

CHAPTER 1

The Demand for and Supply of Financial Accounting Information

CONTENT ANALYSIS OF END-OF-CHAPTER ASSIGNMENTS

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

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	Comprehension
1-14	Standard Setting	FASB; IASB	5	Easy	5	Analytic	Measurement	Analysis
1-15	Standard Setting	Definition of IFRS	5	Easy	5	Analytic	Measurement	Application
1-16	Standard Setting	Changing standards over time; U.S. GAAP; IFRS	5	Easy	5	Analytic	Measurement	Comprehension
1-17	Standard Setting	The impact of pure theory vs. politics in standard setting	5	Easy	5	Analytic	Measurement	Analysis
1-18	Financial Statements	Balance sheet; financial reporting stakeholders	6	Easy	5	Analytic	Reporting	Application
1-19	Financial Statements	Income statement; financial reporting stakeholders	6	Easy	5	Analytic	Reporting	Application
1-20	Financial Statements	Statement of cash flows; financial reporting stakeholders	6	Easy	5	Analytic	Reporting	Application
1-21	Financial Statements	Statement of shareholders' equity; financial reporting stakeholders	6	Easy	5	Analytic	Reporting	Application
1-22	Financial Statements	Purpose of footnotes; disclosure of financial information	6	Easy	5	Analytic	Reporting	Application
1-23	Earnings and the Stock Market	Economic consequences of earnings information	7	Easy	5	Analytic	Measurement	Analysis
1-24	Ethics	Ethics	7	Easy	5	Analytic	Measurement	Application
1-25	Ethics	Ethics; code of professional conduct	7	Easy	5	Analytic	Measurement	Comprehension

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
E1-1	Pronouncements	FASB Accounting Standards Codification; different sources of GAAP	4		Easy	15	Analytic	Measurement	Comprehension
C1-1	Accounting Principles	Describe the meaning of the terms "accounting principles" and "generally accepted"	3	AICPA	Easy	10	Analytic	Measurement	Application
C1-2	Standard Setting	Describe why there is political action and social involvement in the standard-setting process	3	CMA	Easy	10	Analytic	Measurement	Application
C1-3	Organization of the FASB	Summarize the structure of the FASB and its operating procedures	3		Easy	15	Analytic	Measurement	Application
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	Application
C1-5	Lobbying the FASB	Discuss pros and cons of lobbying the FASB by interested parties	3		Easy	5	Analytic	Measurement	Application
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	Application
C1-7	Starbucks'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	Application

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
C1-8	Nestlé's Financial Statements	Identify two important pieces of information from each of three primary financial statements	6		Moderate	20	Analytic	Reporting	Application
C1-9	Coca Cola's Financial Statements	Identify two important pieces of information from each of three primary financial statements	6		Moderate	20	Analytic	Reporting	Application
C1-10	Ethical Responsibilities	Discuss steps to take in an ethical dilemma ("misplaced" book in library)	7		Moderate	5	Reflective Thinking	Measurement	Analysis
C1-11	Ethical Responsibilities	Discuss steps to take in an ethical dilemma (cheating by friend on exam)	7		Moderate	5	Reflective Thinking	Measurement	Analysis
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	Application
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	Application
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	Application

ANSWERS TO GOT IT?

- 1-1 The role of financial accounting is to identify, measure, record, and report relevant and reliable financial information about companies to present and potential future stakeholders. Financial reporting is the process of communicating financial accounting information about a company to existing and potential future investors, creditors, and other external decision makers and stakeholders. An important way a company's financial accounting information is reported is in its quarterly and annual reports. The role of financial reporting is to inform investors, creditors, and other stakeholders. Financial reporting also provides information to mitigate agency problems which stem from the separation of ownership and control of resources.
- 1-2 The primary stakeholders that are important users of financial information include investors, creditors, banks, suppliers, customers, employees, executives, labor unions, pension funds, government regulatory authorities, tax authorities, local communities, and many others (see Exhibit 1.1). The instructor can discuss how these stakeholders can be divided into two major categories: external users and internal users. These two groups do not have the same decision-making information needs because of their differing relationships with the company providing economic information. Of these groups, FASB has stated the primary purpose of financial reporting is to inform investors and creditors.
- 1-3 Investors and creditors take different risks and enjoy different potential upside gains from investing or lending. Equity investors are the residual risk bearers of corporations, but stand to enjoy potentially greater upside if the company is successful and profitable. Creditors face less risk of loss of their investments because they have superior claim in bankruptcy over equity investors. But creditors do not share in the same upside potential as equity investors. As a result of these differences, their information needs differ. Equity investors are more concerned with profitability, whereas creditors tend to be more focused on cash flows.
- 1-4 Information asymmetry arises from the separation of ownership and control of resources. Financial reporting helps reduce (but not eliminate) information asymmetry problems by enabling managers (agents) to provide relevant and faithfully represented information to investors and creditors (principals), thereby reducing information asymmetry.
- 1-5 The demand for financial accounting information, as an economic good in society, arises from the needs of equity shareholders, creditors, and various other stakeholders for information to make resource allocation decisions. This demand arises because businesses have to compete for and attract scarce economic resources, such as equity and debt capital, productive resources, employees, supplier and customer relationships, and so forth. In order to compete for these valuable resources, companies must provide relevant and faithfully represented information to those who can provide the resources.

- 1-6 To solve the problems that would arise from biases in a self-reporting accounting system, a natural demand arises for *accounting standards and audits*. The demand for accounting information drives the demand for professionally established accounting standards that provide authoritative guidance on how to measure and report economic activities in financial statements. In addition, the demand for accounting information also drives the demand for auditing—independent verification and attestation of whether the financial statements have been fairly presented in accordance with professional accounting standards.
- 1-7 Generally Accepted Accounting Principles (GAAP) are the principles, concepts, guidelines, procedures, and practices that U.S. companies that are listed in the United States and subject to SEC regulation are required to use in recording and reporting the accounting information in audited financial statements.
- 1-8 The supply of accounting information that companies report to external stakeholders is determined primarily by the interactions between two sets of forces:
- The authoritative professional accounting standards that govern in the company's country of incorporation, such as U.S. GAAP or IFRS, and
 - the many choices, methods, estimates, and judgments that the company must make in order to apply those accounting standards to measure and report their financial statements.
- 1-9 The stated mission of the U.S. Securities and Exchange Commission is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” The U.S. Congress created the SEC to administer the Securities Act of 1933 and the Securities Exchange Act of 1934. Under these Acts, the SEC has the legal authority to prescribe accounting principles and reporting practices for all corporations issuing publicly traded securities within the U.S. capital markets. The SEC has mandated that the information communicated to external users in financial reporting must be based on professionally established accounting principles, such as GAAP for U.S. companies and IFRS for non-U.S. companies.
- The SEC delegates the authority over standard setting to private standard-setting bodies within the accounting profession, such as the Financial Accounting Standards Board (FASB) establishing GAAP for U.S. companies and the International Accounting Standards Board (IASB) establishing IFRS for companies from many other countries around the world. The SEC monitors closely and oversees the standards being developed by these standard setters. From time to time, the SEC exerts pressure on the standard setters to adopt, or not adopt, specific standards.
- 1-10 The FASB is responsible for identifying financial accounting issues, conducting research to address these issues, and resolving them by issuing new accounting standards applicable to U.S. companies. The FASB fulfills its responsibility by:
- establishing standards that are the most acceptable, given the various affected constituencies, and
 - continually monitoring the consequences of its actions so that revised standards can be issued where appropriate.

1-11

In assisting the FASB, the primary objectives of the EITF are:

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

1-12

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

The FASB issued six types of pronouncements prior to the Codification:

1. *Statements of Financial Accounting Standards*. These pronouncements established GAAP. They indicated the methods and procedures required on specific accounting issues.
2. *Interpretations*. These pronouncements provided clarifications of conflicting or unclear issues relating to previously issued *FASB Statements of Financial Accounting Standards*, *APB Opinions*, or *Accounting Research Bulletins*.
3. *Staff Positions*. The staff of the FASB issued these pronouncements to provide more timely and consistent application guidance in regard to FASB literature, as well as to make narrow and limited revisions of GAAP.
4. *Technical Bulletins*. The staff of the FASB issued these pronouncements to clarify, explain, and elaborate on accounting and reporting issues related to *Statements of Standards* or *Interpretations*.
5. *Statements of Financial Accounting Concepts*. These pronouncements established a theoretical foundation upon which to base GAAP. They are the output of the FASB’s “conceptual framework” project.
6. *Other Pronouncements*. On a major topic, the staff of the FASB may have issued a *Guide for Implementation*.

The Codification did not change GAAP per se, in that it did not issue or rescind any standards. Instead, the FASB developed the Codification to achieve three goals:

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

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

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

After a super-majority vote (five votes out of seven) is attained, the FASB issues an *Accounting Standards Update*.

1-14 The FASB and IASB are structured very similarly, in organizations that are overseen and supported by Boards of Trustees, and supported by large staffs of professional and technical experts and administrative support. 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 16 full-time members. The composition of the IASB is structured to contain representation from different countries and regions of the world. The IASB issues *International Financial Reporting Standards (IFRS)*. To do so, its operating procedures include study of the topic, issuance of an Exposure Draft, evaluation of comments, and consideration of a revised draft. If approved by at least nine members of the IASB, the *International Financial Reporting Standard* is issued.

1-15 They are the principles, concepts, guidelines, procedures, and practices that companies from the roughly 130 countries that have adopted IFRS are required to use in recording and reporting the accounting information in audited financial statements. In the United States, the SEC has decided to allow non-U.S. companies that are listed in the United States and subject to SEC regulation to use IFRS for preparation of financial statements filed with the SEC.

1-16 The FASB and the IASB have worked together toward convergence since the “Norwalk Agreement” in 2002. At that time, the two Boards entered into this agreement to work together on the development of high-quality, compatible accounting standards that could be used for both “domestic” and “cross-border” financial reporting. The Boards in 2009 and 2010 identified a number of major projects they undertook jointly. The Boards have completed most of these major projects. These joint projects have helped achieve greater convergence in accounting standard for revenue recognition (issued 2014), consolidated financial statements (issued 2011), fair value measurement (issued 2011), and financial statement presentation (amendments to reporting comprehensive income completed in 2011; other joint work discontinued).

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

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

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

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

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

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

- 1-21 The statement of shareholders' equity (sometimes called the *statement of changes in shareholders' equity*) provides information about the common shareholders' equity claims on the company, and how those claims changed during the period. The year-end amounts reported in this statement for the various common shareholders' equity accounts will match the amounts reported in the shareholders' equity section of the balance sheet. Equity investors will be particularly interested in the information in this statement.
- 1-22 A firm's accounting system records the results of transactions, events, and commercial arrangements and generates the financial statements, but the financial statements do not stand alone. To provide more relevant and representationally faithful information for financial statement users, firms typically provide a substantial amount of important additional information with the financial statements, including the Notes, Management Discussion and Analysis, and Managers' and Independent Auditors' Attestations. The notes to the statements explain the methods, assumptions, and estimates the firm has used in measuring and reporting the accounting information in the financial statements.
- 1-23 To illustrate the striking links between accounting earnings and stock returns, the chapter provides a brief discussion of the results from empirical research by D. Craig Nichols and James Wahlen. They studied the average cumulative market-adjusted stock returns generated by firms during the 12 months leading up to and including the month in which each firm announced annual earnings numbers. For a sample of 31,923 firm-years between 1988 and 2001, 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 19.2 percent. On the other hand, the average firm that announced a decrease in earnings experienced stock returns that were roughly 16.4 percent lower than the market average. Their results suggest that merely the sign of the change in earnings was associated with a 35.6 percent stock return differential in one year, on average, over their sample period. The results show that earnings information has important economic consequences, because changes in earnings are strongly associated with significant changes in share prices.
- 1-24 As accountants, we create valuable financial information that stakeholders use to make informed resource allocation decisions about companies. Accounting information triggers substantial economic consequences for a wide array of different stakeholders in a company. Because accounting information has such important consequences for so many different stakeholders, being an accountant requires the ability to bear this great responsibility while behaving ethically.
- 1-25 The *Code of Professional Conduct* is a document published by the AICPA to help guide members in public practice, industry, government, and education in performing their responsibilities in an ethical and professional manner. The six areas covered by the Principles include: (1) responsibilities, (2) public interest, (3) integrity, (4) objectivity and independence, (5) due care, and (6) scope and nature of services.

SOLUTION TO EXERCISE

E1-1

1. e 2. c 3. b 4. d 5. f 6. a 7. f

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 are listed in the United States. The FASB and the IASB follow extensive, due processes to deliberate and develop new accounting standards that, if adopted, become “generally accepted.”

C1-2 [CMA Adapted]

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

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

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

C1-3

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

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

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

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

C1-4

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

1. **Responsibilities**: In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities. For example, when a member chooses a depreciation method, she must carefully analyze each alternative based upon well-defined criteria before making a final choice.
2. **The Public Interest**: Members should act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism. When a member refuses to ignore internal control deficiencies in a company with publicly traded stock, but instead enumerates these deficiencies in the Auditor's report, she is adhering to the public interest principle.
3. **Integrity**: To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity. For example, a member who carefully and conscientiously performs each step of an audit without skipping those steps that are tedious or of less interest is exercising the integrity principle.
4. **Objectivity and Independence**: A member should be objective and be free from conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services. For example, a member who declines to audit the financial statements of the company for which his father is a marketing vice president is adhering to this principle.
5. **Due Care**: A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability. When a member reads current accounting literature and strives to employ current principles and procedures, she is exercising due care.

C1-5

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

Advantages

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

C1-5 (concluded)

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

Disadvantages

- Rulings sometimes appear to be biased in favor of certain user groups
- Rulings sometimes are inconsistent with other Statements of Standards
- Rulings sometimes are inconsistent with Statements of Concepts
- Rulings sometimes appear illogical
- FASB is too slow in establishing standards
- Standards are too complex and difficult to implement

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 have been working together toward convergence since the "Norwalk Agreement" in 2002. At that time, the two Boards entered into this agreement to work together on the development of high-quality, compatible accounting standards that could be used for both "domestic" and "cross-border" financial reporting. To achieve this compatibility, the Boards agreed to work together to achieve "short-term" convergence on a number of individual differences between U.S. and international accounting standards. They also agreed to coordinate their future agendas on substantial long-term projects which both Boards would address concurrently. Finally, they agreed to continue working on joint projects they were currently undertaking. This overall collaboration is sometimes referred to as the *convergence* or *harmonization* of accounting standards.

The Boards in 2009 and 2010 identified a number of major joint projects to undertake jointly, as well as short-term projects (in which convergence can occur fairly quickly). The Boards have completed most of their joint efforts to complete these major projects. The major projects the Boards have completed have achieved great convergence in accounting standards for:

- Consolidated financial statements
- Fair value measurement
- Financial statement presentation
- Revenue recognition

C1-6 (continued)

Moving forward, the FASB will continue to work on global accounting issues with the IASB through its membership in the Accounting Standards Advisory Forum (ASAF), a newly established advisory body comprising twelve standard setters from across the globe. Both Boards also provide quarterly progress reports which can be downloaded from their web sites.

The SEC has moved forward on two fronts: (1) changing its filing regulations for foreign companies and (2) considering changing its filing requirements for U.S. companies.

In the past, a foreign company filing its financial statements with the SEC that used accounting standards other than U.S. GAAP had to file a form which “reconciled” certain amounts reported in its financial statements with the amounts that would have been reported using U.S. GAAP. However, in late 2007 the SEC rescinded this rule for foreign companies that use English-language IFRS (with no exceptions) to prepare their financial statements. These companies no longer have to file a reconciliation.

In July 2012, the SEC staff issued its final report considering incorporating IFRS into the financial reporting system for U.S. companies. The report was the final phase of a work plan, initiated in February 2010, to consider specific issues relevant to the SEC’s determination as to where, when, and how the current financial reporting system for U.S. issuers should be transitioned to a system incorporating IFRS.

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. “Additional analysis and consideration of this threshold policy question is necessary before any decision by the Commission concerning the incorporation of IFRS into the financial reporting system for the U.S. issuers can occur,” the report said.

In the report, the staff identified a number of unresolved issues relating to the potential incorporation of IFRS into the U.S. financial reporting system. These issues include the diversity in how IFRS are interpreted, applied, and enforced in various jurisdictions around the world; the potential cost to U.S. issuers of adopting or incorporating IFRS; investor education; and governance.

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

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

C1-6 (concluded)

- (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) Investors, creditors, financial analysts, and other external users would have to retrain to be able to evaluate the financial statements of companies using IFRS. Also, those external users who have more resources to learn about analyses under IFRS may be at a competitive advantage.
- (4) Accountants and auditors 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. Larger auditing firms with more resources for training may be at a competitive advantage over smaller auditing firms.
- (5) Many companies that have borrowed money have “debt covenants” based on U.S. GAAP that restrict their financing activities. Modifications in existing IFRS may have to be made to maintain (or modify) these debt covenants.
- (6) Some accounting issues (e.g., related to extractive industries) are not covered by IFRS. New high-quality IFRS would have to be established to address these issues.

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 Starbucks. 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, \$2,462.3 million.
- Large amount of inventory, \$1,364.0 million.
- Jump in property, plant, and equipment, from \$4,533.8 million to \$4,919.5 million.
- Decrease in goodwill, from \$1,719.6 million to \$1,539.2.
- Significant increase in long-term debt financing—from \$3,185.3 million to \$3,932.6 million.
- Total equity (\$5,457.0 million) comprises just under 38% of the liabilities and equity, \$14,365.6 million.
- The majority of equity arises from retained earnings, which amounts to \$5,563.2. Students may note that retained earnings actually exceeded total shareholders' equity, in part because of the accumulated other comprehensive loss of \$155.6 million.

C1-7 (concluded)

Income Statement:

- Revenues of \$22,386.8 million, most of which come from company-operated retail stores, amounting to \$17,650.7 million.
- Nice jump in revenues in 2017 (+5.0%)—from \$21,315.9 million to \$22,386.8 million.
- Along with the growth in revenues, most of the operating expenses experienced significant increases. Some students will also note that in fiscal 2017, Starbucks recognized \$153.5 million in restructuring and impairment charges. The net result is a slight decrease in operating income, from \$4,171.9 million in 2016 to \$4,134.7 million in 2017.
- Income tax expense in fiscal 2017 is \$1,432.6 million.
- Record earnings in fiscal 2017 of \$2,884.7.

Statement of Cash Flows:

- Operating cash flows in fiscal 2017 are very healthy: \$4,174.3 million, a large portion of which comes from net earnings plus the depreciation and amortization addback.
- Investing cash outflows: (\$850.0 million), primarily for additions to property, plant, and equipment (\$1,519.4 million), less the net cash inflows from net sales and maturities of investment securities.
- Financing cash outflows: (\$3,001.6 million), long-term borrowings (net) contributed \$350.2 million, whereas cash outflows consisted primarily of payments for dividends (\$1,450.4 million) and repurchases of common stock (\$2,042.5 million).
- Cash balance increased in 2017, from \$2,128.8 million to \$2,462.3 million.

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 losses during fiscal 2017 of \$47.2 million increased the accumulated other comprehensive loss from \$108.4 million to \$155.6 million.
- Retained earnings decreased despite net earnings of \$2,884.7 million. The decline is attributable to dividends declared (\$1,515.9 million) and share repurchases (\$2,079.1 million) subtracted from retained earnings, with another \$323.6 million subtracted from additional paid-in capital.

Management Discussion and Analysis:

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

- Starbucks had 27,339 stores worldwide at the end of fiscal 2017.
- In fiscal 2018, Starbucks expects revenue growth in “the high single digits.”
- In fiscal 2018, Starbucks plans to open roughly 2,300 new stores.
- Starbucks expects capital expenditures to be approximately \$2.0 billion in fiscal 2018.

C1-8

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

Note: all amounts in millions of CHF

Balance Sheet:

- The largest assets consist of goodwill (CHF 29,748 million), property, plant, and equipment (CHF 27,775 million), intangible assets (CHF 20,615 million), investments in associates and joint ventures (CHF 11,628 million), and trade and other receivables (CHF 12,422 million).
- Total assets amount to CHF 130,380 million.
- Less financing from equity than from debt—total liabilities amount to CHF 67,603 million and total equity amounts to CHF 62,777 million.
- Financial debt—current (CHF 10,536 million) and noncurrent (CHF 15,932 million)—represent borrowings.
- The largest liability that arises from operating activities is trade and other payables (CHF 18,872 million).
- Retained earnings account for common equity: CHF 84,174 million.

Income Statement:

- Revenues of CHF 89,791 million in 2017, only a slight increase from 2016.
- Profit for the year was CHF 7,538 million in 2017, down significantly from CHF 8,883 for 2016.

Statement of Cash Flows:

- Operating cash flows are very healthy in 2017: CHF 13,486 million, most of which comes from operating profit plus the non-cash items.
- Investing cash flows in 2017: CHF -4,940 million, with capital expenditures being the largest use of cash for investing (CHF -3,934 million).
- Financing cash flows in 2017: (CHF -8,381 million), primarily for dividends and purchases of treasury shares.
- Cash balance decreased CHF 52 million: CHF 7,990 million at the beginning of 2017, CHF 7,938 million at the end of 2017.

C1-9

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

Balance Sheet:

- Enormous holdings of cash, cash equivalents, and short-term investments \$15,358 million.
- Largest asset—equity method investments \$20,856 million.
- Significant holdings of property, plant, and equipment \$8,203 million, goodwill, \$9,401 million, and trademarks with indefinite lives, \$6,729 million.
- Total assets are \$87,896 million.
- Financial debt—current (\$13,205 million in loans and notes payable plus \$3,298 million in current maturities of long-term debt) and long-term (\$31,182 million).
- Financed with more debt than equity—total liabilities amount to \$68,919 million and total equity amounts to \$18,977 million.
- The majority of equity arises from retained (reinvested) earnings.

Income Statement:

- Net operating revenues of \$35,410 million in 2017.
- Big drop in revenues—from \$44,294 million in 2015 to \$35,410 million in 2017.
- Equity income ballooned from \$489 million in 2015 to \$1,071 million in 2017.
- Big drop in net income: \$1,248 million in 2017, down considerably from 2015 net income of \$7,351 million.

Statement of Cash Flows:

- Operating cash flows are healthy in 2017: \$6,995 million, but they have dropped considerably since 2015, when they were \$10,528 million.
- Investing cash flows in 2017: (\$2,385 million), primarily for additions to property, plant, and equipment and (net) purchases of investments.
- Financing cash flows in 2017: (\$7,409 million), primarily for dividends (\$6,320 million) and (net) repurchases of common stock, net of roughly \$1.1 billion in cash flows from net issuances of debt.
- Cash balance decreased by \$2,549 million in 2017, from \$8,555 million to \$6,006 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 USING CODIFICATION

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.

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

C1-13 (concluded)

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

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

C1-14

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

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

- (a) Being realized or realizable. Revenue generally is not recognized until realized or realizable. Revenue is realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenue is realizable when related assets received or held are *readily convertible* to known amounts of cash or claims to cash.
- (b) Being earned. Revenue is not recognized until earned. A company's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenue is considered to have been earned when the company has substantially accomplished what it must do to be entitled to the benefits represented by the revenue.

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

C1-14 (concluded)

The Codification is located at <http://asc.fasb.org> (or, if your institution participates in the American Accounting Association academic access 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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- 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.

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