Chapter 1

The Demand for and Supply of Financial Accounting Information

Content Analysis of End-of-Chapter Assignments

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
1-1	Role of Financial Reporting	Financial accounting; financial reporting	1		Easy	5	Analytic	Measurement	Understand
1-2	Financial Reporting Stakeholders	Major categories of financial reporting stakeholders	1		Easy	5	Analytic	Measurement	Understand
1-3	Financial Reporting Stakeholders	Different information needs of investors and creditors	1		Easy	5	Analytic	Measurement	Apply
1-4	Information Asymmetry	Information asymmetry between financial reporting preparers and users	1		Easy	5	Analytic	Measurement	Understand
1-5	Financial Reporting Information	Demand for financial reporting information	1		Easy	5	Analytic	Measurement	Apply
1-6	Accounting Standards and Audits	Demand for accounting standards and audit verification	1		Easy	5	Analytic	Measurement	Understand
1-7	Generally Accepted Accounting Principles	Definition of U.S. GAAP	1		Easy	5	Analytic	Measurement	Understand
1-8	Standard Setting	Supply of accounting information	2		Easy	5	Analytic	Measurement	Understand
1-9	Standard Setting	Role of SEC	2		Easy	5	Analytic	Measurement	Understand
1-10	Standard Setting	Role of FASB	3		Easy	5	Analytic	Measurement	Understand
1-11	Standard Setting	Role of EITF	3		Easy	5	Analytic	Measurement	Understand
1-12	Standard Setting	FASB Accounting Standards Codification	4		Easy	5	Analytic	Measurement	Apply

Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
1-13	Standard Setting	Process for issuing accounting standard update	4		Easy	5	Analytic	Measurement	Understand
1-14	Standard Setting	FASB; IASB	5		Easy	5	Analytic	Measurement	Analyze
1-15	Standard Setting	Definition of IFRS	5		Easy	5	Analytic	Measurement	Apply
1-16	Standard Setting	Changing standards over time; U.S. GAAP; IFRS	5		Easy	5	Analytic	Measurement	Understand
1-17	Standard Setting	The impact of pure theory vs. politics in standard setting	5		Easy	5	Analytic	Measurement	Analyze
1-18	Financial Statements	Balance sheet; financial reporting stakeholders	6		Easy	5	Analytic	Reporting	Apply
1-19	Financial Statements	Income statement; financial reporting stakeholders	6		Easy	5	Analytic	Reporting	Apply
1-20	Financial Statements	Statement of cash flows; financial reporting stakeholders	6		Easy	5	Analytic	Reporting	Apply
1-21	Financial Statements	Statement of shareholders' equity; financial reporting stakeholders	6		Easy	5	Analytic	Reporting	Apply
1-22	Financial Statements	Purpose of footnotes; disclosure of financial information	6		Easy	5	Analytic	Reporting	Apply
1-23	Earnings and the Stock Market	Economic consequences of earnings information	7		Easy	5	Analytic	Measurement	Analyze
1-24	Ethics	Ethics	7		Easy	5	Analytic	Measurement	Apply
1-25	Ethics	Ethics; code of professional conduct	7		Easy	5	Analytic	Measurement	Understand

Number	Topic	Content	LO	Adapted	Difficulty	Time	AACSB	AICPA	Bloom's
MC1-1	Stakeholders	Different stakeholders that need financial statement information	1		Easy	5	Analytic	Reporting	Understand
MC1-2	Business Activities	Financing activities	1		Easy	5	Analytic	Reporting	Understand
MC1-3	Business Activities	Investing activities	1		Easy	5	Analytic	Reporting	Understand
MC1-4	Business Activities	Operating activities	1		Easy	5	Analytic	Reporting	Understand
MC1-5	Demand	Information asymmetry	1		Easy	5	Analytic	Reporting	Understand
MC1-6	Supply	Determinants of supply	2		Easy	5	Analytic	Reporting	Understand
MC1-7	FASB	Structure of the FASB	3		Easy	5	Analytic	Reporting	Understand
MC1-8	Codification	Objective of the Codification	4		Easy	5	Analytic	Reporting	Understand
MC1-9	IASB and IFRS	Importance	5		Easy	5	Analytic	Reporting	Understand
MC1-10	Product	Balance sheet information	6		Easy	5	Analytic	Reporting	Understand
MC1-11	Product	Income statement information	6		Easy	5	Analytic	Reporting	Apply
MC1-12	Product	Statement of cash flows information	6		Easy	5	Analytic	Reporting	Apply
MC1-13	Economic Consequences	Returns consequences associated with changes in earnings	7		Easy	5	Analytic	Reporting	Apply
MC1-14	Ethics	AICPA Code of Ethics	7		Easy	5	Analytic	Reporting	Apply

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME	AACSB	AICPA	BLOOM'S
E1-1	Stakeholders	Different characteristics and needs for information	1		Easy	5	Analytic	Reporting	Understand
E1-2	Demand	Demand for information in different financial statement0073	1		Easy	10	Analytic	Reporting	Understand
E1-3	Supply	Role of SEC and FASB	2		Easy	10	Analytic	Reporting	Understand
E1-4	FASB	Characteristics of standard setters	3		Easy	10	Analytic	Reporting	Understand
E1-5	Codification	Objective and use of the Codification	4		Easy	10	Analytic	Reporting	Understand
E1-6	IASB	The SEC and IFRS	5		Easy	10	Analytic	Reporting	Understand
E1-7	Product	Financial statement information	6		Easy	10	Analytic	Reporting	Understand
E1-8	Product	Balance sheet information	6		Easy	10	Analytic	Reporting	Apply
E1-9	Product	Income statement information	6		Easy	10	Analytic	Reporting	Apply
E1-10	Economic Consequences	Returns consequences associated with changes in earnings	7		Easy	10	Analytic	Reporting	Apply

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
C1-1	Accounting Principles	Describe the meaning of the terms "accounting principles" and "generally accepted"	3	AICPA	Easy	10	Analytic	Measurement	Apply
C1-2	Standard Setting	Describe why there is political action and social involvement in the standard-setting process	3	CMA	Easy	10	Analytic	Measurement	Apply
C1-3	Organization of the FASB	Summarize the structure of the FASB and its operating procedures	3		Easy	15	Analytic	Measurement	Apply
C1-4	Code of Professional Conduct	Identify, briefly discuss, and provide examples to illustrate the first five principles of CPC	7		Easy	10	Analytic	Measurement	Apply
C1-5	Lobbying the FASB	Discuss pros and cons of lobbying the FASB by interested parties	3		Easy	5	Analytic	Measurement	Apply
C1-6	International Convergence	Discuss convergence of U.S. GAAP and international accounting standards; include discussion of SEC and its role in this convergence; includes IFRS	5		Moderate	10	Analytic	Measurement	Apply
C1-7	Clorox's Financial Statements	Identify two important pieces of information from each of the four primary financial statements and management discussion and analysis	6		Moderate	20	Analytic	Reporting	Apply

Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
C1-8	Nestlé's Financial Statements	Identify two important pieces of information from each of three primary financial statements	6		Moderate	20	Analytic	Reporting	Apply
C1-9	Coca Cola's Financial Statements	Identify two important pieces of information from each of three primary financial statements	6		Moderate	20	Analytic	Reporting	Apply
C1-10	Ethical Responsibilities	Discuss steps to take in an ethical dilemma ("misplaced" book in library)	7		Moderate	5	Reflective Thinking	Measurement	Analyze
C1-11	Ethical Responsibilities	Discuss steps to take in an ethical dilemma (cheating by friend on exam)	7		Moderate	5	Reflective Thinking	Measurement	Analyze
C1-12	Codification	Prepare a memo to explain and demonstrate the Codification to an introductory accounting student, who is familiar with the financial statements and accounts			Moderate	25	Analytic	Measurement	Apply
C1-13	Codification	Search the Codification to determine how a company should account for the cost of a new desktop computer for use in the office			Moderate	15	Analytic	Measurement	Apply
C1-14	Codification	Search the Codification to determine how a company should account for recognition of retail revenues with the right to return			Moderate	25	Analytic	Measurement	Apply

Answers to Got It?

1-1 The objective of financial accounting is to identify, measure, record, and report relevant and reliable financial information about companies to present and potential future stakeholders. Financial reporting is the process of communicating financial accounting information about a company to existing and potential future investors, creditors, and other external decision makers and stakeholders. An important way a company's financial accounting information is reported is in its quarterly and annual reports. The role of financial reporting is to inform investors, creditors, and other stakeholders. Financial reporting also provides information to mitigate agency problems which stem from the separation of ownership and control of resources.

1-2 The primary stakeholders that are important users of financial information include investors, creditors, banks, suppliers, customers, employees, executives, labor unions, pension funds, government regulatory authorities, tax authorities, local communities, and many others (see Exhibit 1.1). In class we discuss how these stakeholders can be divided into two major categories: external users and internal users. These two groups do not have the same decision-making information needs because of their differing relationships with the company providing economic information. Of these groups, FASB has stated the primary purpose of financial reporting is to inform investors and creditors.

1-3 Investors and creditors take different downside risks and enjoy different potential upside gains from investing or lending. Equity investors are the residual risk bearers of corporations but stand to enjoy potentially greater upside if the company is successful and profitable. Creditors face less risk of loss of their investments because they have superior claim in bankruptcy over equity investors. But creditors do not share in the same upside potential as equity investors. As a result of these differences, their information needs differ. Equity investors are more concerned with profitability, whereas creditors tend to be more focused on cash flows.

1-4 Information asymmetry arises from the separation of ownership and control of resources. Financial reporting helps reduce (but not eliminate) information asymmetry problems by enabling managers (agents) to provide relevant and faithfully represented information to investors and creditors (principals), thereby reducing information asymmetry.

1-5 The demand for financial accounting information, as an economic good in society, arises from the needs of equity shareholders, creditors, and various other stakeholders for information to make resource allocation decisions. This demand arises because businesses have to compete for and attract scarce economic resources, such as equity and debt capital, productive resources, employees, supplier and customer relationships, and so forth. In order to compete for these valuable resources, companies must provide relevant and faithfully represented information to those who can provide the resources.

1-6 To solve the problems that would arise from biases in a self-reporting accounting system, a natural demand arises for *accounting standards and audits*. The demand for accounting information drives the demand for professionally established accounting standards that provide authoritative guidance on how to measure and report economic activities in financial statements. In addition, the demand for accounting information also drives the demand for auditing—independent verification and attestation of whether the financial statements have been fairly presented in accordance with professional accounting standards.

1-7 Generally Accepted Accounting Principles (GAAP) are the principles, concepts, guidelines, procedures, and practices that U.S. companies that are listed in the United States and subject to SEC regulation are required to use in recording and reporting the accounting information in audited financial statements.

1-8 The supply of accounting information that companies report to external stakeholders is determined primarily by the interactions between two sets of forces:

- The authoritative professional accounting standards that govern in the company's country of incorporation, such as U.S. GAAP or IFRS, and
- the many choices, methods, estimates, and judgments that the company must make in order to apply those accounting standards to measure and report their financial statements.

1-9 The stated mission of the U.S. Securities and Exchange Commission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." The U.S. Congress created the SEC to administer the Securities Act of 1933 and the Securities Exchange Act of 1934. Under these Acts, the SEC has the legal authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities within the U.S. capital markets. The SEC has mandated that the information communicated to external users in financial reporting be based on professionally established accounting principles, such as GAAP for U.S. companies and IFRS for non-U.S. companies.

The SEC delegates the authority over standard setting to private standard-setting bodies within the accounting profession, such as the Financial Accounting Standards Board (FASB) establishing GAAP for U.S. companies and the International Accounting Standards Board (IASB) establishing IFRS for companies from many other countries around the world. The SEC monitors closely and oversees the standards being developed by these standard setters. From time to time, the SEC exerts pressure on the standard setters to adopt, or not adopt, specific standards.

1-10 The FASB is responsible for identifying financial accounting issues, conducting research to address these issues, and resolving them by issuing new accounting standards applicable to U.S. companies. The FASB fulfills its responsibility by:

- establishing standards that are the most acceptable, given the various affected constituencies, and
- continually monitoring the consequences of its actions so that revised standards can be issued where appropriate.

1-11 In assisting the FASB, the primary objectives of the EITF are:

- to identify significant emerging accounting issues (i.e., unique transactions and accounting problems) that it feels the FASB should address.
- to develop consensus positions on the implementation issues involving the application of standards. In some cases, these consensus positions may be viewed as the ''best available guidance'' on GAAP, particularly as they relate to new accounting issues.

1-12 The Codification is an electronic database that integrates and topically organizes the U.S. GAAP into one coherent body of literature. There are six levels in the framework of Codification: Areas, Topics, Subtopics, Sections, Subsections, and Paragraphs. The Topics level contains a collection of related guidance on a particular subject Area. The Subtopics level includes subsets of a Topic. The Sections level characterizes the nature of the content in a Subtopic (e.g., Recognition, Measurement, Disclosure). The Subsections level provides finer breakdown of the content in a Section. Paragraphs contain the guidance that constitutes GAAP.

The FASB developed the Codification to achieve three goals:

- Simplify user access by codifying all authoritative U.S. GAAP in one spot.
- Ensure the codified content accurately represented all authoritative U.S. GAAP.
- Create a codification research system that is up to date, including the most recently released standards.

1-13 Before issuing an Accounting Standards Update, the FASB generally completes a multistage process as follows:

(1) identifies topic
(2) appoints task force
(3) conducts research
(4) issues Discussion Memorandum or Invitation to Comment
(5) holds public hearings
(6) deliberates on findings
(7) issues Exposure Draft
(8) holds public hearings
(9) modifies Exposure Draft
(10) votes

After a supermajority vote (at least five votes out of seven) is attained, the FASB issues an *Accounting Standards Update*.

1-14 The FASB and IASB are overseen and supported by Foundations comprised of Boards of Trustees and supported by large staffs of professional and technical experts and administrative support. Similarly, both Boards have Advisory Councils as resources for input. Unlike the Financial Accounting Foundation, the IFRS Foundation Trustees are overseen by the IFRS Foundation Monitoring Board, which consists of capital markets authorities from jurisdictions around the world that require or allow the use of IFRS. Both Boards follow similar open, careful due processes in deliberating new accounting standards. Whereas the FASB is a seven-member Board consisting of only U.S. members, the IASB is larger, with 14 full-time members. The composition of the IASB is structured to contain a balanced representation from different countries and regions of the world. The IASB issues *International Financial Reporting Standards (IFRS)*. To do so, its operating procedures include study of the topic, issuance of an Exposure Draft, evaluation of comments, and consideration of a revised draft. If approved by at least nine members of the IASB, the *International Financial Reporting Standard* is issued.

1-15 They are the principles, concepts, guidelines, procedures, and practices that companies from the roughly 140 countries that have adopted IFRS are required to use in recording and reporting the accounting information in audited financial statements. In the United States, the SEC has decided to allow non-U.S. companies that are listed in the United States and subject to SEC regulation to use IFRS for preparation of financial statements filed with the SEC.

1-16 The FASB and the IASB have completed most of their major joint projects, which have helped achieve greater convergence between U.S. GAAP and IFRS. The collaborative efforts of the FASB and the IASB are on a path to both improve U.S. GAAP and IFRS and eliminate or minimize the differences between them.

1-17 Because of the substantial economic consequences of new standards, key constituents often disagree about the objectives for new standards. Because the Boards hold public hearings and open meetings, various external user groups (e.g., investors and creditors) and other interested parties (e.g., affected corporations and CPA firms) exert pressure to influence the new standards, continue existing standards, or change existing standards in their own best interests. In addition, research results about the likely effects of new standards are sometimes conflicting, and only "best guesses" can be made of the future consequences of current standards. A particular difficulty is that costs of complying with new standards are often significant and measurable, whereas the benefits of new information to decision makers are diffuse and hard to quantify. As a consequence, the FASB and the IASB often make decisions about new accounting standards that sometimes require compromise between conflicting views and interests.

1-18 The balance sheet, or statement of financial position, presents a snapshot of the resources of a firm (assets) and the claims on the company (liabilities and shareholders' equity) as of a specific date (usually the last day of the fiscal quarter or the fiscal year). The balance sheet reports the following equality:

Assets = Liabilities + Shareholders' Equity

Most stakeholders in a company, particularly investors and creditors, will be interested in balance sheet information because it reports the financial position (resources and obligations) of the company.

1-19 The income statement measures and reports the financial results of a firm's performance for a period of time, usually a quarter or a year. The income statement provides information about the profits (or losses) the firm has generated during the period by conducting operating, investing, and financing activities. Most stakeholders in a company, particularly equity investors, will be interested in income statement information because it reports the profits and losses that accrue to the common equity shareholders of the company. The chapter shows empirical research evidence on how changes in earnings are associated with changes in stock prices.

1-20 The statement of cash flows reports for a period of time the net cash flows (inflows minus outflows) from the three principal categories of business activities: operating, investing, and financing. The purpose of the statement of cash flows is important but simple: to provide useful information about how a firm is generating and using cash. The statement of cash flows provides information to complement the income statement, demonstrating how cash flows differ from accrual-based income.

Cash flow information is very helpful to financial statement users who want to gauge how the firm is executing its strategy. The statement is particularly useful to creditors and other stakeholders with claims on future cash flows of a firm. The statement of cash flows helps them evaluate the firm's cash-generating ability, giving them information about the likelihood of future cash flows for future payments of their obligations.

1-21 The statement of shareholders' equity (sometimes called the *statement of changes in shareholders' equity*) provides information about the common shareholders' equity claims on the company and how those claims changed during the period. The year-end amounts reported in this statement for the various common shareholders' equity accounts will match the amounts reported in the shareholders' equity section of the balance sheet. Equity investors will be particularly interested in the information in this statement.

1-22 A firm's accounting system records the results of transactions, events, and commercial arrangements and generates the financial statements, but the financial statements do not stand alone. To provide more relevant and representationally faithful information for financial statement users, firms typically provide a substantial amount of important additional information with the financial statements, including the Notes, Management Discussion and Analysis, and Managers' and Independent Auditors' Attestations. The notes to the statements explain the methods, assumptions, and estimates the firm has used in measuring and reporting the accounting information in the financial statements.

1-23 To illustrate the striking links between accounting earnings and stock returns, the chapter provides a brief discussion of the results from empirical research by D. Craig Nichols and James Wahlen. They studied the average cumulative market-adjusted stock returns generated by firms during the 12 months leading up to and including the month in which each firm announced annual earnings numbers. For a sample of 43,827 firm-years between 2002 and 2019, they found that the average firm that announced an increase in earnings (over the prior year's earnings) experienced stock returns that beat market average returns by roughly 12.3%. On the other hand, the average firm that announced a decrease in earnings experienced stock returns that were roughly 13.1% lower than the market average. Their results suggest that merely the sign of the change in earnings was associated with a 25.4% stock return differential in one year, on average, over their sample period. The results show that earnings information has important economic consequences because changes in earnings are strongly associated with significant changes in share prices.

1-24 As accountants, we create valuable financial information that stakeholders use to make informed resource allocation decisions about companies. Accounting information triggers substantial economic consequences for a wide array of different stakeholders in a company. Because accounting information has such important consequences for so many different stakeholders, being an accountant requires the ability to bear this great responsibility while behaving ethically.

1-25 The *Code of Professional Conduct* is a document published by the AICPA to help guide members in public practice, industry, government, and education in performing their responsibilities in an ethical and professional manner. The six areas covered by the Principles are (1) responsibilities, (2) public interest, (3) integrity, (4) objectivity and independence, (5) due care, and (6) scope and nature of services.

Answers to Multiple-Choice

MC 1-1	**(LO1.1)**	Answer: E
MC 1-2	**(LO1.1)**	Answer: C
MC 1-3	**(LO1.1)**	Answer: B
MC 1-4	**(LO1.1)**	Answer: A
MC 1-5	**(LO1.1)**	Answer: B
MC 1-6	**(LO1.2)**	Answer: B
MC 1-7	**(LO1.3)**	Answer: C
MC 1-8	**(LO1.4)**	Answer: A
MC 1-9	**(LO1.5)**	Answer: C
MC 1-10	**(LO1.6)**	Answer: A
MC 1-11	**(LO1.6)**	Answer: B
MC 1-12	**(LO1.6)**	Answer: C
MC 1-13	**(LO1.7)**	Answer: A
MC 1-14	**(LO1.7)**	Answer: C

Solutions to Exercises

E 1-1 (LO 1.1)

Stakeholders:	**Description**
Investors	Receive the profits of successful companies but bear the bottom-line risk of losses if the company is not successful
Creditors	Have superior claim in bankruptcy
Investors	Tend to be more interested in earnings, dividends, and share appreciation
Creditors	Tend to be more interested in cash flows

E 1-2 (LO 1.1)

Demand for Financial Reporting

The balance sheet will help the banker approve your loan by providing her with information about your company's liquidity, the amount of liabilities (particularly any other bank loans you might have outstanding), and the amount of equity capital you have invested in your company. The income statement will help your banker evaluate your revenues, expenses, and net income. The statement of cash flows will help your banker evaluate how your company has been generating and using cash in the business. Ideally, if these financial statements reveal that your company has strong liquidity, not an excessive amount of other loans or liabilities outstanding, adequate equity capital, strong growth in revenues and profits, and strong cash flows from operations, the banker will be more likely to approve your loan.

E 1-3 (LO 1.2)

The SEC has governmental authority over the capital markets, securities trading, and accounting standards and financial reporting. The SEC has delegated its authority to set the accounting principles that must be followed by U.S. companies that are listed on stock exchanges to the FASB. The SEC exercises its authority over the FASB primarily through input and persuasion rather than edict.

E 1-4 (LO 1.3)

The characteristics that FASB members need to have include:

- Full-time employees with no other organizational ties
- Represent a wide cross section of interests (financial statement preparers, auditors, users, and academics)
- Knowledge of and experience in accounting, finance, business, and accounting education and research
- High intelligence, integrity, and discipline
- A concern for the public interest regarding investing, financial accounting, and financial reporting.

E 1-5 (LO 1.4)

Prior to the Codification, the FASB had issued over 2,000 pronouncements, many of which were lengthy, hard to use, and sometimes conflicting. Accountants sometimes found that the standards lacked a consistent and logical structure, which made it difficult and time consuming for them to determine the "right" answer to an accounting issue. The FASB created the Codification to help users of accounting standards (practitioners, regulators, students, the standard setters themselves, and others) by establishing a searchable electronic database that integrates and topically organizes U.S. GAAP into one coherent body of literature. The FASB developed the Codification to achieve three goals:

- Simplify user access by organizing and categorizing (codifying) all authoritative U.S. GAAP in one database.
- Ensure the codified content accurately represented all authoritative U.S. GAAP.
- Create a codification research system that is up to date, including the most recently updated standards.

E 1-6 (LO 1.5)

The SEC permits non-U.S. companies to list securities on U.S. capital markets and file their financial statements with the SEC using IFRS. But the SEC does not allow U.S. companies to use IFRS to prepare and file financial statements. The SEC requires U.S. companies to use U.S. GAAP.

E 1-7 (LO 1.6)

	Description
Statement of Cash Flows	Reports the cash inflows and cash outflows from operating, investing, and financing activities for a period of time.
Balance Sheet	Presents a snapshot of the resources of a firm and the claims on these resources at a point in time.
Income Statement	Measures and reports the financial results of a firm's performance for a period of time.
Balance Sheet	Provides information useful to help stakeholders evaluation a company's liquidity and leverage.
Statement of Shareholders Equity	Provides information about the common shareholders' claims on the company and how those claims changed during the period.
Income Statement	Provides information about the resources the company generated and consumed to produce and sell goods and services to customers and operate the business during a period.

E 1-8 (LO 1.6)

Based on the information in Clorox's balance sheets in Exhibit 1.10:

1. Total assets increased from $6,213 million on June 30, 2020, to $6,334 million on June 30, 2021.
2. Inventories experienced the largest increase (from $454 million to $752 million), and cash and cash equivalents experienced the largest decrease (from $871 million to $319 million).
3. Clorox finances its assets with a much greater proportion of liabilities ($5,742 million) than stockholders' equity ($592 million) as of June 30, 2021. Liabilities were also the much greater proportion of financing at the end of fiscal 2020.
4. Liabilities increased from $5,305 million to $5,742 million during 2021.
5. Stockholders' equity decreased from $908 million to $592 million during 2021.

E 1-9 (LO 1.6)
Based on the information in Clorox's income statements in Exhibit 1.11:

1. Clorox's net sales increased every year, from 2019 ($6,214 million) to 2020 ($6,721 million) and again from 2020 to 2021 ($7,341 million). That indicates Clorox faces strong and growing demand for its products during those years.
2. Clorox's net earnings increased from $820 million in fiscal 2019 to $939 million in fiscal 2020. However, net earnings decreased to $710 million in fiscal 2021. Strong revenue growth during fiscal 2020 was accompanied by an increase in net earnings. But in fiscal 2021, strong revenue growth was more than offset by increasing expenses, which caused net earnings to drop. (In class discussion, we sometimes point out that the most obvious cause for the drop in earnings was the $329 million charge for goodwill, trademark, and other asset impairment during 2021. Without that charge and assuming all else equal, net earnings would have increased in 2021.)
3. Clorox's largest expense on the income statement is cost of products sold ($4,142 million in fiscal 2021). This represents the costs to manufacture and deliver Clorox's products to customers.

E 1-10 (LO 1.7)

Assuming both investments performed like the average results presented in Exhibit 1.14:

1. The value of your investment in the company at the end of the year in which earnings increased would have grown from $10,000 to $11,230 (an increase of 12.3%).
2. Unfortunately, the value of your friend's investment in the company at the end of the year in which earnings decreased would have dropped from $10,000 to only $8,690 (a decline of −13.1%).
3. The difference in value between your portfolio and your friend's portfolio would have amounted to $2,540. As a result, you might want to use some of your gains to do something nice for your friend to make them feel better!

Answers to Cases

C1-1 [AICPA Adapted]

1. The term “accounting principles” in the auditor’s report includes not only accounting principles but also concepts, practices, and the methods of applying them. The auditor's report typically refers to “accounting principles” being applied by the firm being audited. The independent auditor's attestation as to the fairness of a company's financial statements relative to U.S. GAAP or IFRS is an essential element for the reliability of financial statements.

2. Generally accepted accounting principles are those principles that have substantial authoritative support. The SEC has deemed the FASB’s Accounting Standards Codification as GAAP for U.S. companies. In addition, the SEC has deemed IFRS as generally accepted accounting principles for non-U.S. companies that issue securities that are listed in the United States. The FASB and the IASB follow extensive, due processes to deliberate and develop new accounting standards that, if adopted, become “generally accepted.”

C1-2 [CMA Adapted]

Financial accounting standards inspire or encourage political action and social involvement during the standard-setting process because the effects and economic consequences of accounting standards are wide ranging and impact many varying groups. The setting of accounting standards is a social decision, and the user groups play a significant role and have considerable influence.

The economic consequences of financial accounting standards inspire companies, stakeholders, and special interest groups to become vocal and critical when standards are being formulated. The reporting of financial information impacts companies’ financial statements and the wealth and decision making of stakeholders in differing ways. Companies and stakeholders may want particular economic events accounted for in particular ways and are willing to fight for what they want.

The formulation of accounting standards has political roots in the Securities and Exchange Acts of 1933 and 1934. Although the SEC was vested with complete authority to define and formulate accounting standards, it has, for the most part, delegated this authority to the private sector. The SEC supports the FASB in this endeavor and encourages its “due process” system of standard setting. Financial accounting standards issued are considered to be “generally accepted accounting principles,” and, as such, they must be followed in the preparation of financial statements. Therefore, the formulation of standards is of vital interest to companies responsible for preparing the financial statements, stakeholders that use the statements, and auditors.

C1-3

The Financial Accounting Foundation is the parent organization of the FASB. It is governed by a 14- to 18-member Board of Trustees appointed from the memberships of eight organizations (the AICPA, Financial Executives Institute, Institute of Management Accountants, CFA Institute, American Accounting Association, Securities Industry and Financial Markets Association, Government Finance Officers Association, and National Association of State Auditors, Comptrollers, and Treasurers) interested in the formulation of accounting principles. The primary responsibilities of the Financial Accounting Foundation are to provide general oversight to its operations and appoint the members of the Financial Accounting Standards Advisory Council (FASAC) and the FASB. The FASAC consists of about 33 members; it is responsible for advising the FASB about major policy issues, the priority of topics, the selection of task forces, the suitability of tentative decisions, and other matters.

There are seven members of the FASB. Appointees to the FASB are full-time, fully paid members with no other organizational ties and are selected to represent a wide cross section of interests. Each Board member is required to have a knowledge of, and experience in, accounting, finance, investing, business, and accounting education and research; high intelligence, integrity, and discipline; and a concern for the public interest regarding investing, financial accounting, and financial reporting. The FASB is responsible for identifying financial accounting issues, conducting research to address these issues, and resolving them. The FASB is supported by a research and technical staff that performs numerous functions such as researching issues, communicating with constituents, and drafting preliminary findings. The administrative staff assists the FASB by handling library, publications, personnel, and other activities.

Operating Procedures and Pronouncements. Before issuing an accounting standards update, the FASB generally completes a multistage process, although the sequence and numbers of steps may vary. Initially, a topic or project is identified and placed on the FASB's agenda. This topic may be the result of suggestions from the FASAC, the accounting profession, industry, or other interested parties. On major issues, a Task Force may be appointed to advise and consult with the FASB's Research and Technical Staff on such matters as the scope of the project and the nature and extent of additional research. The Staff then conducts any research specifically related to the project.

A Preliminary Views document or Invitation to Comment, which outlines the research related to the issues, is then usually published and a public comment period is set. During this period, public hearings, similar to those conducted by Congress, may be held. The intent is to receive information from and views of interested individuals and organizations on the issues. Many parties submit written comments ("position papers") or make oral presentations. These parties include representatives of CPA firms and interested corporations, security analysts, members of professional accounting associations, and academicians, to name a few. After deliberating on the views expressed and information collected, the FASB issues an Exposure Draft of the proposed Accounting Standards Update. Interested parties generally have 30–90 days to provide written comments of reaction. On major issues, more public hearings may be held. Sometimes, a "field test" of the proposed standard is conducted with selected companies to evaluate implementation issues. A modified draft is prepared, if necessary, and brought to the FASB for a final vote. After a supermajority vote (at least five of seven votes in favor) is attained, the *FASB Accounting Standards Update* is issued.

C1-4

The first five principles of the AICPA's *Code of Professional Conduct* are as follows:

1. Responsibilities: In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities. For example, when a member chooses a depreciation method, she must carefully analyze each alternative based upon well-defined criteria before making a final choice.

2. The Public Interest: Members should act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism. When a member refuses to ignore internal control deficiencies in a company with publicly traded stock, but instead enumerates these deficiencies in the Auditor's report, she is adhering to the public interest principle.

3. Integrity: To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity. For example, a member who carefully and conscientiously performs each step of an audit without skipping those steps that are tedious or of less interest is exercising the integrity principle.

4. Objectivity and Independence: A member should be objective and be free from conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services. For example, a member who declines to audit the financial statements of the company for which his father is a marketing vice president is adhering to this principle.

5. Due Care: A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability. When a member reads current accounting literature and strives to employ current principles and procedures, she is exercising due care.

C1-5

On balance, most people would agree that it is a good idea for the FASB to allow written comments and oral presentations in which interested parties can lobby for a particular ruling. However, there are both pros and cons to allowing interested parties to provide input to its deliberation process. They include:

Advantages

- Enables FASB to get input from different perspectives
- Provides users a forum to express concerns
- Provides preparers a forum to express concerns
- Provides auditors a forum to express concerns
- Overcomes criticism of failing to listen to constituencies
- Allows for consideration of views of all interested parties
- Rulings appear more fair to all constituencies

C1-5 (concluded)

- Rulings consider the costs and benefits of implementation
- Standards are established that are the most acceptable
- Allows for clarification of rules
- Allows for corrections of any errors
- Allows for consideration of implementation issues

Disadvantages

- Interested parties can present views and opinions that are biased by their own self interests to try to influence the FASB
- Interested parties can seek to reduce the likelihood of new standards that are against their self-interest by bringing political pressure to bear on the FASB
- Considering a wide array of differing views and opinions can slow down the standard-setting process

C1-6

Currently, U.S. corporations are subject to the accounting standards (called U.S. GAAP) established by the FASB, while foreign corporations are subject to international standards called IFRS (international financial reporting standards) established by the International Accounting Standards Board (IASB) or by their national accounting standards boards. These differences in accounting standards have led to differences among U.S. and foreign corporations' financial statements. These differences, in turn, have made it difficult for investors and creditors to make valid comparisons across corporations and to make effective buy-sell-hold decisions in the U.S. and foreign capital markets.

To overcome this problem, the FASB and the IASB began working together toward convergence. The Boards have completed their joint efforts on most of their major projects to achieve greater convergence between U.S. GAAP and IFRS.

Moving forward, the FASB will continue to work on global accounting issues with the IASB through its membership in the Accounting Standards Advisory Forum, an advisory body comprising 12 standard setters from across the globe. Both Boards also provide quarterly progress reports that can be downloaded from their websites.

In July 2012, the SEC staff issued its report considering incorporating IFRS into the financial reporting system for U.S. companies. The 2012 report summarized the staff's findings regarding key issues surrounding the potential incorporation of IFRS into U.S. financial reporting but did not make any recommendation to the Commission. In the report, the staff identified a number of unresolved issues relating to the potential incorporation of IFRS into the U.S. financial reporting system. These issues include the diversity in how IFRS are interpreted, applied, and enforced in various jurisdictions around the world; the potential cost to U.S. issuers of adopting or incorporating IFRS; investor education; and governance.

The movement by more foreign companies to using IFRS has created two potential problems for U.S. companies using U.S. GAAP ("regulated companies") and that operate globally. First, their financial statements are likely to be different from those of the foreign companies with which they are competing for capital, creating difficulties for investors in comparing companies. Second, if they have subsidiaries operating in foreign countries, they may be required to prepare their subsidiaries' financial statements according to IFRS for local filings. Since they still have to prepare their financial statements using U.S. GAAP to file with the SEC, this creates potential costly inefficiencies. There are many issues related to this possible change, and they are very complex and far reaching. These include:

(1) Many U.S. companies (particularly smaller ones) filing with the SEC do not operate globally, so they would not see any advantage to using IFRS. If IFRS were required, it would likely be very costly for them to switch from U.S. GAAP to IFRS, thereby affecting their profitability during the conversion period.

(2) The vast majority of U.S. corporations do not issue publicly traded securities and therefore are not regulated by the SEC. These corporations use U.S. GAAP in preparing their financial statements. A switch to IFRS for regulated U.S. companies would create a "dual-GAAP" system in the United States.

(3) Accountants, auditors and financial statement users would have to be trained and/or retrained to understand the impact of IFRS on the preparation of financial statements and the related audits of companies using IFRS.

(4) Many companies have entered contrats with covenants based on U.S. GAAP, For example many companies have borrowed money with loan contracts that have debt covenants based on U.S. GAAP that restrict their financing activities. A shift to IFRS would require renegotiating these contracts and debt covenants.

<u>C1-7</u>

Note to Instructor: This is an open-ended case question intended to get students reading and thinking about interesting information in each of the financial statements for Clorox. Because of its open-ended nature, we take an open-minded approach to the answers students might offer. We are willing to accept any reasonable answers regarding what students consider to be interesting information, so long as the information is drawn from the appropriate statement and is explained in an appropriate manner. Some simple examples for each statement follow.

Balance Sheet:

- Large holdings of cash and cash equivalents, $871 million at fye 2020, but a significant drop to $319 million by fye 2021.
- Large amounts of receivables and inventory, $604 million and $752 million, respectively.
- Jump in property, plant, and equipment, from $1,103 million to $1,302 million.
- Significant decrease in long-term debt financing—from $2,780 million to $2,484 million, but that is because $300 million has become current.
- Total equity ($592 million) comprises just over 9% of the liabilities and equity, $6,334 million Clorox has a proportionately very large amount of liabilities relative to equity. Accounts payable and accrued liabilities amount to $1,675 million.

- As noted in the chapter, Clorox has raised $1,317 million from issuing common equity, but it has used more than that to repurchase treasury stock, $1,396 million. The majority of equity arises from retained earnings, which amounts to $1,036 million. Students may note that retained earnings actually exceeded total shareholders' equity.
- As of fye 2021, Clorox recognizes its first noncontrolling interests in equity. This arose from the acquisition of the Saudi joint venture, and the noncontrolling interests represent the remaining Saudi investors' interests.

Income Statement:

- Nice jump in net sales in 2021 (+9.2%)—from $6,721 million to $7,341 million. Much of this increase is due to the surge in demand for Clorox products as a result of the pandemic.
- Along with the growth in revenues, most of the operating expenses experienced significant increases. Some students will also note that in fiscal 2021, Clorox recognized $329 million in impairment charges for goodwill, trademarks and other assets. The net result is a big decrease in operating income, from $1,185 million in 2020 to $900 million in 2021.
- Income tax expense in fiscal 2021 is $181 million.
- Record earnings in fiscal 2020 of $939 million.

Statement of Cash Flows:

- Operating cash flows in fiscal 2021 are very healthy: $1,276 million, a large portion of which comes from net earnings plus the depreciation and amortization addback as well as the addback of the noncash impairment charge.
- Investing cash outflows: ($452 million), primarily for capital expenditures.
- Financing cash outflows: ($1,391 million), consisted primarily of payments for dividends ($558 million) and repurchases of common stock ($905 million).
- Cash balance decreased in 2021, from $879 million to $324 million. Sharp students will notice that these amounts differ from the amounts reported for cash and cash equivalents on the balance sheets. The difference is due to the amounts of restricted cash included in other assets.

Statement of Shareholders' Equity:

- Interesting pieces of information about equity from the balance sheet can be applied to this part of the case, too.
- Other comprehensive income items during fiscal 2021 of $94 million reduced the accumulated other comprehensive loss from $640 million to $546 million.
- Retained earnings decreased despite net earnings of $710 million. The decline is attributable to dividends declared ($564 million) and the retirement of treasury stock ($2,640 million) subtracted from retained earnings.

Management Discussion and Analysis:

The MD&A section contains many pieces of information, including:

- Information on the performance of the four segments and the factors that contributed to sales growth in each segment.
- The impact of events related to the COVID-19 pandemic.
- The two different treasury stock purchase programs.

C1-8

Note to Instructor: This is an open-ended case question intended to get students reading and thinking about interesting information in each of the financial statements of Nestlé. Because of its open-ended nature, we take an open-minded approach to the answers students might offer. We are willing to accept any reasonable answers regarding what students consider to be interesting information, so long as the information is drawn from the appropriate statement and is explained in an appropriate manner. Some simple examples for each statement follow.

Note: all amounts in millions of CHF

Balance Sheet:

- The largest assets consist of goodwill (CHF 31,012 million), property, plant, and equipment (CHF 28,345 million), intangible assets (CHF 22,223 million), inventories (CHF 11,982 million), investments in associates and joint ventures (CHF 11,806 million), and trade and other receivables (CHF 11,155 million).
- Total assets amount to CHF 139,142 million.
- More financing from debt than from equity—total liabilities amount to CHF 85,415 million and total equity amounts to CHF 53,727 million.
- Financial debt—current (CHF 10,092 million) and noncurrent (CHF 36,482 million)—represent Nestle's largest borrowings.
- The largest liability that arises from operating activities is trade and other payables (CHF 20,907 million).
- Retained earnings account for common equity: CHF 81,363 million.

Income Statement:

- Revenues of CHF 87,088 million in 2021, an increase of 3.25% over 2020.
- Profit for the year was CHF 17,196 million in 2021, up significantly from CHF 12,372 for 2020.

Statement of Cash Flows:

- Operating cash flows are very healthy in 2021: CHF 13,864 million, most of which comes from operating profit plus the non-cash items.
- Investing cash flows in 2021: CHF –3,044 million, with capital expenditures being a large use of cash (CHF –4,880 million). Nestlé also generated and used large amounts of cash for acquisitions and divestitures of business and associates and joint ventures.
- Financing cash flows in 2021: (CHF –9,152 million), primarily for dividends and purchases of treasury shares.
- Cash balance increased CHF 1,757 million: CHF 5,235 million at the beginning of 2021, CHF 6,992 million at the end of 2021.

C1-9

Note to Instructor: This is an open-ended case question intended to get students reading and thinking about interesting information in each of the financial statements for Coca-Cola. Because of its open-ended nature, we take an open-minded approach to the answers students might offer. We are willing to accept any reasonable answers regarding what students consider to be interesting information, so long as the information is drawn from the appropriate statement and is explained in an appropriate manner. Some simple examples for each statement follow.

Balance Sheet:

- Enormous holdings of cash, cash equivalents, and short-term investments $10,926 million.
- Largest assets—goodwill ($19,363 million), trademarks with indefinite lives ($14,465 million) and equity method investments ($17,598 million).
- Significant holdings of property, plant, and equipment $9,920 million.
- Total assets are $94,354 million.
- Financial debt—current ($3,307 million in loans and notes payable plus $1,338 million in current maturities of long-term debt) and long-term ($38,116 million).
- Financed with more debt than equity—total liabilities amount to $69,494 million and total equity amounts to $24,860 million.
- The majority of equity arises from retained (reinvested) earnings.

Income Statement:

- Net operating revenues of $38,655 million in 2021.
- Big jump in revenues—from $33,014 million in 2020 to $38,655 million in 2021 (+17.1%).
- Equity income ballooned from $978 million in 2020 to $1,438 million in 2021.
- Big jump in net income: $9,804 million in 2021, up considerably from 2020 net income of $7,768 million.

Statement of Cash Flows:

- Operating cash flows are healthy in 2021: $12,625 million, up considerably from 2020, when they were $9,844 million.
- Investing cash flows in 2021: ($2,765 million), primarily for additions to property, plant, and equipment and (net) purchases of investments.
- Financing cash flows in 2021: ($6,786 million), primarily for dividends ($7,252 million). Coca-Cola issued $13,094 million in debt but repaid $12,866 million
- Cash balance increased by $2,915 million in 2021, from $7,110 million to $10,025 million.

C1-10

Note to Instructor: Listed below are some possible findings that students may discuss at each step in the moral reasoning process:

I. Gather facts: (A) What has occurred? (1) there is only one copy of the needed book, (2) everyone in my class is required to use the book to write a report, (3) the book has been intentionally misfiled. (B) Who are the stakeholders? (1) me, (2) classmate who has misfiled the book, (3) other members of the class, (4) the professor, (5) other students wanting to use the book, (6) library staff. (C) What are my responsibilities? (1) to write a report (2) to be socially responsible. (D) How will my actions affect the stakeholders? My actions will affect the stakeholders who need to use the book, the professor who gave the assignment, the library staff, and the student who "misfiled" the book. If I report the misfiling, my actions will likely help the other students and I prepare the assignment, will help the professor and the library staff, and will likely incur negative consequences for the person who misfiled the book.

II. Ask whether the action (my classmate misfiling the book) is acceptable according to ethical criteria: (A) How does the action affect stakeholders? (1) the classmate who misfiled the book can satisfactorily use the book without having to wait his turn, (2) I am unable to use the book to finish my report, (3) the rest of the class cannot use the book to finish their reports, (4) the professor cannot collect the assignment on the regularly scheduled due date, (5) others wanting to use the book cannot find it, (6) library staff will be forced to search for the book. (B) Does the action respect the rights of all stakeholders? (1) the classmate who misfiled the book has the right to use the book, (2) other members of the class as well as other students have the right to use the book, but cannot if it is misfiled, (3) the professor cannot exercise his/her right to set due dates and expect them to be adhered to, (4) the library staff cannot effectively and efficiently perform its job. (C) Is the act fair and just? (1) purposely preventing others from completing an assignment is not fair, (2) making it difficult for others to find a book is not just, (3) inhibiting the library staff's ability to perform its job is not fair, (4) forcing the professor to accept late reports is not just.

III. Consider whether there are any overwhelming factors that may justify disregarding any of the ethical criteria: In this situation, there do not appear to be overwhelming factors but students may bring up issues like: (1) classmate has full-time job, (2) classmate is disabled, (3) classmate has family (or other) obligations, (4) library has limited hours.

IV. Decide what ethical action to take: Students may decide on a number of alternative courses of action, including: (1) doing nothing, (2) discussing with classmate, (3) discussing with other students to exert pressure on classmate to refile book, (4) reporting to professor (in person or anonymously).

C1-11

Note to Instructor: Listed below are some possible findings that students may discuss at each step in the moral reasoning process:

I. Gather facts: (A) What has occurred? (1) my friend copied an answer, (2) she received an A on the test, (3) I received a B on the test, (4) our professor is unaware that she cheated, (5) I am aware that she cheated. (B) Who are the stakeholders? (1) my friend who cheated, (2) me, (3) student from whom my friend copied the answer, (4) our professor, (5) other members of the class, (6) all students in other sections of the same course, (7) all accounting students at my school who have taken the same class, (8) all students who will be competing with my friend for jobs, (9) all accountants, (10) company that hires her. (C) What are my responsibilities? (1) to take the examination honestly (2) to be socially responsible. (D) How will my actions affect the stakeholders? My actions will affect the stakeholders involved with the exam: the professor who gave the exam, the students who took the exam and did not cheat, including me, the student who cheated on the exam; and the other stakeholders who evaluate (and hire) students based on their academic performance, including results on exams. If I report the cheating, my actions will likely help the professor, the other students and I to be evaluated fairly on this exam, and will likely incur negative consequences for the person who cheated.

II. Ask whether the action (my friend's cheating) is acceptable according to ethical criteria: (A) How does the action affect all stakeholders? (1) her copying led to a short-term satisfaction in the form of an A. However, in the long run, this A may prove to be harmful to her if she views the A as a reward for cheating and continues to cheat in the future, (2) my receipt of a lower grade puts her at an unfair advantage over me, (3) others in the class who received the same grade as her had to rely on their own effort and intelligence, whereas she was rewarded with the same grade for relying on someone else's work, (4) others in the class who received a lower grade than her are at a disadvantage to her even though they may be equally intelligent, (5) because recruiters compare the grades of all their applicants, she will appear more qualified because her A will cause her GPA to increase, (6) the professor may be placed in a position of giving her a higher recommendation than warranted, (7) her future employer may be depending on higher qualifications than she has. (B) Does the action respect the rights of all stakeholders? (1) my friend forfeited her right to a good grade by cheating, (2) others in the class had their rights violated because they can no longer compete fairly, (3) the professor can no longer exercise his/her right to distribute grades fairly, (4) recruiters cannot exercise their right to use GPA as a quantitatively reliable guide for selecting employees. (C) Is the act fair and just? (1) cheating is not generally accepted as being fair, (2) receiving a better grade through deceit is not just, (3) having an advantage in recruiting due to dishonesty is not fair.

III. Consider whether there are any overwhelming factors that may justify disregarding any of the ethical criteria: In this situation, there do not appear to be overwhelming factors but students may bring up issues like: (1) friend has full-time job, (2) friend is disabled, (3) friend has family (or other) obligations, (4) friend was sick before class, (5) friend was an athlete.

IV. Decide what ethical action to take: Students may decide on a number of alternative courses of action, including: (1) doing nothing, (2) discussing with friend, (3) discussing with student from whom friend copied (or other students) to exert pressure on friend to confess action to professor, (4) reporting to professor (in person or anonymously).

Answers to Research and Analytics

C1-12

Note to Instructor: Students are expected to cite references to GAAP in their research of this issue. While they might use various sources to conduct their research, the *FASB Accounting Standards Codification,* which is the primary source of GAAP, is cited.

The *FASB Accounting Standards Codification* is an electronic database that integrates and topically organizes the U.S. accounting standards (GAAP). The Codification is important because it is the *only* source of authoritative U.S. GAAP for companies to determine how to record their transactions, events, or circumstances and how to report the results in their financial statements. (An exception to this statement is the rules and interpretive releases of the SEC, which are sources of authoritative GAAP for publicly traded companies that are required to file their financial statements with the SEC. For convenience, the Codification includes selected portions of GAAP issued by the SEC for publicly traded companies. The Codification, however, does not contain all of the SEC's rules and regulations that constitute GAAP.)

The Codification is located at http://asc.fasb.org (or, if your institution participates in the American Accounting Association academic access initiate, at http://aaahq.org/ascLogin.cfm). All users must register before they can log in. After logging in, the "home page" provides a notice to constituents, links to tutorials, instructions on how to "join sections," and explanations of how to cross-reference the Codification sections to the original pronouncements. The framework of the Codification contains six components or levels: (1) Areas, (2) Topics, (3) Subtopics, (4) Sections, (5) Subsections, and (6) Paragraphs containing GAAP. The *Areas* component is located on the left side of the home page and contains links to nine broad accounting subjects, which include *General Principles*, *Presentation*, *Assets*, *Liabilities*, *Equity*, *Revenue*, *Expenses*, *Broad Transactions*, and *Industry*, along with a *Master Glossary* link and a "*Go To*" box for users familiar with the Codification numbering system.

The Topics, Subtopics, Sections, Subsections, and Paragraphs are considered descending "levels" of the Codification database, and each item in each level is numbered for reference and search purposes. The Topics level is accessed by clicking on the Area "subject" links on the Codification home page. The following is an explanation of the descending order of the levels within each Area.

- Topics involve a collection of related guidance on a particular subject area (e.g., Assets).
- Subtopics are subsets of a Topic and generally are distinguished by "type" or by "scope" (e.g., under the Leases Topic, there are Subtopics for Operating Leases and Capital Leases because they are different types of Leases).
- Sections characterize the nature of the content in a Subtopic (e.g., Recognition, Measurement, Disclosure).
- Subsections refine and break down Sections into narrower and more specific items. If a Subsection is necessary, it is *not* numbered but does include the Paragraphs that contain the guidance that constitutes GAAP.
- Paragraphs contain the guidance that constitutes GAAP.

<u>C1-12</u> (concluded)

To find the GAAP for a particular accounting issue, after logging in, you would go to the Area links in the left column of the home page and click on an Area (e.g., Assets). This would bring you to a menu of Topics, after which you would click on one topic. This would bring you to a menu containing Subtopics. After clicking on a Subtopic, this would bring you to a menu containing several Sections. Here, you would have to decide which Section is most likely to contain the answer to your question. You would click on that Section, which would bring you to the paragraphs containing the answer (GAAP) for your question. This completes your search. If you wanted to reference this answer, you would indicate that it can be found by listing the Topic, Subtopic, Section, and paragraph numbers (e.g., ASC 330-10-30-1). Now, suppose you had left this screen and wanted to go back to this paragraph. To save time, you could enter 330-10-30-1 in the "Go To" box on the home page, and it would bring you directly to the paragraph.

<u>C1-13</u>

Note to Instructor: Students are expected to cite references to GAAP in their research of this issue. While they might use various sources to conduct their research, the *FASB Accounting Standards Codification,* which is the primary source of GAAP, is cited.

The cost of a productive facility (e.g., machine) is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles (GAAP) require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, which aims to distribute the cost, less salvage (if any), over the estimated useful life of the unit in a systematic and rational manner. It is a process of allocation, not of valuation.

This is a summary. The complete GAAP may be found at FASB ASC 360-10-35-4.

The Codification is located at http://asc.fasb.org (or, if your institution participates in the American Accounting Association academic access initiate, at http://aaahq.org/ascLogin.cfm). All users must register before they can log in. After logging in, the "home page" provides a notice to constituents, links to tutorials, instructions on how to "join sections," and explanations of how to cross-reference the Codification sections to the original pronouncements. The framework of the Codification contains six components or levels: (1) Areas, (2) Topics, (3) Subtopics, (4) Sections, (5) Subsections, and (6) Paragraphs containing GAAP. The *Areas* component is located on the left side of the home page and contains links to nine broad accounting subjects which include *General Principles, Presentation*, *Assets*, *Liabilities*, *Equity*, *Revenue*, *Expenses*, *Broad Transactions*, and *Industry*, along with a *Master Glossary* link and a "*Go To*" box for users familiar with the Codification numbering system.

- The Topics, Subtopics, Sections, Subsections, and Paragraphs are considered descending "levels" of the Codification database, and each item in each level is numbered for reference and search purposes. The Topics level is accessed by clicking on the Area "subject" links on the Codification home page. The following is an explanation of the descending order of the levels within each Area.
- *Topics* involve a collection of related guidance on a particular subject area (e.g., Assets).

C1-13 (concluded)

- *Subtopics* are subsets of a Topic and generally are distinguished by “type” or by “scope” (e.g., under the Leases Topic, there are Subtopics for Operating Leases and Capital Leases because they are different types of Leases).
- *Sections* characterize the nature of the content in a Subtopic (e.g., Recognition, Measurement, Disclosure).
- *Subsections* refine and break down Sections into narrower and more specific items. If a Subsection is necessary, it is *not* numbered but does include the Paragraphs that contain the guidance that constitutes GAAP.
- *Paragraphs* contain the guidance that constitutes GAAP.

To find the GAAP for a particular accounting issue, after logging in you would go to the Area links in the left column of the home page and click on an Area (e.g., Assets). This would bring you to a menu of seven Topics of assets, after which you would click on one topic. This would bring you to a menu containing Subtopics. After clicking on a Subtopic, this would bring you to a menu containing several Sections. Here, you would have to decide which Section is most likely to contain the answer to your question. You would click on that Section, which would bring you to the paragraphs containing the answer (GAAP) for your question. This completes your search. If you wanted to reference this answer, you would indicate that it can be found by listing the Topic, Subtopic, Section, and paragraph numbers (e.g., ASC 360-10-35-4). Now, suppose you had left this screen and wanted to go back to this paragraph. To save time, you could enter 360-10-35-4 in the “Go To” box on the home page, and it would bring you directly to the paragraph.

C1-14

Note to Instructor: Students are expected to cite references to GAAP in their research of this issue. While they might use various sources to conduct their research, the *FASB Accounting Standards Codification,* which is the primary source of GAAP, is cited.

The recognition of revenue of a company during a period involves consideration of the following two factors, with sometimes one and sometimes the other being the more important consideration:

(a) Being realized or realizable. Revenue generally is not recognized until realized or realizable. Revenue is realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenue is realizable when related assets received or held are *readily convertible* to known amounts of cash or claims to cash.

(b) Being earned. Revenue is not recognized until earned. A company’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenue is considered to have been earned when the company has substantially accomplished what it must do to be entitled to the benefits represented by the revenue.

This is a summary. The complete GAAP may be found at FASB ASC 605-10-25-1.

C1-14 (concluded)

The Codification is located at http://asc.fasb.org (or, if your institution participates in the American Accounting Association academic access initiate, at http://aaahq.org/ascLogin.cfm). All users must register before they can log in. After logging in, the "home page" provides a notice to constituents, links to tutorials, instructions on how to "join sections," and explanations of how to cross-reference the Codification sections to the original pronouncements. The framework of the Codification contains six components or levels: (1) Areas, (2) Topics, (3) Subtopics, (4) Sections, (5) Subsections, and (6) Paragraphs containing GAAP. The *Areas* component is located on the left side of the home page and contains links to nine broad accounting subjects, which include *General Principles, Presentation*, *Assets*, *Liabilities*, *Equity*, *Revenue*, *Expenses*, *Broad Transactions*, and *Industry*, along with a *Master Glossary* link and a "*Go To*" box for users familiar with the Codification numbering system.

The Topics, Subtopics, Sections, Subsections, and Paragraphs are considered descending "levels" of the Codification database, and each item in each level is numbered for reference and search purposes. The Topics level is accessed by clicking on the Area "subject" links on the Codification home page. The following is an explanation of the descending order of the levels within each Area.

- Topics involve a collection of related guidance on a particular subject area (e.g., Assets).
- Subtopics are subsets of a Topic and generally are distinguished by "type" or by "scope" (e.g., under the Leases Topic, there are Subtopics for Operating Leases and Capital Leases because they are different types of Leases).
- Sections characterize the nature of the content in a Subtopic (e.g., Recognition, Measurement, Disclosure).
- Subsections refine and break down Sections into narrower and more specific items. If a Subsection is necessary, it is *not* numbered but does include the Paragraphs that contain the guidance that constitutes GAAP.
- Paragraphs contain the guidance that constitutes GAAP.

To find the GAAP for a particular accounting issue, after logging in, you would go to the Area links in the left column of the home page and click on an Area (e.g., Assets). This would bring you to a menu of Topics, after which you would click on one topic. This would bring you to a menu containing Subtopics. After clicking on a Subtopic, this would bring you to a menu containing several Sections. Here, you would have to decide which Section is most likely to contain the answer to your question. You would click on that Section, which would bring you to the paragraphs containing the answer (GAAP) for your question. This completes your search. If you wanted to reference this answer, you would indicate that it can be found by listing the Topic, Subtopic, Section, and paragraph numbers (e.g., ASC 605-10-25-1). Now, suppose you had left this screen and wanted to go back to this paragraph. To save time, you could enter 605-10-25-1 in the "Go To" box on the home page, and it would bring you directly to the paragraph.