FINANCIAL ACCOUNTING ENVIRONMENT

Financial accounting focuses on external users, primarily investors, creditors and financial intermediaries. Financial reporting is the process of providing relevant financial information to these third-party users.

The Economic Environment and Financial Reporting
Capital markets are a composite of investors and creditors who use published financial reports to make investment and/or credit decisions. The success of capital markets to a large degree depends on the integrity of the financial reporting process.

The primary capital markets are where publicly regulated corporations sell stocks and bonds. Once these securities are in circulation they are traded among investors in secondary markets. Once a corporation sells its securities in the primary market it receives no more revenue from activities in the secondary markets.

A Cash Flow Perspective: The Investment-Credit Decision
Investors purchase stock based on some anticipated future return. The cash flows as a result of an investment in publicly traded stock come from two sources: Periodic payment of dividends and the gain realized from the eventual sale of the stock. The two variables that are evaluated by investors are the expected rate of return and the uncertainty (risk) associated with ownership of the stock. Financial reports provide information needed in making investment and credit decisions. Based on this information investors and creditors assess the amounts, timing, uncertainty of future cash flows. Financial accounting plays a major role in providing reliable information to third party investors and creditors in making these decisions.

Cash Basis Accounting
On a cash basis the results of operations are called net operating cash flows. Although helpful information, short-term operating cash flows may not reflect the prospect for future cash flows of the business entity.

Accrual Accounting
Results of operations in accrual accounting are called net income. It reflects the revenues earned and the expenses incurred during the accounting period that result in net income or net loss. This is a better reflection of potential future cash flows of the business entity.

THE DEVELOPMENT OF FINANCIAL ACCOUNTING AND REPORTING STANDARDS

Generally accepted accounting principles provide the conceptual framework which is the theoretical foundation governing financial accounting, and somewhat specific standards that business entities must use in measuring and reporting financial information in published financial statements.

The federal government established regulator authority over publicly traded companies with the establishment of the 1933 Securities Act and the 1934 Securities Exchange Act. The Securities
Environment and Theoretical Structure of Financial Accounting

and Exchange Commission (SEC) was given the authority to set accounting and enforce financial accounting standards. The SEC was only given authority over business entities that sold stock to the public. Over the years the SEC has delegated the standards setting process to the private sector, although it has at times it has issued standards, *Financial Reporting Releases* (FRR) that apply to business entities directly under its regulation.

In the early years financial accounting standards were established by the Committee on Accounting Procedure (CAP) which was a committee of the American Institute of Accountants (AIA). The standards were specific applications of accounting and reporting issues. There was not theoretical framework to support the development of the standards. The standards issued by the CAP where called *Accounting Research Bulletins* (ARB).

The name of the AIA was changed to the American Institute of Certified Public Accountants (AICPA) in 1957. Shortly thereafter, the CAP was replaced by the Accounting Principles Board (APB). During its tenure the APB issued *Accounting Principles Board Options* (APBO), *Interpretations* and *Statements*. The APB attempted to establish a theoretical framework but was unsuccessful for a number of reasons.

The Financial Accounting Standards Board (FASB) was formed in 1973 to replace the APB. This was the first organization that was independent of the public accounting profession. The board is comprised of seven full-time members from a variety of constituencies that have a direct interest in financial accounting. At its formation the FASB adopted many of the previously issued ARBs and APBOs, APBO Interpretations and APBO Statements. Since its inception the FASB has developed a conceptual framework, *Statements of Financial Accounting Concepts* (FASCs), and issued specific standards, *Statements of Financial Accounting Standards* (SFAS), *Interpretations*, *Technical Bulletins* and *Emerging Issues Task Force* (EITF) Issues.

**The Establishment of Accounting Standards-A Political Process**

Changes in accounting standards can and do have significant economic impact on business entities and entire industries. The FASB is very careful to assess this impact before proposing a change in a standard or the adoption of a new standard. There is a lengthy due process that the FASB follows to make sure that the unintended consequences of its standards setting process is fully examined and understood.

**The Global Marketplace**

Many multinational corporations are domiciled in the U.S. These business entities must not only comply with accounting standards in this country but also comply with standards in a variety of host countries. The most important issue is access to capital markets. To access a particular capital market the issuing corporation must meet the financial accounting standards of the country in which the capital market is located. This has presented some problems which are currently being addressed.

The International Accounting Standards Committee (IASC) was formed to attempt to develop global accounting and reporting standards. After a recent reorganization it formed the International Accounting Standards Board (IASB) which has become the standard-setting body of the organization. This organization is working with financial accounting standards setting
organizations throughout the world in an attempt to bring some degree of harmonization among standards. This is a messy and slow process and probably will take many more years to achieve. The IASC issued 41 *International Accounting Standards* before forming the IASB. The IASB has endorsed these standards and will be issuing *International Financial Reporting Standards* in the future.

**The Role of the Auditor**
Management is responsible for applying GAAP in reporting financial information to third party users. To assure that management is fulfilling its obligation to the public; auditors are retained to provide independent, objective assurance that the financial statements prepared by management fairly reflect the results of operations and financial positions of the business entity. Auditors play a vital role in maintaining the integrity of the financial reporting process.

**Financial Reporting Reform**
As a result of the multiple business failures and associated audit failures congress passed the *Public Company Accounting Reform and Investor Protection ACT of 2002*. The key provisions of the act are as follows:

- Public Company Accounting Oversight Board was established with the authority to establish and enforce standards.
- Corporate executive accountability requires that corporate executives must personally certify the financial statements and related disclosures.
- Non-audit services are prohibited or severely restricted.
- Retention of work papers by public accountants is required.
- Auditor rotation is required and audit firm rotation is still under consideration.
- Conflicts of interest restrict the audit of corporations where a chief executive was recently a member of the audit firm.
- Hiring of the auditor must be done by the audit committee of the board of directors.