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CHAPTER 1: THE DEMAND FOR AND SUPPLY OF FINANCIAL ACCOUNTING INFORMATION

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CONTENT ANALYSIS OF GOT IT? QUESTIONS AND 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 EST.	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 EST.	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

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
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
C1-8	Nestlé's Financial Statements	Identify two important pieces of information from each of the 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 the 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

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
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 KEY CONCEPTS: GOT IT?

1-1. Solution:

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. Solution:

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 (refer to 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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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. Solution:

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
<u>Investors</u>	Receive the profits of successful companies but bear the bottom-line risk of losses if the company is not successful
<u>Creditors</u>	Have superior claim in bankruptcy
<u>Investors</u>	Tend to be more interested in earnings, dividends, and share appreciation
<u>Creditors</u>	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
<u>Statement of Cash Flows</u>	Reports the cash inflows and cash outflows from operating, investing, and financing activities for a period of time.
<u>Balance Sheet</u>	Presents a snapshot of the resources of a firm and the claims on these resources at a point in time.
<u>Income Statement</u>	Measures and reports the financial results of a firm's performance for a period of time.
<u>Balance Sheet</u>	Provides information useful to help stakeholders evaluation a company's liquidity and leverage.
<u>Statement of Shareholders Equity</u>	Provides information about the common shareholders' claims on the company and how those claims changed during the period.
<u>Income Statement</u>	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 decreased from \$5,945 million on June 30, 2023, to \$5,751 million on June 30, 2024.
2. The Other Assets account experienced the largest increase (from \$462 million to \$545 million), and cash and cash equivalents experienced the largest decrease (from \$367 million to \$202 million).
3. Clorox finances its assets with a much greater proportion of liabilities (\$5,259 million) than stockholders' equity (\$492 million) as of June 30, 2024. Liabilities were also the much greater proportion of financing at the end of fiscal 2023.
4. Total liabilities decreased from \$5,557 million to \$5,259 million during 2024.
5. Stockholders' equity increased from \$388 million to \$492 million during 2024.

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 from 2022 (\$7,107 million) to 2023 (\$7,389 million) but then decreased from 2023 to 2024 (\$7,093 million).
2. Clorox's net earnings decreased from \$462 million in fiscal 2022 to \$149 million in fiscal 2023. However, net earnings increased to \$280 million in fiscal 2024. In fiscal 2023, strong revenue growth was more than offset by an impairment charge (\$445 million) for goodwill, trademark and other assets, which caused net earnings to drop. (In class discussion, we sometimes point out that without that charge and assuming all else equal, net earnings would have increased in 2023.) In fiscal 2024, net income increased even though net sales dropped considerably (due in part to disruptions from the cyberattack) and Clorox recognized a \$240 million loss on a divestiture as well as a \$171 million pension settlement charge. Despite those effects, the main reason Clorox managed to increase in net income in 2024 was a large drop in costs of products sold.
3. Clorox's largest expense on the income statement is cost of products sold (\$4,045 million in fiscal 2024). 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.

C1-3 (concluded)

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
- 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.

C1-6 (concluded)

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 at least two benefits that would arise if U.S. companies were required to use IFRS.

First, the shift to IFRS by U.S. companies would make their financial statements more comparable to the financial statements prepared by non-U.S. companies. Second, if U.S. companies 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 costly inefficiencies. These inefficiencies would be reduced for U.S. companies that adopt IFRS. There are many concerns 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 contracts 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.

C1-7

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 drop in cash and cash equivalents, \$367 million at fye 2023, but only \$202 million by fye 2024.
- Large amounts of receivables and inventory, \$695 million and \$637 million, respectively.
- Jump in other assets from \$462 million to \$545 million.
- Significant decrease in accounts payable and accrued liabilities—from \$1,659 million to \$1,486 million.

C1-7 (concluded)

- Total equity (\$492 million) comprises just under 9% of the liabilities and equity, \$5,751 million. Clorox has a proportionately very large amount of liabilities relative to equity. Long-term debt amounts to \$2,481 million.
- As noted in the chapter, Clorox has raised \$1,419 million from issuing common equity, but it has used \$1,186 million to repurchase treasury stock, \$1,396 million. The majority of equity arises from retained earnings, which amounts to \$250 million. Students may note that retained earnings actually exceeded total shareholders' equity.
- As of fye 2024, Clorox recognizes \$164 million of 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:

- Big drop in net sales in 2024 (−4.0%)—from \$7,389 million to \$7,093 million. Some of this increase is due to the disruption in production and sales of Clorox products as a result of the cyber attack.
- Along with the decline in revenues, most of the operating expenses experienced decreases, particularly cost of products sold. Some students will also note that in fiscal 2024, Clorox recognized a \$240 million loss on a divestiture and \$171 million in pension settlement charges. The net result is an increase in operating income, from \$238 million in 2023 to \$398 million in 2024.
- Income tax expense in fiscal 2024 is \$106 million.
- Net earnings attributable to Clorox in fiscal 2024 of \$280 million.

Statement of Cash Flows:

- Operating cash flows in fiscal 2024 are very healthy: \$695 million, a large portion of which comes from net earnings plus the depreciation and amortization addback as well as the addback of the noncash pension settlement charge and loss on divestiture.
- Investing cash outflows: (\$175 million), primarily for capital expenditures.
- Financing cash outflows: (\$655 million), consisted primarily of payments for dividends (\$595 million).
- Cash balance decreased in 2024, from \$368 million to \$207 million. Sharp students will notice that these amounts differ slightly 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 2024 of \$338 million reduced the accumulated other comprehensive loss from \$493 million to \$155 million.
- Retained earnings decreased despite net earnings of \$280 million. The decline is attributable to dividends declared (\$600 million) and other employee stock plan activities (\$3 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 cyber attack.

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 are reported on the 2024 financial statements and are stated in millions of CHF

Balance Sheet:

- As of December 31, 2024, the largest assets consist of property, plant and equipment (CHF 33,706 million), goodwill (CHF 30,595 million), intangible assets (CHF 19,245 million), inventories (CHF 13,260 million), investments in associates and joint ventures (CHF 14,326 million), and trade and other receivables (CHF 11,251 million).
- Total assets amount to CHF 139,264 million.
- More financing from debt than from equity—total liabilities amount to CHF 102,571 million and total equity amounts to CHF 36,693 million.
- Financial debt—current (CHF 11,863 million) and noncurrent (CHF 51,697 million)—represent Nestlé's largest borrowings.
- The largest liability that arises from operating activities is trade and other payables (CHF 21,807 million).
- Retained earnings account for common equity: CHF 66,693 million.

Income Statement:

- Revenues of CHF 91,354 million in 2024, a decrease of 1.77% from 2023.
- Profit for the year was CHF 11,174 million in 2024, down from CHF 11,509 in 2023.

Statement of Cash Flows:

- Operating cash flows are very healthy in 2024: CHF 16,675 million, most of which comes from operating profit plus the noncash items.
- Investing cash flows in 2024: CHF –8,624 million, with capital expenditures being a large use of cash (CHF –5,638 million). Nestlé also generated and used large amounts of cash for acquisitions and divestitures of investments and associates and joint ventures.
- Financing cash flows in 2024: (CHF –7,362 million), primarily for dividends and purchases of treasury shares.
- Cash balance increased CHF 742 million: CHF 4,816 million at the beginning of 2024, CHF 5,558 million at the end of 2024.

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 Nike. 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 and cash equivalents, and short-term investments \$9,860 million and \$1,722 million, respectively.
- Largest assets—cash and cash equivalents (\$9,860 million), inventories (\$7,519 million) and property, plant, and equipment (\$5,000 million).
- Total assets are \$38,110 million.
- Financial debt—current (\$6 million in notes payable and long-term (\$7,903 million). In addition, Nike reports operating lease liabilities (\$477 million current and \$2,566 long-term).
- Financed with more debt than equity—total liabilities amount to \$23,680 million and total equity amounts to \$14,430 million.
- The majority of equity arises from retained (reinvested) earnings.

Income Statement:

- Total revenues of \$51,362 million in 2024.
- Slight increase in revenues—from \$51,217 million in 2023 to \$51,362 million in 2024 (+0.3%).
- Increase in gross profit from \$22,292 million in 2023 to \$22,887 million in 2024 (+2.7%).
- Big jump in net income: \$5,700 million in 2024, up considerably from 2023 net income of \$5,070 million (+12.4%).

Statement of Cash Flows:

- Operating cash flows are healthy in 2024: \$7,429 million, up considerably from 2023, when they were \$5,841 million.
- Net cash inflows from operating activities in 2024: (\$894 million), primarily from maturities and sales of short-term investments, which exceed purchases of short-term investments and cash used for additions to property, plant, and equipment.
- Financing cash outflows in 2021: (\$5,888 million), primarily for dividends (\$2,169 million) and repurchases of common stock.
- Cash balance increased by \$2,419 million in 2024, from \$7,441 million to \$9,860 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 initiative, 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.

C1-12 (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.

C1-13

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 initiative, 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).

C1-13 (concluded)

- *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 initiative, 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.

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- 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.

Instructor Manual

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Chapter 01: The Demand for and Supply of Financial Accounting Information

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PURPOSE AND PERSPECTIVE OF THE CHAPTER

The purpose of this chapter is to explore the demand for and supply of financial accounting information. Accounting is a profession devoted to helping people by creating and reporting the financial information they need to make good business decisions. Investors and creditors are becoming increasingly sophisticated and global, demanding more relevant and reliable information from companies all over the world. Future years will present great opportunities for the accounting profession to continue to create tremendous value in the world economy and in local economies. In surveys of small business owners, accountants are consistently viewed as among the most trusted business advisers. In addition, many companies are placing increasing importance on accounting skills in their executive training programs and emphasizing the certified public accountant (CPA) credential in their executive searches. The demand for talented individuals with strong accounting skills is expected to continue.

The chapter begins by describing the forces that drive the demand for financial accounting information in the world economy. This is followed by discussions about the Securities and Exchange Commission (SEC) and the roles of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The four primary financial statements used for reporting are covered, as well as the important information that gets reported with those statements. A discussion regarding the economic consequences of financial accounting information is followed by an exploration of how data analytics are being used by accountants to make better decisions, predict future trends, control operations, and mitigate risk. Lastly, the chapter highlights the importance to the accounting profession of integrity and the ability to resolve ethical dilemmas.

LIST OF STUDENT DOWNLOADS

Students should download the following items from the Student Companion Center to complete the activities and assignments related to this chapter:

- Excel Template
- FASB Accounting Standards

CHAPTER OBJECTIVES

The following objectives are addressed in this chapter:

- LO 1.1 Describe the forces that drive the demand for financial accounting information in the world economy.
- LO 1.2 Describe the forces that determine the supply of accounting information, including the role of the Securities and Exchange Commission (SEC).

- LO 1.3 Explain the role of the Financial Accounting Standards Board (FASB) for establishing U.S. Generally Accepted Accounting Principles (U.S. GAAP).
- LO 1.4 Use the FASB Accounting Standards Codification system and understand the standard-setting process.
- LO 1.5 Explain the role of the International Accounting Standards Board (IASB) in establishing International Financial Reporting Standards (IFRS) and the efforts to try to converge accounting standards between the FASB and the IASB.
- LO 1.6 Describe the output of the financial reporting process and the four primary financial statements, as well as the important information reported with financial statements.
- LO 1.7 Explain how financial accounting information triggers important economic consequences, and explain why integrity and the ability to resolve ethical dilemmas is essential to the accounting profession.

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LIST OF POWERPOINT ACTIVITIES AND ASSESSMENTS

For additional guidance, refer to the Teaching Online Guide.

Chapter Objective	Activity/Assessment	Source
LO 1.1	Knowledge Check 1	PPT Slides 10–11
LO 1.2	Knowledge Check 2	PPT Slides 16–17
LO 1.3	Discussion Question 1	PPT Slides 20–21
LO 1.4	Discussion Question 2	PPT Slides 32–33
LO 1.6	Discussion Question 3	PPT Slides 40–41
LO 1.7	Knowledge Check 3	PPT Slides 45–46
LOs 1.1–1.7	Self-Assessment	PPT Slide 47

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KEY TERMS

Accounting standards: A natural demand used to measure and report relevant and representationally faithful financial statements to investors and creditors.

Accounting Standards Update: A new standard issued by the FASB.

Agents: Persons hired to invest financial resources and run the company's daily business activities on behalf of the investors and creditors.

Assets: Resources of a firm.

Assurance Opinion: The independent auditor must provide dual opinions on the effectiveness of the internal control system.

Audit Opinion: The fairness of the amounts reported in the financial statement.

Balance sheet (or statement of financial position): The financial position of a company which includes assets, liabilities, and shareholders' equity at a point in time.

Code of Professional Conduct (CPC): The AICPA adopts it to help guide members in performing their responsibilities in public practice, industry, government, and education.

Comprehensive income: The change in equity of a company during a period from transactions, events, and circumstances relating to nonowner sources.

Earnings: The excess of the revenue over the expenses.

Emerging Issues Task Force (EITF): An organization that aims to provide a response to the need for timely guidance on new, specific accounting issues.

Environmental, social and corporate governance (ESG): Criteria used to evaluate how responsibly and sustainably an organization operates beyond its financial performance. Environmental reporting involves providing information about the company's environmental impact, risks, and practices. Social reporting typically involves providing information about a company's impact on people, local communities, human rights, and initiatives for diversity, equity and inclusion, employment practices, and other factors. Corporate governance reporting often provides information about the company's governance structure, executive compensation, employee relations, shareholders' rights, and how the corporate board holds managers and executives accountable.

Ethical dilemmas: A situation in which an accountant must have the integrity to decide what is the "right" (ethical) action to take in given circumstances.

Expenses: The outflows of assets that a company consumes and the obligations it incurs in operating the business to generate revenues.

FASB Accounting Standards Codification (or Codification): A searchable electronic database that integrates and topically organizes U.S. GAAP into one coherent body of literature.

Financial Accounting Standards Board (FASB): The authoritative body that has the primary responsibility for developing accounting principles.

Financial reporting: The process of communicating financial accounting information to existing and potential future investors, creditors, lenders, and other external decision-makers.

Financing activities: Activities that include all the cash inflows and outflows involved in the financing activities of the company.

Form 8-K: A report used to describe significant events that have affected or may affect the company.

Form 10-K: An extensive annual report.

Form 10-Q: An extensive quarterly report.

Form 20-F: An extensive annual report from non-U.S. companies.

Generally Accepted Accounting Principles (U.S. GAAP): The principles, concepts, guidelines, methods, and practices that regulated companies are required to use in reporting accounting information in financial statements for U.S. companies.

Income statement: A summary of the revenue and expenses for a specific period of time, usually a quarter or a year.

Independent audits: A process to evaluate a company's accounting records and verify whether the company has applied the accounting standards and principles fairly and consistently by external, independent experts.

Information asymmetry problems: Problems that arise from parties needing but not having the same information.

International Accounting Standards Board (IASB): An organization that issues International Financial Reporting Standards for many countries outside the United States.

International convergence of accounting standards: A goal and the path taken to reach accounting standards.

International Financial Reporting Standards (IFRS): A common set of global accounting standards for non-U.S. companies.

Investing activities: Activities to invest the financial capital in productive resources that are necessary to operate the business.

Liabilities: Present obligations of an entity to transfer economic benefits.

Management discussion and analysis (MD&A): An annual report disclosure that provides management's analysis of the results of current operations, financial condition, and plans for the future.

Net income (or net loss): It measures the bottom-line profit (or loss) of a company for an accounting period.

Notes: The notes to the financial statements explain how the accounts and amounts have been determined.

Operating activities: Day-to-day actions a company undertakes to produce goods or services and sell them to customers.

Principals: They provide financial resources by investing in and lending to the company, such as common equity shareholders and creditors.

Proxy Statement: A report used when management requests the right to vote through proxies for shareholders at shareholders' meetings.

Revenues: The inflows of assets and the settlements of obligations from selling goods and providing services to customers.

Sarbanes–Oxley Act of 2002: An act that requires company executives to take responsibility for the financial statements.

Securities and Exchange Commission (SEC): An agency of the U.S. government that has the authority to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

Separation of ownership and control: The investors and creditors who have provided financial capital own the resources but are separate from the executives, managers, and employees who control those resources.

Shareholders' equity: A residual interest claim.

Stakeholders: Parties with some type of interest in the company's interests.

Statement of cash flows: It reports the net cash flows (inflows minus outflows) from operating, investing, and financing activities for a period of time.

Statement of shareholders' (or stockholders') equity (sometimes called **statement of changes in shareholders' equity**): The information about the common shareholders' equity claims on the company and how those claims changed during the period.

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WHAT'S NEW IN THIS CHAPTER

See the Transition Guide for specific changes made to this chapter.

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CHAPTER OUTLINE

The following outline organizes activities (including any existing discussion questions in PowerPoint or other supplements) and assessments by chapter (and therefore by topic), so that you can see how all the content relates to the topics covered in the text.

- I. Introduction (PPT Slide 4, ACBSP: APC-01-Purpose)
 - a. As the world economy allocates resources and enables productive investments, it needs useful and credible information.
 - b. Accounting provides that information and acts as the language of business to enable effective decision-making.

- c. Exhibit 1-1 provides a graphic representation of how accounting information helps people.
 - d. Accountants need to understand the conceptual framework of financial reporting as well as the financial reporting process and the key elements of financial statements.
- II. Why Does the World Need Financial Accounting Information? (LO 1.1, PPT Slides 5–11, ACBSP: APC-01-Purpose)
- a. To compete successfully, companies first develop a business plan that includes broad strategic objectives and more specific tactics.
 - b. A company's business model should guide its strategy and business activities to make the most of its competitive advantages.
 - c. After formulating a strategic plan, the company will typically engage in three sets of activities: financing, investing, and operating.
 - **Financing Activities:**
 - Raise equity capital by attracting investments from business owners, such as common shareholders
 - Acquire resources from lenders or by issuance of bonds
 - **Investing Activities:**
 - Acquire productive resources such as property, plant, equipment, technology, intellectual property, legal rights, and operating agreements necessary to operate the business
 - **Operating Activities:**
 - Utilize resources in day-to-day activities to produce goods and/or services and sell them to customers
 - d. **Stakeholders** are parties with an interest in a company.
 - Information valuable to investors: The company's business model, strategies, and competitive advantages, as well as company resources, net income/loss, cash flows, and growth over time
 - Information valuable to creditors: A company's level of equity capital, company resources and debts, and the company's cash flow's ability to meet interest and principal payments when due
 - Exhibit 1-2 illustrates a company and its relationship with various stakeholders.
 - Stakeholders include common equity shareholders, banks, creditors, managers and employees, suppliers, customers, labor unions, pension funds, government authorities (tax, regulatory, and legal), local communities, and others.
 - e. The **financial reporting** process must communicate financial accounting information to existing and potential investors, creditors, lenders, and other external decision-makers.
 - Because people are generally risk-averse, more information can encourage them to invest and help businesses make better decisions.

- Information must be relevant and faithfully representative.
- Problems can arise because of the **separation of ownership and control**.
 - Investors and creditors own the resources because they are the ones providing the financial capital.
 - **Principals** own the resources but are separate from the **agents** who have day-to-day control of those resources.
 - Exhibit 1-3 (PPT Slide 8) illustrates the separation of ownership and control.
 - The need to solve **information asymmetry problems** controls the demand for financial accounting information.
 - The need to bridge the information asymmetry created by the separation of ownership and control drives the demand for and the supply of financial accounting information.
 - Financial reporting enables agents to convey to principals information such as sales, profits, cash flows, financial position, and so on.
- f. **Accounting standards** increase investors' and other principals' confidence in the relevance and faithful representation of a company's financial information.
 - Accounting standards require many choices, judgments, and estimates that don't always fully meet principals' demands for information.
 - Professional standards include **Generally Accepted Accounting Principles (U.S. GAAP)** and **International Financial Reporting Standards (IFRS)**.
 - GAAP and IFRS are the principles, concepts, guidelines, methods, and practices that regulated companies are required to use in reporting accounting information in financial statements.
 - External auditors perform **independent audits** to carefully evaluate a company's accounting records and verify whether the financial statements are fairly presented in accordance with professional standards.
 - To be effective, auditors must be independent of the company, they must be experts in accounting and auditing methods, and they must tell the truth.
- g. **Knowledge Check 1:** *What is the difference between a principal and an agent? (PPT Slides 10–11)*
 - The answer is: An agent directs the investment of a company's resources and its operations, whereas a principal owns the company's resources.
 - Although both principals and agents are stakeholders of a company, principals own the resources and are separate from the

agents who have day-to-day control of those resources and make decisions about the company's business activities.

- III. The Supply of Financial Accounting Information (LO 1.2, PPT Slides 12–17, AICPA: FN-Reporting)
- a. Companies report accounting information as determined primarily by the interactions between two main forces:
 - Authoritative professional accounting standards, such as U.S. GAAP or IFRS, that govern in the company's country of incorporation
 - Choices, methods, estimates, and judgments that the company must make in order to apply those accounting standards to measure and report their financial statements
 - b. The **Securities and Exchange Commission (SEC)** administers the Securities Act of 1933 and the Securities Exchange Act of 1934.
 - Its mission: to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation”
 - Has authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities within U.S. capital markets
 - Each company offering securities for sale to the public in the primary and secondary markets must file a Form S-1 registration statement.
 - The registration statement is required by the Securities Act of 1933.
 - The Securities Exchange Act of 1934 established extensive reporting requirements for listed companies. The most commonly required reports for listed companies:
 - **Form 10-K**—An annual report including financial statements
 - **Form 10-Q**—A quarterly report including financial statements
 - **Form 20-F**—An extensive annual report from non-U.S. companies that list their securities on U.S. exchanges
 - **Form 8-K**—A report used to describe significant events that may affect the company
 - **Proxy Statement**—A report used when management requests the right to vote through proxies at shareholders' meetings
 - The SEC enforces regulations on companies, exchanges, and investors.
 - Authority to establish accounting standards falls to the following entities:
 - **Financial Accounting Standards Board (FASB)**

- **International Accounting Standards Board (IASB)**
 - o The SEC affects accounting standards through input and informal approval (or rejection) of proposed, but not yet issued, standards.
 - o The SEC has endorsed the concept of “substantial authoritative support.”
 - Substantial authoritative support means that “principles, standards, and practices promulgated by the FASB will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.”
 - By allowing this type of input, the bulk of the accounting principles are more substantially formulated by the private sector than by the government.
 - c. **Knowledge Check 2:** *Which of the following is an extensive quarterly report that includes financial statements?* (PPT Slides 16–17)
 - The answer is: Form 10-Q: An extensive quarterly report, including financial statements
- IV. What Is the Role of the FASB in Standards Setting? (LO 1.3, PPT Slides 19–21, AICPA: BB-Legal)
 - a. There are seven members of the FASB who are full-time employees with no other organizational ties.
 - Members represent a wide cross-section of interests (auditors, users, academics, financial statement preparers).
 - b. Each board member is required to have the following:
 - A 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 reporting
 - c. Exhibit 1-4 shows the current structure of the FASB.
 - d. The FASB established the **Emerging Issues Task Force (EITF)** in 1984 as a response to the need for timely guidance on new, specific accounting issues.
 - The EITF works to provide timely guidance on new, specific accounting issues.
 - The primary objectives of the EITF are:
 - o To identify significant emerging accounting issues that it feels the FASB should address
 - o To develop *consensus positions* on the implementation issues involving the application of standards

(a) In some cases, these consensus positions may be viewed as the “best available guidance” on GAAP, particularly as they relate to new accounting issues.

e. **Discussion Question 1:** *Pose the questions to the class.* (PPT Slides 20–21)

- Discuss the purpose of the Emerging Issue Task Force (EITF).
 - The EITF is an organization created to respond to queries related to specific accounting issues. A group of technical experts from large and small CPA firms are gathered to address new and emerging problems by (1) identifying significant emerging accounting issues that it feels the FASB should address and (2) developing a consensus on how to implement the standards in a specific situation. In some cases, the recommendation will be the best guidance that they can provide if no definitive answer can be found. The EITF is appointed by the FASB and will consult with the FASB as well as research and technical staff.
- Many governments provide tax credits to companies that invest in ways to counter the negative effects their company might have on climate change. What role would the EITF have in addressing reporting issues related to this issue for companies?
 - For many companies, environmentally friendly operations are nothing new, but with new laws and tax requirements related to this area, a consensus for reporting investments and/or fines for violations of environmental laws is a new concern.
 - The EITF would address any accounting issues that arise and develop a consensus, or best available guidance, on how to apply the standards of GAAP.

V. FASB Accounting Standards Codification (LO 1.4, PPT Slides 22–24, AICPA: BB-Legal)

- a. FASB-issued pronouncements were lengthy, hard to use, sometimes conflicting, and lacked consistent structure.
 - Prompted the **FASB Accounting Standards Codification**, a searchable electronic database that integrates and topically organizes U.S. GAAP into one coherent body of literature
- b. FASB goals for the Codification:
 - Simplify user access by organizing and categorizing all authoritative U.S. GAAP in one database
 - Ensure the codified content accurately represents all U.S. GAAP
 - Create a codification research system that includes the most recently released standards
- c. The Codification is now the source of authoritative GAAP for U.S. companies to determine how to record their transactions, events, or

circumstances and how to report the results in their financial statements.

- d. The framework of the Codification contains six levels, which are increasingly more specific: (1) Areas, (2) Topics, (3) Subtopics, (4) Sections, (5) Subsections, and (6) Paragraphs.
 - The **Areas** cover nine broad and general accounting subjects: General Principles, Presentation, Assets, Liabilities, Equity, Revenue, Expenses, Broad Transactions, and Industry.
 - Expressed as: FASB ASC Reference # Topic, Subtopic, Section, Paragraph (e.g., FASB ASC 850-10-50)
- e. A newly released standard by FASB is referred to as an **Accounting Standards Update**.
 - Before issuing a new standard, the FASB completes a multistage process.
 - Exhibit 1-5 (PPT Slide 24) illustrates FASB operating procedures.

VI. What Are the Roles of the IASB and IFRS? (LO 1.5, PPT Slides 25–33, AICPA: BB-Legal)

- a. The IFRS Foundation supports and oversees two standard-setting boards:
 - The IASB, which sets international accounting standards that are required or permitted in roughly 140 countries
 - The International Sustainability Standards Board (ISSB), responsible for establishing IFRS Sustainability Disclosure Standards
- b. The IFRS Foundation is 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.
 - The Monitoring Board includes representatives from the U.S. SEC, the European Commission, IOSCO (the International Organization for Securities Commissions), and others.
 - Exhibit 1-6 (PPT Slide 26) illustrates the three-tier structure of the IFRS Foundation.
- c. The SEC and Accounting Standard Convergence
 - Companies from outside the United States that list their securities on U.S. capital markets, the SEC requires U.S. corporations to prepare and file their financial statements using the accounting standards established by the FASB (U.S. GAAP).
 - The SEC accepts IFRS-based filings from non-U.S. companies but does not require reconciliation of differences between IFRS and U.S. GAAP.
 - In increasingly global capital markets, there is ongoing demand for international convergence of accounting standards which is useful for decision-making across companies and across countries

d. Should the SEC Adopt IFRS for U.S. Companies?

- SEC identified at least two benefits that would arise from the use of IFRS by U.S. companies filing with the SEC.
 - U.S. companies' financial statements would be more comparable to those of the foreign companies they compete with for capital.
 - U.S. companies with foreign subsidiaries are required to prepare those subsidiaries' financial statements according to IFRS for local filings.
- Because these companies still have to prepare and file consolidated financial statements with the SEC using U.S. GAAP, this creates costly inefficiencies.
- Adopting IFRS for U.S. companies would reduce these inefficiencies. However, concerns include the following:
 - Publicly listed U.S. companies (particularly smaller ones) that file with the SEC but do not operate globally would incur costs to transition but would obtain little benefit from using IFRS rather than U.S. GAAP.
 - The majority of U.S. corporations are small companies that do *not* issue publicly traded securities and therefore are not regulated by the SEC.
 - Accountants, auditors, and financial statement users would have to be trained to understand the impact of IFRS on the financial statements of U.S. companies using IFRS.
 - Many companies have entered into contracts based on U.S. GAAP. For example, companies may have borrowed money with debt covenants based on U.S. GAAP.
- **International convergence of accounting standards** refers to both a goal and the path chosen to reach it.
 - Across different countries, differences in financial reporting objectives, business cultures, regulatory environments, and legal systems can make it difficult for standard setters around the world to reach consensus on the most effective accounting treatments.
- Standard setting in a Political Economic Environment
 - The SEC allows foreign companies to use IFRS rather than U.S. GAAP. These companies do not need to reconcile how differences between IFRS and U.S. GAAP affect their reported financial statements.
 - The FASB and the IASB develop new accounting standards in a thorough, thoughtful, and efficient manner, with due process, and in open public forums.
 - Compromise is inevitable as the FASB and the IASB respond to the globalization of capital markets.

- Because of the substantial economic consequences, key constituents often disagree about the objectives for new standards.
 - FASB is utilizing a three-part strategy for seeking greater international comparability in accounting standards international:
 - Developing high-quality GAAP standards
 - Actively participating in the development of IFRS by providing input to the IASB through its membership in the Accounting Standards Advisory Forum
 - Enhancing relationships and communications with other national standards setters
 - e. **Discussion Question 2:** *In July 2012, the SEC staff issued a report considering specific issues relevant to the SEC's determination as to whether and how the current financial reporting system for U.S. companies should be transitioned to a system based on IFRS. Discuss the important issues identified by the SEC staff (PPT Slides 32–33)*
 - What are the significant implications of IFRS adoption for U.S.-based firms?
- VII. What Is the Product? Financial Reporting and the Financial Statements (LO 1.6, PPT Slides 34–41, AICPA: FN-Reporting)
- Note to Instructors:** *An introduction to the Clorox Company, which is used to illustrate various accounting principles and processes throughout the text, is provided at the beginning of this unit in the textbook.*
- a. The financial statements that companies provide to external stakeholders include the following:
 - Balance sheet
 - Income statement
 - Statement of cash flows
 - Statement of shareholders' equity
 - Notes and other items that typically accompany these statements
 - b. The **balance sheet** (Exhibit 1-7) is the cornerstone of financial reporting.
 - The balance sheet presents the following:
 - A snapshot of the resources of a firm (**assets**)
 - The claims on the firm (**liabilities** and **shareholders' equity**)
 - As of a specific date, usually the last day of the fiscal quarter or the fiscal year
 - Also known as the **statement of financial position**
 - The balance sheet views resources from two perspectives:
 - Specific resources of the firm—cash, inventory, and equipment

- The claims by persons or entities—investors, creditors, lenders, suppliers, employees, and other stakeholders
- The balance sheet reports the following equation:
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
 - **Assets** are present rights of an entity to economic benefits. This section of the balance sheet reports the effects of operating and investing decisions.
 - **Liabilities** are present obligations of an entity to transfer economic benefits. This section of the balance sheet reports obligations that arise from operating and investing decisions.
 - The **shareholders' equity** in a firm is a residual interest claim. Two general categories of shareholders' equity—contributed capital and earned capital—reflect financing and operating activities.
- c. The **income statement** (Exhibit 1-8) measures and reports the financial results of a firm's performance—the profits or losses generated by conducting operating, investing, and financing activities—for a period of time such as a quarter or a year.
 - **Revenues**—Inflows of assets and settlements of obligations from selling goods and providing service to customers
 - **Expenses**—Outflows of assets and obligations incurred in the process of operating the business to generate revenues
 - $\text{Net Income} = \text{Revenues} - \text{Expenses} + \text{Gains} - \text{Losses}$
 - Net Income (or Net Loss) measures the bottom-line profit (or loss) of a company for the period. Another term for net income is earnings.
 - **Comprehensive income** is the change in common shareholders' equity of a company during a period from transactions, events, and circumstances relating to nonowner sources.
- d. The **statement of cash flows** (Exhibit 1-9) reports for a period of time the net cash flows from operating, investing, and financing activities.
 - Provides useful information about how a firm is generating and using cash
 - Complements the income statement by demonstrating how cash flows differ from accrual-based income
 - Is useful to creditors and other stakeholders for evaluating the company's cash-generating ability
 - Provides information about the likelihood of future cash flows for future payments of obligations
 - **Operating activities:** Assessing cash flow from operations over several years indicates the extent to which operating activities have provided the necessary cash to maintain operating capabilities.

- **Investing activities:** Acquiring long-lived productive assets, particularly property, plant, and equipment, usually represent major ongoing uses of cash for a company.
 - **Financing activities:** Short- and long-term borrowing and issuing preferred and common stock are common ways a company obtains cash.
- e. The **statement of shareholders' equity** (Exhibit 1-10) provides information about the common shareholders' equity claims.
- Contributed capital includes Common Stock and Additional Paid-in Capital, the amounts initially contributed by shareholders for an interest in a company.
 - Earned capital includes:
 - Retained Earnings: Cumulative net income in excess of dividends declared
 - Accumulated Other Comprehensive Income: Shareholders' equity effects from recognition or valuation of certain assets or liabilities
 - Treasury Stock: Cumulative amounts of cash distributed to shareholders to repurchase shares
- f. To provide more relevant and representationally faithful information for financial statement users, companies typically provide additional information with the financial statements.
- **Notes**
 - The financial statements explain how the accounts and amounts have been determined.
 - Notes to the financial statements provide important details about the accounting principles, methods, and estimates the company has used to measure assets, liabilities, equity, revenues, expenses, gains, and losses, including fair values of investment securities, pension and postemployment liabilities, income taxes, and intangible assets.
 - **Management Discussion and Analysis (MD&A)**
 - An annual report disclosure provides management's analysis of the results of current operations, financial condition, and plans for the future.
 - Includes an extensive narrative discussion and quantitative analysis provides managers' insights into company performance.
 - **Managers' and Independent Auditors' Attestations**
 - The **Sarbanes–Oxley Act of 2002** makes management responsible for financial statements and the underlying accounting and control system that generates the financial statements.

- Independent auditors are responsible for assessing a company's internal control system (referred to as the **Assurance Opinion**), designing audit tests, and forming an opinion (referred to as the **Audit Opinion**) about the fairness of the amounts reported in the financial statements.
 - g. **Discussion Question 2:** *Pose the questions to the class.* (PPT Slides 40–41)
 - Why is an auditor's opinion an essential element of financial reporting?
 - The Sarbanes–Oxley Act of 2002 explicitly requires company executives to take responsibility for the financial statements. This legislation was in response to Enron and other companies misrepresenting their financial statements to the serious detriment of investors.
 - An independent auditor reports on the effectiveness of the internal control system (referred to as the Assurance Opinion) and the fairness of the amounts reported in the financial statements (referred to as the Audit Opinion). Investors and other users of the financial statements rely on the independent auditor's attestation as to the fairness of a company's financial statements relative to U.S. GAAP or IFRS.
 - Discuss the difference between an assurance opinion and an audit opinion. Why are they important?
 - An assurance opinion addresses the internal control system of a company, while the audit opinion addresses the fairness of the amounts reported on the financial statement.
 - This information, provided by the auditor, is essential in identifying the reliability of the company's financial statements in the capital markets. Investors and others who depend on financial statements know that they can be trusted if an auditor has reviewed them and found them fair and reliable according to U.S. GAAP or IFRS.
- VIII. Why Is Accounting Important? The Economic Consequences of Financial Reporting (LO 1.7, PPT Slides 42–46, ACBSP: APC-01-Purpose)
- a. Financial reporting provides external stakeholders, such as common equity shareholders, with valuable information that helps them evaluate the profitability, risk, and growth of the company, which is information they can use to value the company's shares.
 - The striking link between accounting earnings and stock returns has been demonstrated in many empirical accounting research studies.

- Exhibit 1-11 illustrates the association between changes in annual earnings and cumulative abnormal stock returns.
- b. The role of data analytics in business and in accounting has been growing exponentially.
 - Data analytics—Using data to examine the relation between changes in earnings and stock returns
 - There are four basic types of data analytics:
 - Descriptive—Describe what has happened in the past
 - Diagnostic—Identify relations to explain why things happened
 - Predictive—Predict what will happen in the future
 - Prescriptive—Recommend a possible course of action
 - Accounting professionals must be well positioned to use data analytics to help companies gain valuable insights into their financial statements, identify opportunities for profitable growth, control operations, and manage risk.
- c. Accountants serve the greater good of society and owe a responsibility of ethics and fairness to all current and potential stakeholders. Ethical accountants create tremendous social welfare by producing reliable and relevant information for decision-makers.
 - Accountants face ethical dilemmas, situations in which an accountant must make a decision about what is the “right” (ethical) action to take in given circumstances.
 - Professional accounting organizations have established codes of ethics for their members.
 - The AICPA has adopted the Code of Professional Conduct (CPC).
 - Exhibit 1-12 (PPT Slide 44) lists the principles of the AICPA Code of Professional Conduct.
 - The CPC’s six principles express the basic tenets of ethical and professional conduct and call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.
- d. **Knowledge Check 3:** *Which of the following types of Data Analytics recommends a possible course of action? (PPT Slides 45–46)*
 - Answer is: Prescriptive: Recommends a possible course of action
 - Example: With 70% probability of the video going viral, how much should we increase production of the product?
- e. **Self-Assessment:** *Pose the questions to the students. Students can volunteer to discuss these questions with the larger group or answer them privately. Discussing them will help the students consider what they’ve learned and apply it to their experiences and understand the reasoning for the rules and standards. (PPT Slide 47)*
 - What roles of accounting discussed in the chapter most surprised you?

- What are your thoughts on the professionally established accounting standards and how they are derived and implemented?
- How would you explain to another person the level of ethics necessary in accounting?

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ADDITIONAL DISCUSSION QUESTIONS

The following are discussion questions that do not appear in the text, PPTs, or courseware—they are for you to use as you wish. You can assign these questions several ways: in a discussion forum in your LMS; as whole-class discussions in person; or as a partner or group activity in class.

1. Discussion: Creating Value in the World (Data Analytics for Accountants (What Is the Importance of Data Analytics in Accounting?, LO 1.7, PPT Slides 42–44). Duration 10 minutes.
 - a. In what ways does accounting information create value in the world?
 - i. Answer: Accounting information triggers important economic consequences about companies. For example, research evidence shows that firms that report earnings increases enjoy stock returns that are much higher than market-average returns, whereas firms that report earnings decreases experience stock returns that are much lower than the market average. Financial reporting provides external stakeholders, such as common equity shareholders, with valuable information that helps them evaluate the profitability, risk, and growth of the company, which is information they can use to value the company's shares. The striking link between accounting earnings and stock returns has been demonstrated in many empirical accounting research studies.
2. Discussion: Data Analytics for Accountants (What Is the Importance of Data Analytics in Accounting?, LO 1.7, PPT Slide 42–44). Duration 10 minutes.
 - a. In addition to evaluating a company's performance, what are some possible accounting applications of data analytics?
 - i. Answer: Students' responses will vary. Possible examples include:
 - Identifying where process improvements could impact the company's profitability
 - Identifying new opportunities related to current market patterns
 - Predicting future buying patterns
 - Identifying potential key acquisitions
 - Informing business strategy

- Understanding customer behavior
- Managing risk in an agile fashion during times of economic uncertainty

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ADDITIONAL ACTIVITIES AND ASSIGNMENTS

The following are activities and assignments developed by Cengage but not included in the text, PPTs, or courseware—they are for you to use if you wish.

1. **Internet Activity:** *The Costs of Unethical Behavior* (Reflection, LO 1.7, PPT Slides 42–44). Duration 30 minutes.
 - a. Acting ethically is not easy. In some circumstances it can be very difficult, requiring disciplined integrity and professional judgment in pressure-filled situations. There are numerous real-life examples of unethical accounting behavior, which has sometimes resulted in steep fines in addition to a loss of revenue due to customer backlash. Split the class into small groups of three to five students and ask them to search online for an example of the costs of unethical accounting behavior.
 - i. Answer: Students' responses will vary. One possible example is that of Ernst & Young, which was charged by the SEC after audit professionals were found cheating on exams. The SEC further found that Ernst & Young withheld evidence of the misconduct while the SEC was investigating. Ultimately Ernst & Young admitted guilt and agreed to pay a \$100 million penalty, the largest ever imposed by the SEC against an audit firm.

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ADDITIONAL RESOURCES

CENGAGE VIDEO RESOURCES

- 2 Why Does This Matter to Me videos
- 2 Tell Me More videos (1 for each learning objective)

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