**CHAPTER 1 Financial Accounting and Its Economic Context**

**SYNOPSIS**

In this introductory chapter, the author discusses the economic context of financial accounting including:

1. the demand for financial information;
2. the environment of financial accounting;
3. the controls associated with the financial accounting process; and
4. generally accepted accounting principles.

The author illustrates and discusses the roles that equity investors, debt investors, managers, and auditors have in the financial accounting environment, providing a basis for the discussion of both a user orientation and an economic consequence perspective.

The author introduces the auditor’s report, the management letter, the financial statements and the footnotes. The author also presents the basic concepts of financial statement analysis, solvency and earning power. The basic forms of investment, debt and equity are described.

The economic environment in which financial reports are prepared and used is discussed and key elements of the financial environment are introduced.

An international perspective of the general state of accounting practices and standards throughout the world is also considered.

The ethics vignette considers the independence of accounting firms who also serve as middlemen in the sale of their audit client’s products.

The Internet research exercise examines subsequent results for Chipotle a company that has performed well during recent years, but fell short of analysts’ expectations in 2015.

The author compares and contrasts the four different types of accounting (i.e., financial, not-for-profit, managerial, and tax) along six dimensions in Appendix 1A.

The following learning objectives are emphasized in Chapter 1:

1. Discuss the role of financial reports in investment decisions and the difference between the economic consequence and user perspectives.

2. Explain the difference between consumption and investment and why investors demand documentation and independent audits.

3. Describe the standard audit report, management letter, four financial statements, and related footnotes.

4. Differentiate debt from equity and the concepts of solvency and earning power.

5. List the major elements of the environment in which financial reports are prepared and used and describe how these elements encourage effective corporate governance.

6. Summarize the current status of accounting standard setting – both in the United States and internationally.

**TEXT/LECTURE OUTLINE**

Financial accounting and its economic context.

I. Financial reporting and investment decisions.

A. Investment decisions.

1. *Profit-seeking companies* – Managers prepare reports for owners. These reports include the four financial statements: the balance sheet, income statement, statement of shareholders’ equity and statement of cash flows.

2. *Owners and other interested parties* including potential investors, bankers, government agencies, customers, and suppliers use publicly available financial reports to assess the financial condition and performance of the company and its managers.

3. *User decisions* are often based on information provided by financial reports.

4. *Effects of user decisions* may impact the financial condition of the company, its managers and owners.

B. Economic consequences.

The use of financial statements by outsiders leads to economic consequences for managers and companies. Knowledge of how business decisions effect the financial statements is useful in assessing how management decisions might be perceived by outsiders. Considering and understanding how such decisions affect the financial statements is an economic consequence perspective.

C. User orientation.

Managers need to know how financial statements are used. They also need to know how to read, evaluate, and analyze financial statements. This perspective is called user orientation. See also Appendix 1A introducing managerial, tax and not-for-profit accounting.

II. The demand for financial information: a user’s orientation (Mary Jordan / Microline vignette).

A. Consumption vs. investment.

B. Where to invest?

C. Demand for documentation.

D. Demand for independent audit.

E. Martin and the CPA: different incentives.

F. The auditor’s report, management letter, financial statements, and footnotes.

1. Balance sheet.

a. Assets.

b. Liabilities.

c. Shareholders’ equity.

i. Common stock.

ii. Retained earnings.

2. Income statement.

a. Revenues.

b. Expenses.

c. Net income.

3. Statement of shareholders’ equity – *retained earnings and* *dividends.*

4*.* Statement of cash flows.

*a.* Operating activities.

*b.* Investing activities.

*c.* Financing activities.

G*.* Analysis of financial statements.

1. Solvency.

2. Earning power.

H. Forms of investment.

1. Debt.

2. Equity.

I. Summary and wind up of Microline vignette.

III. The economic environment in which financial reports are prepared and used.

A. Key elements of the financial accounting environment.

1. Providers of capital.

a) Equity investors.

(1) Equity investors purchase ownership shares (i.e., equity) in a company.

(2) Equity investors are most interested in acquiring information about a company's earning power.

b) Debt investors.

(1) Debt investors loan capital to a company.

(2) Debt investors are most interested in acquiring information about a company's solvency position.

2. Managers.

3. Contracts.

a) Debt contracts.

b) Compensation contracts.

4. Financial accounting statements.

5. Independent auditors.

6. Legal liability.

7. Ethics and professional reputation.

B. Reporting entities and industries.

1. Consolidated financial statements.

2. Subsidiaries.

3. Industries.

a. Manufacturing.

b. Retailing.

c. Services.

d. SIC codes.

IV. Corporate governance.

A. Financial information users and capital markets.

1) Equity investors.

2) Debt investors.

3) Management and other users.

4) Capital markets.

B. Contracts.

1) Debt covenants.

2) Management compensation.

C. Regulations and standards.

1) SEC.

2) GAAP.

3) Political process.

D. Independent auditors.

1) “Big Four”.

2) Regional and local firms.

E. Board of directors and audit committee.

F. Sarbanes-Oxley Act (2002).

1) Certification by principal executive and financial officers.

2) Additional responsibilities to assure adequate internal control.

3) Annual report on internal controls over financial reporting.

G. Legal liability.

H. Professional reputation and ethics.

V. International Perspective: Movement Toward a Single Global Financial Reporting System.

VI. Appendix 1A Three Other Kinds of Accounting:

A. Not-for-profit accounting.

Not-for-profit accounting generates financial information for those entities that do not exist solely to generate profits.

B. Managerial accounting.

Managerial accounting generates financial information useful to managers for making day-to-day operating decisions.

C. Tax accounting.

Tax accounting generates financial information in compliance with the Internal Revenue Code.

VII. Ethics in the real world.

VIII. Internet research exercise.

**LECTURE TIPS**

1. Students often expect accounting to be a boring “cookbook” course. Discussion of Chapter 1 can set the tone for the rest of the course through a relevant, interesting discussion of the economics of accounting and an early introduction of real world examples.

2. Although students usually understand the motives underlying the economic consequences arguments, they often do not apply these motives to accounting.