASB has 19 members, most of whom either work for public accounting firms such as KPMG LLP or are university professors, governmental accountants, or other workers in the field of accounting. Members serve one- to three-year terms and are jointly nominated by the director of the AICPA Audit and Attest Standards Staff and the ASB chair. The responsibilities of approving the nominations fall to the AICPA Board of Directors.

A financial accountant provides an *attestation service* when issuing a report on a subject that is the responsibility of another person or business. For example, a company can hire you to calculate *net accounts receivable*, which is what customers owe the company, minus an allowance for uncollectible accounts (see Chapter 9), making sure your figures match the company's amount showing on the balance sheet.



The AICPA also has a Code of Professional Conduct by which its members must abide. I discuss the tie-in between being a member of the AICPA and following the ethical responsibilities of financial accountants in the “Considering Ethical Responsibilities” section of this chapter.

### **FASB**

Before you get into the meat and potatoes of FASB, you need a little history lesson! Resulting from some congressional criticism of the standard-setting work being done by the AICPA, the Financial Accounting Foundation (FAF) was established in the state of Delaware as a nonprofit corporation.

The FAF, in turn, established the *Financial Accounting Standards Board* (FASB), which, today, is currently the private-sector body establishing GAAP for all nongovernmental entities.



Governmental entities follow procedures set up by the Governmental Accounting Standards Board (GASB).

The FASB has five full-time members, who are selected by the FAF. All are required to have knowledge of accounting, finance, and business. For more info on the FASB, accounting standards, and FAF, check out the FASB website at [www.fasb.org/home](http://www.fasb.org/home).



The FASB further formed the Emerging Issues Task Force (EITF) in 1984 to help identify emerging accounting issues in need of standardization. The EITF consists of accounting professionals who meet six times a year with nonvoting members of the SEC and FASB to mull over current economic, business, and industrial developments.

## *Recognizing generally accepted accounting principles*

GAAP defines for financial accountants the acceptable practices in the preparation of financial statements in the United States. The preponderance of the information I provide in Parts II, III, IV, and V of this book directly ties back to GAAP. Specifically, GAAP tells financial accountants exactly how financial data has to show up on the income statement, balance sheet, and statement of cash flows.

As I mentioned already, GAAP was, in the past, a collaborative effort among several different standard-setting bodies. I discuss all three of them earlier in this chapter: the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).

But hold on to your hats! How financial accountants view GAAP changed in 2009 with the adoption of FASB Accounting Standards Codification, which I discuss in the next section.

## *Explaining Codification*

As of July 1, 2009, the FASB Accounting Standards Codification (ASC) became the single source of authoritative GAAP in the United States. Before you get in a dither, keep in mind that the Codification doesn't change GAAP; it organizes GAAP in a more user-friendly fashion and consistent format across the board for all GAAP topics.

FASB allows free, albeit limited, access to the Codification. To check this out, go to <http://asc.fasb.org/>. On the right side of the page, click *Order Professional or Basic View*. Then at the bottom of the page, under *Basic View — Free Access*, click the Select button and follow the order registration instructions.



Access is free, but for some reason, your free access comes with an expiration date. You get an e-mail asking you to renew the free access before your expiration date. If you forget, no biggie. You can renew next time you go to the Codification, regardless of whether your expiration date already passed.

After you complete the log-in procedure, on the Basic View home page, browse the topics on the taskbar at the left to see how to apply GAAP for accounting topics such as revenue (which I discuss in Chapter 20 of this book); assets, liabilities, and equity (I discuss all three in Parts III and IV of

this book); and financial statement presentation (for more info, see Part II of this book). Each topic allows you to drill down to more detailed information. For example, if you select *Equity*, you can further select *Stock Dividends and Stock Splits* (see Chapter 16 in this book for more information on stock) to find out how to account for stock transactions under GAAP.



The ASC professional version annual subscription costs \$850. However, ask your financial accounting instructor if your school has academic accounting access. If so, you have free access to better search functions, allowing for a fully functional view of the Codification.

## ***Introducing international accounting standards***

Your intermediate accounting textbook goes into this topic a whole lot more than your basic financial accounting textbook. In the last few decades, business has increasingly spanned borders. The U.S. was content to rely only on U.S. GAAP for many years, but since the 1970s, there's been an increasing demand for international accounting standards, to deal with the increasing international aspects of U.S. companies.

The first organization to work on harmonizing international accounting standards worldwide was the International Accounting Standards Committee (IASC), formed in 1973. The International Accounting Standards Board (IASB) preceded the IASC. Currently, the IASB has promulgated approximately 50 International Financial Reporting Standards (IFRS) in use by more than 130 countries.



Noting that the IASC dates back to 1973, it's clear to see that converging FASB and IASB standards is an ongoing process. Indeed, it's been ten years since the FASB and IASB agreed to converge in "The Norwalk Agreement." Added to the mix is the SEC, which is pushing to have the FASB act as an endorsement (vs. convergence) body for the IASB standards in the U.S.

This is a hot accounting topic that will take center stage in the accounting arena for the foreseeable future. For more information, visit the FASB website at [www.fasb.org/intl/convergence\\_iasb.shtml](http://www.fasb.org/intl/convergence_iasb.shtml).

## ***Considering Ethical Responsibilities***

Just as you probably follow your own personal code of conduct, every profession should operate following ethical guidelines. In other words, you must always attempt to do the right thing, regardless of whether doing the right thing is at that particular moment best for you personally. Linked to staying

true to ethical responsibilities are such items as adhering to high standards of business behavior and fostering an atmosphere of trust and mutual respect between employees and customers.

## *Following the accountant's code of conduct*

Most professions that require state licensing have to abide by that state's code of conduct. In the case of financial accountants, this licensing is in the form of being designated as a certified public accountant (CPA).

In addition to state codes, your code of conduct as a financial accountant comes from the *AICPA*, which is the national professional organization for all CPAs. You don't have to be a member of the AICPA to be a CPA. If you're serious about your profession, membership has many rewards such as automatically informing you about new accounting and auditing standards.



Since the AICPA Code of Professional Conduct is for nonpublic companies, you're probably wondering about codes of conduct to follow when auditing publicly traded companies. All publicly traded companies' standard of professional conduct comes from The Public Company Accounting Oversight Board (PCAOB) of the SEC. (The acronym PCAOB is pronounced "Pee-Ca-Boo.") The Sarbanes–Oxley Act of 2002 established PCAOB.

But what if you're a financial accountant who isn't a CPA or a member of the AICPA? Do you still have to worry about abiding by a code of conduct? Well, of course you do. Any profession that lacks ethical behavior will descend into chaos. Financial accountants must have high professional standards, a strict code of professional ethics, and a commitment to serving the public interest. They achieve these goals through their integrity, objectivity, and independence.

## *Having integrity*

In the world of financial accounting, integrity means you act according to a code or standard of values. You demonstrate integrity when you do the right thing, regardless of whether doing so is best for you personally.

Accountants must follow specific rules, standards, or guidance. You read about these different standards and rules throughout the rest of this book. For example, Part II shows you the right way to prepare financial statements, Part III homes in on accounting for assets, and Part VI delves into accounting for debt and equity.

## Understanding the AICPA's effect on the Code of Conduct

You may be wondering what the big deal is about the AICPA Code of Professional Conduct, since membership in the AICPA isn't mandatory. Well, to practice as a CPA, you must be licensed by your state, which does recognize the authority of the AICPA. State and federal courts consistently hold that all practicing

CPAs, regardless of membership in the AICPA, must follow the professional ethical standards contained in their Code of Professional Conduct. Find out more about the Code of Professional Conduct at [www.aicpa.org/About/code/sec50.htm](http://www.aicpa.org/About/code/sec50.htm).

Keep in mind that you have to follow both the form and the substance of technical and ethical standards. Substance over form is a pretty common expression, but you may not understand exactly what it means. Form represents the tangible; you also may think of it as following the letter of the law. Substance represents an implied fact.

For intermediate accounting, integrity means that you prepare financial statements to the best of your ability, keeping in mind that doing so may not be the same as completely agreeing with the way the user of the financial statements prefers them to look.

In the same vein is the fact that you don't record a transaction in such a way that you hide the true effect of the transaction, regardless of whether you are following form. In other words, you must show the true nature (substance) instead of hiding a negative financial event behind form.

Integrity also requires you to be objective, remain independent, and show due care. Objectivity and independence are somewhat interrelated. Showing due care means you're competent and diligent. I discuss each in more detail in the next few sections of this chapter.

### *Maintaining objectivity*

Accountants must be *objective*, meaning impartial and intellectually honest. Being *impartial* means you're neutral and unbiased in all decision-making processes. You base your opinion and reporting only on the facts, not on any preconceived notions or prejudices. Remaining *intellectually honest* means that you interpret rules and policies in a truthful and sincere manner, staying true to both their substance and their form.

Therefore, despite what one person may tell you, until all the facts are revealed, you keep an open mind. And always keep in mind that whether the users of the financial statements *perceive* the accountant to be objective is just as important as the fact that the accountant is actually 100 percent objective.

## *Achieving independence*

Many types of public accounting services, such as auditing services, require the financial accountant be independent in both fact and appearance. Being *independent* while providing services means that you have no special relationship with or financial interest in the client that may cause you to disregard evidence and facts when evaluating your client.

What does it mean to be independent in both fact and appearance? The biggie is that you avoid any perceived conflicts of interest. You don't perform services for any client with whom you have either a personal or a non-audit-related business relationship. For example, if you have a significant financial interest with a major competitor of your client, your client may question whose best interests you have in mind while performing the accounting services.



The concept of independence and objectivity differs somewhat, depending on whether the financial accounting work is in public accounting or private accounting. In public accounting, the financial accountant (most likely a CPA) works for an accounting firm, providing services such as auditing or financial statement preparation for clients. In private accounting, you do accounting work for your own employer rather than for a client. Obviously, you can't strive for independence when you're doing accounting work for your own employer, so in private accounting, objectivity is key.

## *Taking due care*

When providing services, you must be competent and practice diligence. In addition, due care means you plan and supervise adequately any professional activity for which you are responsible. For example, your boss has the responsibility to make sure you understand how you are to handle your piece of the financial accounting pie and to supervise you to make sure you stay on course. Due care on your part as an accountant means you follow the instructions of your manager and ask questions if some accounting transaction comes up that you don't understand.

*Competence* means you have the education and experience to be able to do the job. Maintaining competence requires a commitment to professional development by taking continuing education classes throughout your career.

Each state requires a certain number of continuing education classes to recertify your CPA license. Most states require 80 hours of continuing education every two years, with 20 of those hours in accounting and auditing.

*Diligence* means you work to the best of your ability, showing concern for the best interest of the user of the financial statement while remaining consistent with your responsibilities and serving the public trust. It also means you provide information in a timely fashion.

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