


**Chapter 1, Module 2 – Introduction Part 2**

**Slide 1**

*Chapter 1 Module 2*

**AMIS 211**  
**Introduction to Financial Accounting**

Professor Marc Smith



Hi everyone. Welcome back.

Do you remember where we left off from last time?

We were talking about a basic investment Scenario.

Imagine you are the Investor. And, you are thinking about investing some money either in Company A or Company B.

And, we said, “How are you going to go about making that decision?”

And we said, “Look, among other things, you are going to look at the financial statements of those two companies. And you are going to compare them to see: which is the better investment.

And then, we left off the last module with this question:

Go ahead to the next slide with me.

**Slide 2**

*Chapter 1 Module 2: Introduction*

**QUESTION**

**In order for the comparison of financial statements to be meaningful what needs to be true about the two sets of financial statements?**

Here was the question:

In order for this comparison of financial statements that you are going to make to decide which of the two is the better investment—in order for that comparison to be valuable and meaningful—what needs to be true about the two sets of financial statements?

Hopefully, you have thought about it for a couple of minutes anyway and have tried to come up with an answer to yourself.

Let's go to the next slide and see if you were able to come up with the right answer.

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*Chapter 1 Module 2: Introduction*

**ANSWER:**

**The two sets of financial statements must be prepared using the same methods, concepts, terminology, classifications, etc.**

**In other words, the outside user must be able to compare apples to apples in order to obtain value from the comparison of financial statements**

**How is this goal achieved?**

The answer is: those two sets of financial statements need to be prepared using the same set of rules, procedures, terminology, concepts, and so on and so forth.

You need to be able to compare “apples to apples” in making decisions.

If the two different companies were following their own sets of rules, then comparing those two statements would not tell you anything. The comparison would be worthless and have no meaning whatsoever. You might as well not bother wasting your time.

But, by having everybody follow that one set of rules—by having everyone prepare their statements in the same way; using the same terminology, the same standards, etc.; now, we can make meaningful comparisons across the board.

We can compare a lot of different companies. We can compare companies in different industries in trying to decide: What is a better investment? Is this a good credit risk? And, so on and so forth...

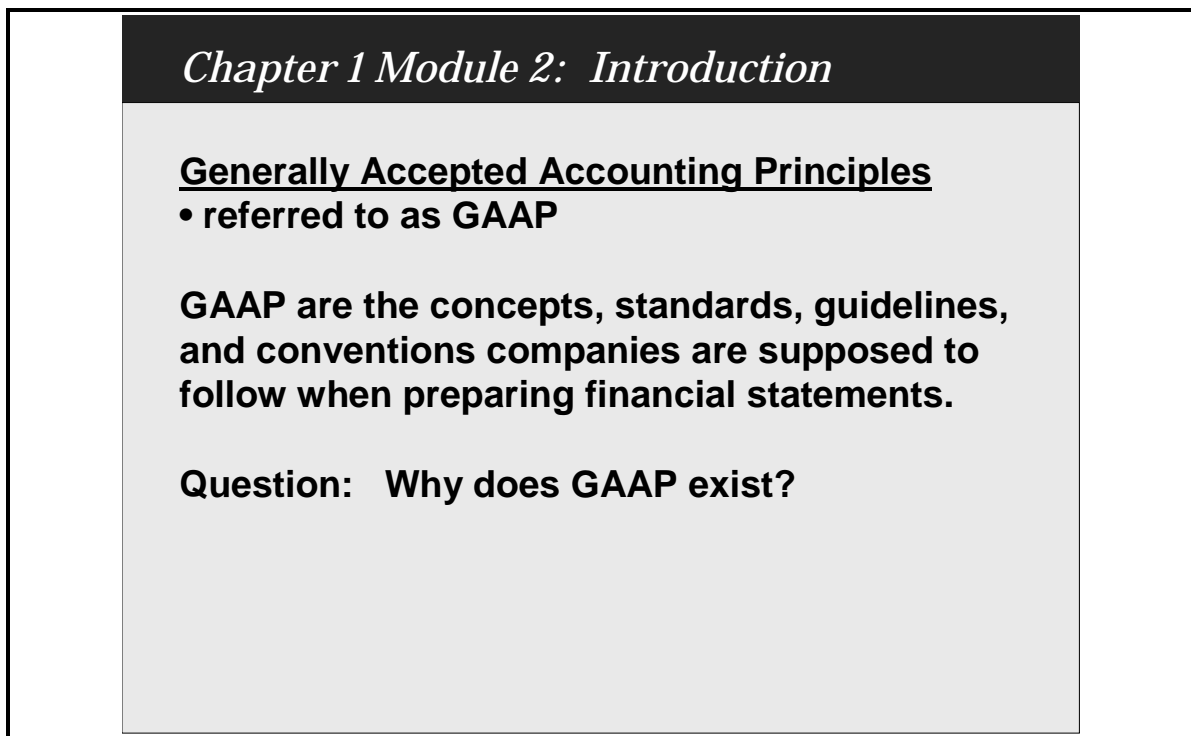
So, this is important: this idea of everybody preparing statements in the same way.

The next question, of course, that we need to answer is:

How do we get that to happen? How do we achieve this goal of having everybody follow the same set of concepts in preparing financial statements?

To see the way in which we do that, go to the next slide with me...

**Slide 4**

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*Chapter 1 Module 2: Introduction*

**Generally Accepted Accounting Principles**  
• referred to as GAAP

**GAAP are the concepts, standards, guidelines, and conventions companies are supposed to follow when preparing financial statements.**

**Question: Why does GAAP exist?**

It is through a set of rules referred to as: Generally Accepted Accounting Principles (GAAP, for short). It is much easier to write: GAAP: G-A-A-P; than Generally Accepted Accounting Principles.

We can define GAAP as the concepts, procedures and standards that must be followed in preparing financial statements.

All companies should prepare financial statements according to GAAP.

The next question is then: Why bother? Why is GAAP even meant to be around? Why does GAAP exist?

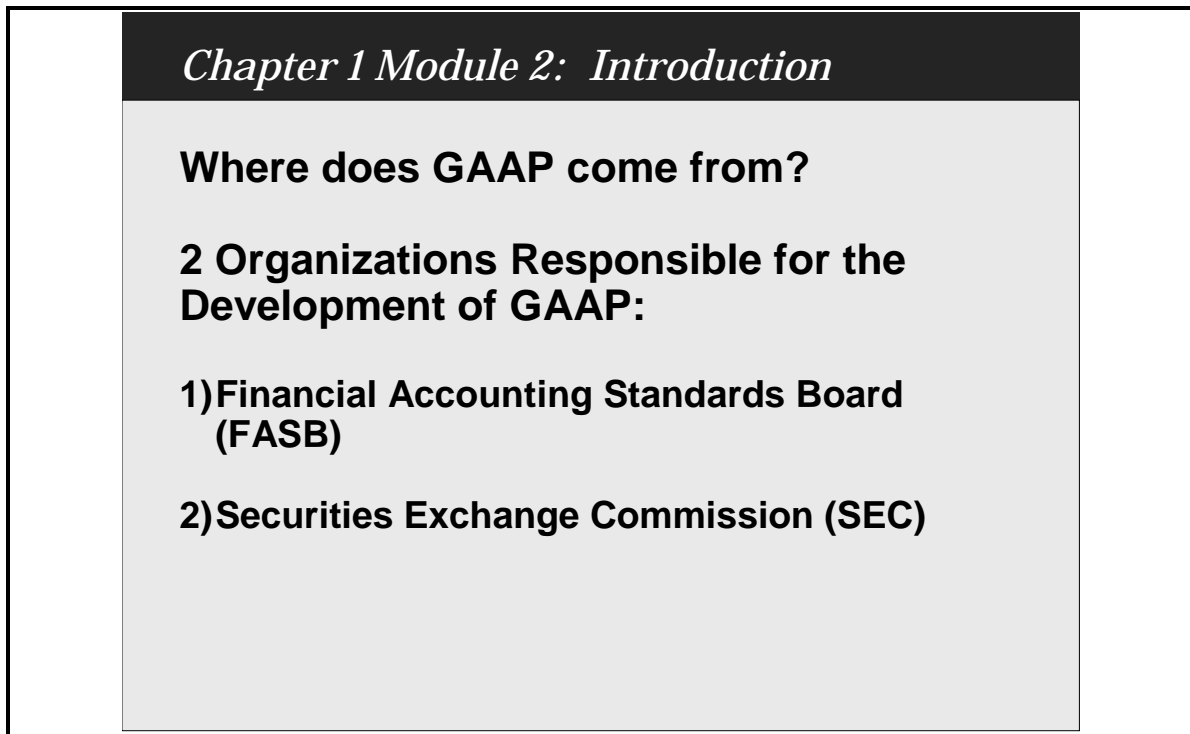
This has kind of brought us full circle, right?

The reason GAAP exists is: it allows these comparisons to have meaning. It allows the users of financial statements—the people we are so worried about, the people we are trying to get information to: the Investors and Creditors—it allows them to make meaningful comparisons and aide in their decision-making process.

And, that is what this is really all about: getting information to decision makers so they can make, hopefully, a high quality decision.

Go ahead to the next slide with me.

**Slide 5**

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*Chapter 1 Module 2: Introduction*

**Where does GAAP come from?**

**2 Organizations Responsible for the Development of GAAP:**

- 1) Financial Accounting Standards Board (FASB)**
- 2) Securities Exchange Commission (SEC)**

So, we know what GAAP is: the set of rules that everybody must follow in preparing their financial statements.

Where do they come from?

Who actually develops this Generally Accepted Accounting Principles (GAAP)?

There are actually two (2) organizations out there that have the ability or responsibility to develop GAAP.

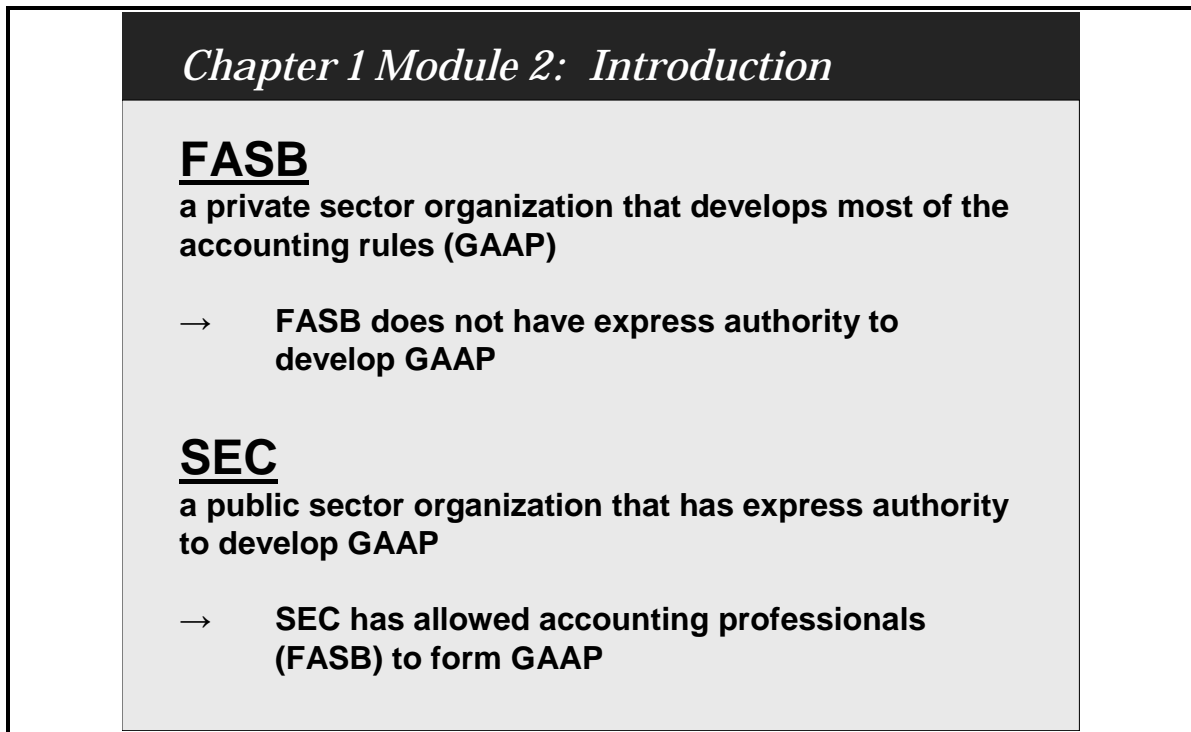
One of the organizations is 1) the Financial Accounting Standards Board (FASB). You will hear it pronounced—the FAS-BEE. It stands for the Financial Accounting Standards Board.

The other organization—one that you have probably heard of—is 2) the Securities Exchange Commission—the SEC.

How do these two organizations differ?

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**Slide 6**

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*Chapter 1 Module 2: Introduction*

**FASB**  
a private sector organization that develops most of the accounting rules (GAAP)

→ **FASB does not have express authority to develop GAAP**

**SEC**  
a public sector organization that has express authority to develop GAAP

→ **SEC has allowed accounting professionals (FASB) to form GAAP**

You see that: the FASB is a private sector organization whereas the SEC is a public sector organization.

It might be worth noting that: the private sector organization is one in which there is no government control. So, a private sector company is one that is NOT run by the government.

A public sector organization—such as the SEC—is one that is controlled by the government.

Look at the rest of that definition for FASB: a private sector organization that develops most of our accounting rules; most of GAAP; whereas the SEC is a public sector organization who has the authority to develop GAAP.

So, what is the story here?

Here is the way it works.

Back in the mid 1930s, Congress passed a law—the Securities and Exchange Act that developed the SEC—that brought about the Securities Exchange Commission (SEC).

Now, if you remember back to the 1930s what was going on was the Great Depression, right? We had just had that huge problem with the Stock Market crash.

So, Congress came up with this agency—the SEC—and said, “Hey SEC! You are responsible. It is your job to develop accounting rules that all these companies are supposed to follow. Oh, and by the way, SEC, we are going to give you a lot of other stuff to do as well.”

At some point the SEC just could not do it all.

So, the FASB came about.

And, the FASB—all they do—all that they are intended to do is develop accounting rules. They do not get involved in anything else. They simply develop GAAP and monitor the rules that exist.

But, they have no express authority to have anybody follow these rules. They can develop rules until they are blue in the face and companies do not need to follow them. They have no authority to do this.

So, what has happened is: the FASB develops the rules and the SEC basically gives the meat to them by saying: “Look, we have the express authority. You must follow these rules, Companies, or you are going to be subject to fines and perhaps worse.”

So, the SEC, while they have the express authority to do the standard setting, they do not get involved that much in actual standard setting. That is the FASB. But, the SEC, then, provides the “meat” to it by having that authority that everybody, thus, must follow it.

So, this whole Generally Accepted Accounting Principles (GAAP) idea is very important:

There is one set of rules that everyone must follow. That way we can make meaningful comparisons among financial statements.

Those rules; they are regulated and developed by the FASB and the SEC.

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Slide 7

*Chapter 1 Module 2: Introduction*

**QUESTION:** How do we know that companies are following GAAP in preparing their financial statements?

**ANSWER:** Companies need to have their financial statements audited every year by an independent auditor

Another question for you:

Think about it before we give you the answer.

We have the rules and we know who sets them.

But, how do we know that companies actually follow them in preparing financial statements? How do we have any assurance or any comfort level in knowing that these companies follow GAAP in preparing their financial statements?

The answer is: Companies need to have what is called: a Financial Statement Audit.

And, they need to have an audit of their financial statements every year by an independent auditor.

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**Audit of Financial Statements**

- Independent audits are required to safeguard investors and creditors from misleading financial statements.
- The auditor must issue an audit report that will state if the statements are fair and comply with GAAP.
- The independent audit report must accompany the financial statements.

Audits of financial statements must be done by independent auditors—that is those people who are not directly related to the company being audited.

The purpose, or intent, of the audit is to provide some safeguard to Investors and Creditors so they do not have misleading financial statements.

When companies DO NOT follow GAAP in preparing their financial statements—think Enron—bad things happen! Creditors and Investors lose a lot of money.

So, by having these independent audits, we, at least, give some comfort level to Creditors and Investors that the financial statements they are looking at are prepared using Generally Accepted Accounting Principles (GAAP).

As a quick aside: we know that when the auditors are involved with the companies—as tightly wound together as Enron and Arthur Andersen were—that whole idea of independence gets really cloudy. And, that is when financial statements tend to be misleading and the company does bad things. They do not follow GAAP. And, people lose a lot of money.

So, this idea of independence is really very important.

Once the auditor has completed the audit, they will give the company what is called: an Audit Report.

And, this Audit Report, which basically states that either the statements follow GAAP or they DO NOT follow GAAP, will actually be attached to the financial statements that are issued by the company.

So, this independent Audit Report will always accompany the financial statements. And thus, as a user, not only will you be able to look at the statements, but you will be able to see the Audit Report that says: Yes or No, the financial statements do or do not conform to GAAP.

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### Slide 9

#### *Chapter 1 Module 2: Introduction*

##### **Why Are Audits Necessary?**

- Managers have an incentives to use 'flexible' accounting methods to manipulate the statements.
- Some of the reasons for manipulating financial data include:
  - To deceive investors and creditors into providing cash to the company
  - Management bonuses and compensation are tied to firm performance
  - To avoid violating debt (loan) covenants
  - To avoid higher tax liability

Last question for you:

Why are audits necessary? Why do we have to do them? Why can't we just trust the companies? They want to do what is in our best interests, right?

Audits are necessary because managers often have incentives to use what we will term “flexible” or “creative” accounting methods to manipulate the financial statements—to maybe make it so the statements do not reflect reality.

Some of the common reasons for doing this include:

One reason is to deceive Investors and Creditors into putting money into the company.

So: “Hey look, Investors and Creditors! Our financial statements look great. ‘Invest here!’ or ‘Lend money here!’”

They might not be as accurate as they should be if they DO NOT follow GAAP.

Another reason that managers have this incentive: oftentimes, they have a bonus or compensation tied to financial goals.

So: “Hey, Manager! You will get a 40% bonus if Net Income is a certain amount.”

All of the sudden you have given them a huge incentive to make sure that the Net Income is that certain amount, whether or not it actually is, they do not care. They want that bonus.

Having an audit would certainly detect something like that.

Another reason is: to avoid violating debt or loan covenants.

Oftentimes, when you borrow money, the bank will require you to sign a note. And, within the note are certain rules that you must follow. And, those rules are typically financial in nature and relate to numbers in the financial statements. If you violate the terms, usually the loan comes due immediately.

So, to prevent something like that from happening, we might try to manipulate the numbers.

Another reason, of course, is: to avoid a high tax liability.

Showing a high profit is great but it also means that the government is going to get its bigger share or its claws into that money. And, we might want to try to avoid that.

So, independent audits are very important. They provide some comfort level to the users of financial statements that those statements follow GAAP.

We will wrap this module up with this:

I think it is very important to recognize that just because the audit says the financial statements conform to GAAP DOES NOT guarantee that they do.

All it does is provides some level of assurance called “reasonable assurance” that the statements follow GAAP. There are no guarantees with an audit but it gives you at least some comfort level.