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Paper : Financial Reporting & Analysis

Question No 1

Answer

1. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The AICPA is a professional accounting organization whose members are certified public accountants. During the 1930s, the AICPA had a special committee working with the New York Stock Exchange on matters of common interest. An outgrowth of this special committee was the establishment in 1939 of two standing committees the Committee on Accounting Procedures and the Committee on Accounting Terminology. These committees were active from 1939 to 1959 and issued 51 Accounting Research Bulletins (ARBs). These committees took a problem-by-problem approach, because they tended to review an issue only when there was a problem related to that issue. This method became known as the brushfire approach. They were only partially successful in developing a well-structured body of accounting principles. ARBs are part of GAAP unless they have been superseded. In 1959, the AICPA replaced the two committees with the Accounting Principles Board (APB) and the Accounting Research Division. The Accounting Research Division provided research to aid the APB in making decisions regarding accounting principles. Basic postulates would be developed that would aid in the development of accounting principles, and the entire process was intended to be based on research prior to an APB decision. However, the APB and the Accounting Research Division were not successful in formulating broad principles. The combination of the APB and the Accounting Research Division lasted from 1959 to 1973. During this time, the Accounting Research Division issued 14 Accounting Research Studies. The APB issued 31 Opinions (APBOs) and four Statements (APBSs). The Opinions represented official positions of the Board, whereas the Statements represented the views of the Board but not the official opinions. APBOs are part of GAAP unless they have been superseded.

2. FINANCIAL ACCOUNTING STANDARDS BOARD

The structure of the FASB is as follows:

A panel of electors is selected from nine organizations. They are the AICPA, the Financial Executives Institute, the Institute of Management Accountants, the Financial Analysts Federation, the American Accounting Association, the Security Industry Association, and three not for profit organizations. The elector's appoint the board of trustees that governs the Financial Accounting Foundation (FAF). There are 16 trustees. The FAF appoints the Financial Accounting Standards Advisory Council (FASAC) and the FASB. There are approximately 30 members of the FASAC. This relatively large number is to obtain representation from a wide group of interested parties. The FASAC is responsible for advising the Financial Accounting Standards Board.

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- **The FASB issues four types of pronouncements:**

1. Statements of Financial Accounting Standards.

These Statements establish GAAP for specific accounting issues. SFASs are part of GAAP unless they have been superseded.

2. Interpretations.

These pronouncements provide clarifications to previously issued standards, including SFASs, APB Opinions, and Accounting Research Bulletins. The interpretations have the same authority and require the same majority votes for passage as standards (a supermajority of five or more of the seven members). Interpretations are part of GAAP unless they have been superseded.

3. Technical bulletins.

These bulletins provide timely guidance on financial accounting and reporting problems. They may be used when the effect will not cause a major change in accounting practice for a number of companies and when they do not conflict with any broad fundamental accounting principle. Technical bulletins are part of GAAP unless they have been superseded.

4. Statements of Financial Accounting Concepts.

These Statements provide a theoretical foundation upon which to base GAAP. They are the output of the FASB's Conceptual Framework project. But they are not part of GAAP.

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3. Securities and Exchange Commission

The stock market crash of 1929 provoked widespread concern about external financial disclosure. Some alleged that the stock market crash was substantially influenced by the lack of adequate financial reporting requirements to investors and creditors. The Securities Act of 1933 was designed to protect investors from abuses in financial reporting that developed in the United States. This act was intended to regulate the initial offering and sale of securities in interstate commerce. In general, the Securities Exchange Act of 1934 was intended to regulate securities trading on the national exchanges, and it was under this authority that the Securities and Exchange Commission (SEC) was created. In effect, the SEC has the authority to determine GAAP and to regulate the accounting profession. The SEC has elected to leave much of the determination of GAAP and the regulation of the accounting profession to the private sector. At times, the SEC will issue its own standards. Currently, the SEC issues Regulation, which describes the primary formal financial disclosure requirements for companies. The SEC also issues Financial Reporting Releases that pertain to financial reporting requirements. Regulation S-X and FRRs are part of GAAP and are used to give the SEC's official position on matters relating to financial statements. The formal process that exists today is a blend of the private and public sectors. A number of parties in the private sector have played a role in the development of GAAP. The American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) have had the most influence.

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Question No.2

Answer

The sequence of accounting procedures completed during each accounting period is called the accounting cycle.

1. Recording transactions

2. Recording adjusting entries

3. Preparing the financial statements

RECORDING TRANSACTIONS

A transaction is an event that causes a change in a company's assets, liabilities, or stockholders' equity, thus changing the company's financial position. Transactions may be external or internal to the company. External transactions involve outside parties, while internal transactions are confined within the company. For example, sales is an external transaction, while the use of equipment is internal.

Transactions must be recorded in a journal (book of original entry). All transactions could be recorded in the general journal. However, companies use a number of special journals to record most transactions. The special journals are designed to improve record-keeping efficiency that could not be obtained by using only the general journal. The general journal is then used only to record transactions for which the company does not have a special journal.

A transaction recorded in a journal is referred to as a journal entry. All transactions are recorded in a journal (journal entry) and are later posted from the journals to a general ledger (group of accounts for a company). After posting, the general ledger accounts contain the same information as the journals, but the information has been
summarized by account
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Accounts store the monetary information from the recording of transactions. Examples of accounts include Cash, Land, and Buildings. An accounting system can be computerized or manual. A manual system using T-accounts is usually used for textbook explanations because a T-account is a logical format. T-accounts have a left (debit) side and a right (credit) side.
A double-entry system has been devised to handle the recording of transactions. In a double entry system, each transaction is recorded with the total dollar amount of the debits equal to the total dollar amount of the credits. The scheme of the double-entry system revolves around the accounting equation:
Assets Liabilities Stockholders' Equity With the double-entry system, *debit* merely means the left side of an account, while *credit* means the right side. Each transaction recorded must have an equal number of dollars on the left side as it does on the right side. Several accounts could be involved in a single transaction, but the debits and credits must still be equal.

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The debit and credit approach is a technique that has gained acceptance over a long period of time. This book will not make you competent in the use of the double-entry (debit and credit) technique. It will enhance your understanding of the end result of the accounting process and enable you to use the financial accounting information in a meaningful way. Asset, liability, and stockholders' equity accounts are referred to as permanent accounts because the balances in these accounts carry forward to the next accounting period. Balances in revenue, expense, gain, loss, and dividend accounts, described as temporary accounts, are closed to retained earnings and not carried into the next period.

RECORDING ADJUSTING ENTRIES

A distinction was made between the accrual basis of accounting and the cash basis. It was indicated that the accrual basis requires that revenue be recognized when realized (realization concept) and expenses recognized when incurred (matching concept). The point of cash receipt for revenue and cash disbursement for expenses is not important under the accrual basis when determining income. Usually, a company must use the accrual basis to achieve a reasonable result for the balance sheet and the income statement.

The accrual basis needs numerous adjustments to account balances at the end of the accounting period. For example, $1,000 paid for insurance on October 1 for a one-year period (October 1–September 30) could have been recorded as a debit to Insurance Expense ($1,000) and a credit to Cash ($1,000). If this company prepares financial statements on December 31, it would be necessary to adjust Insurance Expense because not all of the insurance expense should be recognized in the three-month period October 1–December 31. The adjustment would debit Prepaid Insurance, an asset account, for $750 and credit Insurance Expense for $750. Thus, insurance expense would be presented on the income statement for this period as $250, and an asset, prepaid insurance, would be presented on the balance sheet as $750.Adjusting entries are recorded in the general journal and then posted to the general ledger. Once the accounts are adjusted to the accrual basis, the financial statements can be prepared.

PREPARING THE FINANCIAL STATEMENTS

The accountant uses the accounts after the adjustments have been made to prepare the financial statements. These statements represent the output of the accounting system. Two of the principal financial statements, the income statement and the balance sheet, can be prepared directly from the adjusted accounts. Preparation of the statement of cash flows requires further analysis of the accounts.

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QUESTION NO 3

ANSWER

Forms of Business Entities

A business entity may be a sole proprietorship, a partnership, or a corporation. A sole proprietorship, a business owned by one person, is not a legal entity separate from its owner, but the accountant treats the business as a separate accounting entity. The profit or loss of the proprietorship goes on the income tax return of the owner. The owner is responsible for the debts of the sole proprietorship. In the United States, a sole proprietorship may qualify to be treated as a limited liability company (LLC). As an LLC, the owner may limit the liability of the sole proprietor, but may increase the tax exposure of the proprietorship A partnership is a business owned by two or more individuals. Each owner, called a partner, is personally responsible for the debts of the partnership. The accountant treats the partners and the business as separate accounting entities. The profit or loss of the partnership goes on the individual income tax return of the partners. Like a proprietorship, a partnership may qualify to be treated as an LLC. As an LLC, the owners may limit the liability of the partners, but may increase the tax exposure of the partnership. In the United States, a business corporation is a legal entity incorporated in a particular state. Ownership is evidenced by shares of stock. A corporation is considered to be separate and distinct from the stockholders. The stockholders risk only their investment; they are not responsible for the debts of the corporation. Since a corporation is a legal entity, the profits or losses are treated as a separate entity on an income tax return. The owners are not taxed until profits are distributed to the owners (dividends). In the United States, some corporations qualify to be treated as a sub chapter corporation. These corporations do not pay a corporate income tax. The profits or losses go directly on the income tax returns of the owners. In the United States, most businesses operate as proprietorships, but corporations perform the bulk of business activity. Since the bulk of business activity is carried on in corporations and because much of financial accounting is concerned with reporting to the public, this book focuses on the corporate form of business. Accounting for corporations, sole proprietorships, and partnerships is the same, except for the owners' equity section of the balance sheet. The owners' equity section for a sole proprietorship consists of the owners' capital account, while the owners' equity section for a partnership has a capital Account for each partner. The more complicated owners' equity section for a corporation will be described in detail in this book.

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The Financial Statements

The principal financial statements of a corporation are the balance sheet, income statement, and statement of cash flows. Notes accompany these financial statements. To evaluate the financial condition, the profitability, and cash flows of an entity, the user needs to understand the statements and related notes. The interrelationship of the balance sheet, income statement, and statement of cash flows. The most basic statement is the balance sheet. The other statements explain the changes between two balance sheet dates.

BALANCE SHEET (STATEMENT OF FINANCIAL POSITION)

A balance sheet shows the financial condition of an accounting entity as of a particular date. The balance sheet consists of three major sections: assets, the resources of the firm; liabilities, the debts of the firm; and stockholders' equity, the owners' interest in the firm. At any point in time, the total assets amount must equal the total amount of the contributions of the creditors and owners. This is expressed in the accounting equation: Assets Liabilities Stockholders' Equity
In simplistic form, the stockholders' equity of a corporation appears as follows:

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STATEMENT OF STOCKHOLDERS' EQUITY
(RECONCILIATION OF STOCKHOLDERS' EQUITY ACCOUNTS)

Firms are required to present reconciliations of the beginning and ending balances of their stockholders' equity accounts. This is accomplished by presenting a "statement of stockholders' equity." Retained earnings is one of the accounts in stockholders' equity. Retained earnings links the balance sheet to the income statement. Retained earnings is increased by net income and decreased by net losses and dividends paid to stockholders. There are some other possible increases or decreases to retained earnings besides income (losses) and dividends. For the purposes of this chapter, retained earnings will be described as prior earnings less prior dividends. Firms usually present the reconciliation of retained earnings within a "statement of stockholders' equity." Some firms present the reconciliation of retained earnings at the bottom of the income statement (combined income statement and retained earnings). In this case, the other stockholders' equity accounts may be reconciled in a statement that excludes retained earnings.

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INCOME STATEMENT (STATEMENT OF EARNINGS)

The income statement summarizes revenues and expenses and gains and losses, ending with net income. It summarizes the results of operations for a particular period of time. Net income is included in retained earnings in the stockholders' equity section of the balance sheet. (This is necessary for the balance sheet to balance.)

STATEMENT OF CASH FLOWS (STATEMENT OF INFLOWS AND OUTFLOWS OF CASH)

The statement of cash flows details the inflows and outflows of cash during a specified period of time the same period that is used for the income statement. The statement of cash flows consists of three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities.