Intermediate Accounting

Second Edition

Elizabeth A. Gordon | Jana S. Raedy | Alexander J. Sannella

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Elizabeth A. Gordon
Fox School of Business, Temple University

Jana S. Raedy
Kenan-Flagler Business School, University of North Carolina at Chapel Hill

Alexander J. Sannella
Rutgers Business School, Rutgers University

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For Paul, Andrew, Mary, and my parents
EAG

For Nicholas, Aidan, and Kevin
JSR

For Ayden Alexander and Chloe Mikenzie
AJS

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About the Authors

Elizabeth A. Gordon, Ph.D., MBA, CPA

ELIZABETH A. GORDON IS ASSOCIATE PROFESSOR OF ACCOUNTING at the Fox School of Business at Temple University and a Merves Research Fellow. She received her doctorate from Columbia University, master's degree in business administration from Yale University, and bachelor's of science degree in accounting with highest distinction from Indiana University.

Dr. Gordon specializes in the areas of financial accounting and international financial reporting and investigates topics such as international financial reporting standards, corporate disclosure, executive compensation, related-party disclosures, and market development. Her research is published in top journals in her field including *Journal of Accounting Research*, *The Accounting Review*; *Review of Accounting Studies, Journal of Accounting, Auditing and Finance*; and *Journal of Accounting and Public Policy*. She serves as an editor of *Journal of International Financial Management and Accounting* and an associate editor of *Journal of International Accounting Research*. Dr. Gordon is a past president of the International Accounting Section of the American Accounting Association and serves as the vice president, finance and administration of the International Association for Accounting Education and Research.

Dr. Gordon has taught courses in financial accounting and international accounting at the graduate and undergraduate levels, receiving a number of teaching awards. She has coauthored accounting readings for the CFA Institute, integrating IFRS and U.S. GAAP. She was an auditor with PricewaterhouseCoopers, LLP, and interned at the U.S. Office of Management and Budget before entering academia. Dr. Gordon is a CPA in the State of Maryland. She has been on the faculty of the Graduate School of Business at the University of Chicago, the Rutgers Business School, and a visiting professor at the University of Pennsylvania.

Jana S. Raedy, Ph.D., CPA

JANA RAEDY IS ASSOCIATE PROFESSOR OF ACCOUNTING, associate dean of the Master of Accounting Program, and the Ernst & Young Scholar in Accounting at the Kenan-Flager Business School at the University of North Carolina at Chapel Hill. She received her bachelor of science and master of science degrees from the University of Kentucky and her doctorate from the Pennsylvania State University.

Dr. Raedy's research is primarily focused on issues in international financial reporting as well as areas in which financial reporting and taxation intersect. Her research is published in top journals such as *Journal of Accounting Research, Journal of Accounting and Economics, The Accounting Review, Contemporary Accounting Research*, and *Journal of the American Taxation Association*.

Dr. Raedy has taught a number of courses in financial reporting at the graduate level, including core financial reporting (both introductory and intermediate accounting), international financial reporting, and forensic accounting. For over 15 years, she has taught a self-developed course in applied financial accounting research with a heavy emphasis on judgment and decision making. During her academic career, she has received a number of different teaching awards. She currently is a team member of the Ernst & Young Academic Resource Center, which provides faculty nationwide with comprehensive teaching materials related to topics such as judgment, IFRS, and fair value.

Alexander J. Sannella, Ph.D., CPA

ALEXANDER J. SANNELLA IS CURRENTLY AN ASSOCIATE PROFESSOR of Accounting at the Rutgers Business School and is the Director of the MBA in Professional Accounting Program, Director of the Master of Accountancy in Professional Accounting and the Director of the Rutgers Business School Teaching Excellence Center. He earned a BBA in Finance and an MBA in Accounting from Iona College. He received his doctorate in accounting and finance from New York University and is a New York State Certified Public Accountant.

During his years at Rutgers Business School, Dr. Sannella has taught at both the graduate and undergraduate levels and served as Associate Dean of the Business School and Vice Chair of the Department of Accounting and Information Systems. Previously, Dr. Sannella served on the faculty of New York University as instructor of accounting at the Stern School of Business and as an Associate Professor of Accounting at Iona College's Hagan School of Business.

He has public accounting experience as an auditor for PricewaterhouseCoopers, LLP and KPMG, LLP. Dr. Sannella was also an independent consultant working on many projects with other public accounting firms, bankruptcy trustees, and leasing divisions of major insurance companies. He also served as a consultant to the Line of Business Program at the Federal Trade Commission in Washington.

Dr. Sannella has over 40 years of teaching experience at the university level and over 30 years of experience in developing and teaching commercial and investment bank training programs. His clients have included eight major investment banks and four of the world's largest commercial banks. His training programs include courses designed to train financial analysts and associates as well as special programs for sales and trading professionals.

The author of many scholarly journal articles and three books, Dr. Sannella's articles have focused on accounting education and market-based accounting research. His books focus on the effects of accounting alternatives on the judgment of analysts and other statement users. Many of the books' topics are included on training videos and CPE courses.

Dr. Sannella has been interviewed by several publications including the *Newark Star Ledger* and *NJ Biz*.

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Preface

New to This Edition

Coverage of the Latest Standards

Students need to begin understanding and applying standard changes to critical topics such as revenue recognition and leasing as early as possible in their college curriculum to be prepared for the CPA exam and practice when they graduate. With this in mind, key second edition updates include:

- Chapter 10 incorporates ASU 2015-11, which changes the measurement of the market value for lower-of-cost-or-market computations to net realizable value for all firms except those using LIFO or RIM.
- Chapter 14 incorporates ASU 2015-03, which changes the accounting method for debt issue costs under U.S. GAAP and converges U.S. GAAP with IFRS. Debt issue costs are now netted with the debt, thus changing the effective interest rate.
- Chapter 16 is significantly altered to incorporate ASU 2016-01, ASU 2016-13, and changes to IFRS 9. The principal impact of these standards is to the subsequent measurement of equity investments and the impairment of debt investments.
- Chapter 17 incorporates ASU 2015-17, which simplifies the presentation of deferred tax assets and liabilities on the balance sheet. The deferred tax accounts are now reported only as noncurrent assets and liabilities.
- Chapter 18 is a new chapter that incorporates the entirely new lease standards, ASU 2016-02, and IFRS 16.
- Chapter 19 incorporates ASU 2016-09, which allows companies the option of reporting actual forfeitures in addition to the current method of estimated forfeitures.

Solving Teaching and Learning Challenges

Our textbook is based on the belief that success in today's business environment requires an intuitive understanding of financial reporting and the ability to interpret and apply changing standards. In a world where there are simply too many rules to memorize, a traditional rules-based teaching approach has become inefficient and inadequate. Our goals for this textbook are aligned with the American Accounting Association's Pathways Commission, which seeks to correct misperceptions about the mechanical nature of accounting and to shift focus to the importance of critical thinking by accounting decision makers, particularly when the business context and related accounting rules require judgment.

We seek to develop the judgment and decision-making skills that accountants require to critically evaluate financial accounting methods and the financial statements. Using the conceptual framework fundamentals as a guide throughout, we emphasize solving accounting problems by applying standards, understanding how business activities are reflected in the financial statements, and critically evaluating the trade-offs and assumptions of accounting methods.

Coverage Grounded in the Conceptual Principles

To apply what they learn in the classroom to their professional lives, students need a solid grounding in the conceptual principles of financial reporting and the economic concepts underlying accounting. Thus, we open the textbook with coverage of these foundational topics, including the conceptual framework. In each chapter, sections called "The Conceptual Framework Connection" guide discussions and analyses by explicitly laying out the relevant conceptual underpinnings. For example, in the chapter on long-term operating assets, we discuss the capitalization decision.

Focus on Judgment, Decision Making, and Critical-Thinking Skills

Increasingly, the accounting profession and business world are looking for well-trained professionals with strong problem-solving and critical-thinking skills.

Judgment

To prepare students for future careers, we highlight the various *judgments* involved in all major topics in the context of real-business situations. For example, in Chapter 3, we discuss the factors that Activision Blizzard, a leading provider of interactive game services, considered when applying revenue recognition rules to its new technology and virtual goods. Our goal is to develop students' critical-thinking skills in assessing the assumptions, choices, and judgments that managers make when analyzing and reporting the business activities of a company. For example, many rules govern impairments, but ultimately, reporting comes down to judgment related to issues such as the expectation of future cash flows. Future career success depends on students' understanding the importance and prominence of the many judgments that inform a final set of financial statements.

Real-World Business

We pair our focus on real business situations with meaningful *real-company examples*. We examine financial statements from several high-profile firms—such as Johnson & Johnson, Netflix, Tesla, Amazon, Snap, Facebook, General Electric, Ericsson, Target, Adidas, Nike, Novartis, Coca-Cola, Pepsi Bottling Group, Starbucks, Walmart, and Ford Motor Company—in examples throughout the book.

In addition, our *Practitioner Interviews* feature question-and-answer-style exchanges with leaders in the field that provide insights into topics from a practitioner perspective and timely viewpoints on the business impact of rapidly evolving standards. Interviews profile executives at major firms—the Big Four accounting firms and name-brand companies such as Microsoft—as well as members of standard-setting boards.

Problem-Solving Skills

We emphasize problem solving within the chapters with *worked examples* accompanying every important concept. The consistent problem-solving methodology utilizes a problem/solution format and highlights the logic guiding the process, fostering students' ability to tackle problems on their own.

A variety of *end-of-chapter exercises* revolves around judgment and decision making. We include short problems and time-intensive cases that emphasize building students' ability to read and interpret authoritative accounting literature.

Highlighting Key Differences between U.S. GAAP and IFRS Standards

The book's central focus and grounding for each topic is U.S. GAAP. When IFRS diverges, we address the key conceptual differences in separate sections, often working through examples that parallel the GAAP coverage and providing tables with side-by-side comparisons of the GAAP and IFRS standards. With the aim of preparing students to apply the latest standards, we highlight key differences between IFRS and U.S. GAAP as pertinent. Our approach allows the instructor flexibility in IFRS topics covered and the depth of coverage. End-of-chapter summaries recap the main points for each section and contrast the U.S. GAAP and IFRS standards.

Presenting both sets of standards is important because the business world now operates in a global setting. Given the large number of multinational firms and foreign subsidiaries in the United States and the mobility of the workforce across international borders, students need to understand both IFRS and U.S. GAAP.

Reassessment of Coverage

We give fresh consideration to the necessary and proper content of an intermediate textbook. Due to changes in the business world and in the authoritative accounting literature, some topics may warrant less coverage while others have gained importance. This focused reconsideration of topical coverage will set students on a trajectory for success in their accounting careers and on the CPA exam.

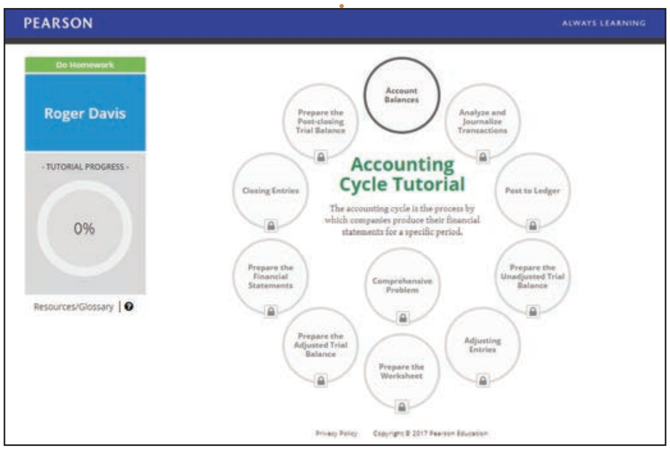
We have chosen to reassess coverage of topics based primarily on five criteria: (1) The topic is repeated elsewhere in the normal accounting curriculum, (2) the topic is industry specific, (3) the topic covers transactions/events that rarely occur, (4) the particular accounting method is not typically allowed under U.S. GAAP or IFRS, and (5) the topic covers transactions/events that do not commonly occur and the accounting treatment of the transaction is rule intensive.

By reassessing the coverage, we have made room for a number of topics not typically included in texts that have gained importance in the field (for example, tax contingencies, and revaluations of long-term operating assets under IFRS).

Get Students Ready . . .

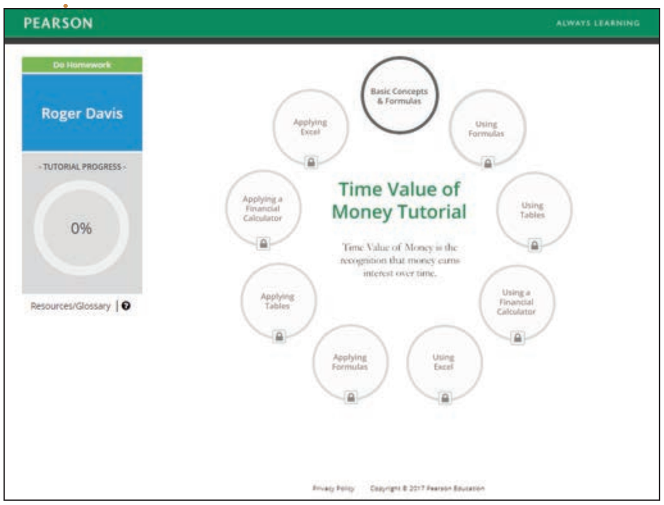
Accounting Cycle Tutorial

Accessed through MyLab Accounting by computer, smartphone, or tablet, the Accounting Cycle Tutorial provides a refresher on the basics so students are ready for intermediate-level work. This updated version includes a new comprehensive problem.



Time Value of Money Tutorial

The Time Value of Money Tutorial in MyLab ensures that students understand the basic theory and formulas of the TVM while helping test their ability to *apply* the TVM in the measurement of financial statement items. Students work through two sections. The first is to help them understand the theory using whichever method the instructor chooses (manually, through Excel, with tables, or via a calculator), and the second is to give students the opportunity to apply the theory by giving them a number of scenarios regarding each financial statement.



Worked Problem Videos

Worked Problem Videos provide step-by-step explanations of problems similar to those students will encounter in the text, helping them to understand how to arrive at the correct answers themselves.

Concept Overview Videos

Concept Overview Videos are short videos focusing on key concepts available in MyLab Accounting to further emphasize major concepts. These videos can be assigned as homework or used as part of a flipped classroom strategy.

To Be Decision Makers . . .

Conceptual Framework Connections

Each chapter guides students through discussions and analysis with a solid grounding in the conceptual framework fundamentals of reporting relevant, useful, timely, and understandable financial information.

THE CONCEPTUAL FRAMEWORK CONNECTION: Usefulness and Limitations of the Income Statements

The income statements provide useful information to financial statement users in three ways:

1. **Evaluate past performance.** Income statements enable financial statement users to evaluate the entity's past performance. By disclosing separate components of revenues and expenses, income statements provide useful information about the entity's overall past performance (i.e., the earnings) and identify the main factors that influence performance. Income statements provide confirmatory value, which is an aspect of relevant information. For example, investors are interested in whether companies meet or beat analysts' forecasts of net income as indicated by the statement of net income.
2. **Predict future performance.** Income statements have predictive value because they provide a basis for estimating future performance. Predictive value is an aspect of relevance. For example, a firm with a trend of earnings growth over the last 10 years may continue that growth in the future.
3. **Assess risks or uncertainties of achieving future cash flows.** Income statements provide information that is useful in assessing the risks or uncertainties of achieving future cash flows. Some items of income are more persistent in nature than others, making them strong indicators of future cash flows. For example, revenue from normal sales tends to persist from year to year. However, a gain from the sale of a specialized piece of equipment is

Emphasis on Judgment and Decision Making

Sections in each chapter identify key management decision points, and a unique full chapter dedicated to judgment and research identifies the assumptions, choices, and financial statement impacts from reporting business activities.

JUDGMENTS IN ACCOUNTING Inventory Costs

Judgment is crucial in determining the initial measurement of inventory. Deciding what costs to include in inventory is often subjective, as indicated by the Codification's statement that "although principles for the determination of inventory costs may be easily stated, their application . . . is difficult because of the variety of considerations in the allocation of costs and charges."[6] As a simple example, consider the requirement that companies capitalize freight-in costs into the inventory account whereas abnormal freight must be expensed. Deciding what freight cost is normal versus what is abnormal requires subjective judgment. For example, if an auto dealer pays freight for a shipment of vehicles delivered from the factory, it is a normal part of the dealer's business operations. In this case, the freight is considered part of the cost of inventory because it was reasonable and necessary to have the inventory in place and ready for sale. However, if sales begin to slow down and the dealer holds too much inventory, this inventory may have to be shipped to alternate locations. This additional freight may be considered abnormal and expensed because it is not a reasonable and necessary cost and does not represent a part of inventory value.

The decision to use the gross or net method of recording purchase discounts also affects the balance in the inventory account. In Example 10.4, the final balance in the inventory account is $4,960 using the gross method and $4,900 using the net method for the same three transactions. Thus, the inventory balance is impacted by management's choice of the method to account for the discount.

Worked Examples

Bolster students' problem-solving skills with model problem solutions for *every* important concept.

EXAMPLE 15.4 **Common Stock Issue Costs**

PROBLEM: Piper Products decided to raise additional financing by issuing common stock. The company received $4,000 in exchange for 1,000 shares of $1 par value common stock. Piper paid an underwriter $200 in stock issue costs. What is the necessary journal entry to record this transaction?

SOLUTION: The $200 of issue costs reduces Piper's cash received from the sale of the stock. Thus, it records the cash received at the net amount of $3,800, which is the $4,000 total proceeds less the $200 stock issue costs. The issue costs also reduce the additional paid-in capital in excess of par—common by $200. The journal entry follows.

Account	Current Year	
Cash	3,800	
Common Stock – $1 par		1,000
Additional Paid-in Capital in Excess of Par – Common		2,800

To Think Like Accountants . . .

Focus on Real-Company Financials

Disclosures and statements from well-known companies provide a connection to the application of accounting concepts and financial statement analysis.

EXHIBIT 10.11 Inventory Disclosures, ***Foot Locker, Inc.***, Financial Statements, January 28, 2017

From Financial Statement Notes:

NOTE 1: Summary of Significant Accounting Policies

Merchandise Inventories and Cost of Sales

Merchandise inventories for the Company's Athletic Stores are valued at the lower of cost or market using the retail inventory method. Cost for retail stores is determined on the last-in, first-out ("LIFO") basis for domestic inventories and on the first-in, first-out ("FIFO") basis for international inventories. Merchandise inventories of the Direct-to-Customers business are valued at the lower of cost or market using weighted-average cost, which approximates FIFO.

The retail inventory method is commonly used by retail companies to calculate gross margins due to its practicality. Under the retail invent applying a cost-to-retail percentage across groupings of similar items to-retail percentage is applied to ending inventory at its current owne cost of ending inventory on a department basis. The Company provid ing prices when the inventory has not been marked down to market.

NOTE 5: Merchandise Inventories

	2016	2015
	(in millions)	
LIFO inventories	$ 861	$ 847
FIFO inventories	446	438
Total merchandise inventories	$1,307	$1,285

The value of the Company's LIFO inventories, as calculated on a LIFO calculated on a FIFO basis.

Source: Foot Locker, Inc. January 28, 2017 Financial Statement. https://www data/850209/000085020917000003/fl-20170128x10k.htm, pages 44 and 52.

Inventory Disclosures: IFRS. IFRS inventory disclos under U.S. GAAP. Additionally, IFRS requires firms to report

Classification of Dividends, Interest, and Taxes: IFRS

IFRS differs from U.S. GAAP in the classification of the following items:

1. Cash receipts from interest and dividends
2. Cash payments for taxes
3. Cash payments for interest
4. Cash payments for dividends

As shown in Exhibit 6.8, U.S. GAAP requires companies to report the preceding items in operating cash flows except for the payment of dividends. IFRS grants companies discretion in classifying these items as operating, investing, or financing activities as Exhibit 6.8 illustrates.

EXHIBIT 6.8 Classification of Dividends, Interest, and Taxes

	Standard	
Activities	**U.S. GAAP**	**IFRS**
Cash receipts from interest and dividends	Operating	Operating or Investing
Cash payments for taxes	Operating	Operating activities, unless they can be specifically identified with Financing or Investing activities.
Cash payments for interest	Operating	Operating or Financing
Cash payments for dividends to owners	Financing	Operating or Financing

Key IFRS Differences

To prepare students for the global business world, IFRS material is highlighted in separate chapter sections. Side-by-side comparisons of GAAP and IFRS standards focus students on the key differences.

Interviews

Question-and-answer style exchanges with leaders in the field provide insight on topics from both standard-setter and practitioner perspectives and timely viewpoints on changing standards. Assign the new discussion questions to challenge students' understanding and critical-thinking skills.

Interview

BARBARA J. WIGHT

CHIEF FINANCIAL OFFICER

TAYLOR GUITARS »

Barbara J. Wight

Barbara Wight is Chief Financial Officer at Taylor Guitars, an industry-leading guitar manufacturer whose instruments are played by leading musicians worldwide. She directs all financial, information technology, and legal affairs on behalf of the company and oversees various aspects of operations management, multinational manufacturing, acquisitions, and international compliance.

material market deliveries, it might want to use LIFO for materials subject to inflation and FIFO for materials whose pricing is stable or even in decline.

3 Describe the most common components included in the unit cost of inventory at Taylor.

Taylor states inventories at standard cost based on the expected raw material costs, labor, and overhead. Our primary raw material is wood.

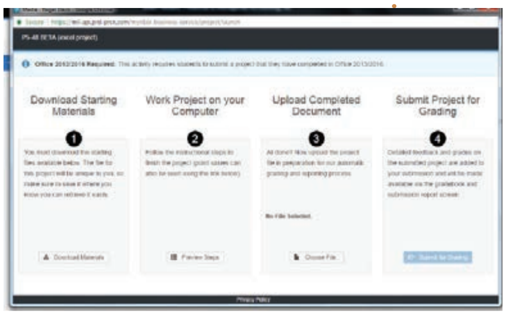
At the beginning of each year, Taylor determines how many total labor hours it will need to build the forecasted number of guitars and allocates overhead (and labor) to each guitar based on the calculated overhead and labor rate. The overhead rate times the number of labor hours per guitar equals overhead applied to each guitar unit. Taylor drives production based on a hybrid model; we build to order and to a sales forecast of specific models to ensure that high-turnover models are in stock at all times.

4 What are the most significant judgments employed in the decision to write inventory down to market when applying the lower-of-cost-or-market rule?

From the First Day of Class and into Their Careers

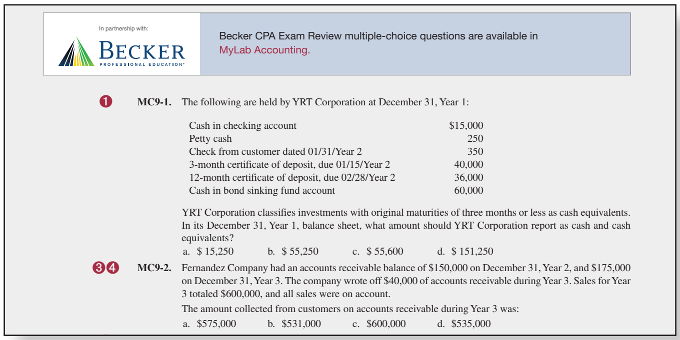
Auto-Graded Excel Projects

Using proven, field-tested technology, MyLab Accounting's new auto-graded Excel Projects allow instructors to seamlessly integrate Excel content into their course without having to manually grade spreadsheets. Students have the opportunity to practice important accounting skills in Microsoft Excel, helping them to master key concepts and gain proficiency with Excel. Students simply download a spreadsheet, work live on an accounting problem in Excel, and then upload that file back into MyLab Accounting where they receive reports on their work that provide personalized, detailed feedback to pinpoint where they went wrong on any step of the problem.



Becker

Sample problems assignable in MyLab Accounting provide an introduction to the CPA Exam format and an opportunity for early practice with CPA exam style questions.



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Becker CPA Exam Review multiple-choice questions are available in MyLab Accounting.

1 **MC9-1.** The following are held by YRT Corporation at December 31, Year 1:

Cash in checking account	$15,000
Petty cash	250
Check from customer dated 01/31/Year 2	350
3-month certificate of deposit, due 01/15/Year 2	40,000
12-month certificate of deposit, due 02/28/Year 2	36,000
Cash in bond sinking fund account	60,000

YRT Corporation classifies investments with original maturities of three months or less as cash equivalents. In its December 31, Year 1, balance sheet, what amount should YRT Corporation report as cash and cash equivalents?

a. $ 15,250 b. $ 55,250 c. $ 55,600 d. $ 151,250

3 4 **MC9-2.** Fernandez Company had an accounts receivable balance of $150,000 on December 31, Year 2, and $175,000 on December 31, Year 3. The company wrote off $40,000 of accounts receivable during Year 3. Sales for Year 3 totaled $600,000, and all sales were on account.

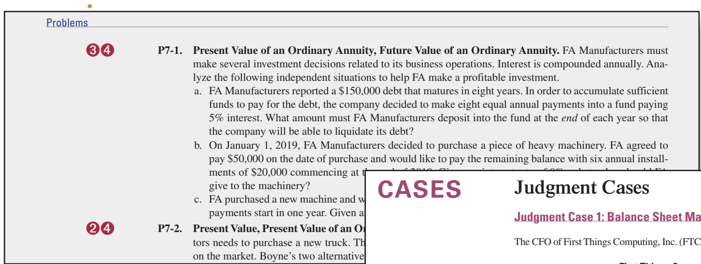
The amount collected from customers on accounts receivable during Year 3 was:

a. $575,000 b. $531,000 c. $600,000 d. $535,000

High-Quality and High-Quantity End-of-Chapter Exercises

Keyed to learning objectives, the items here progress in difficulty to test student understanding from the conceptual to multi-concept applied level.

Case exercises build students' ability to apply judgment-based analysis, read and interpret accounting literature, and analyze financial statements.



Problems

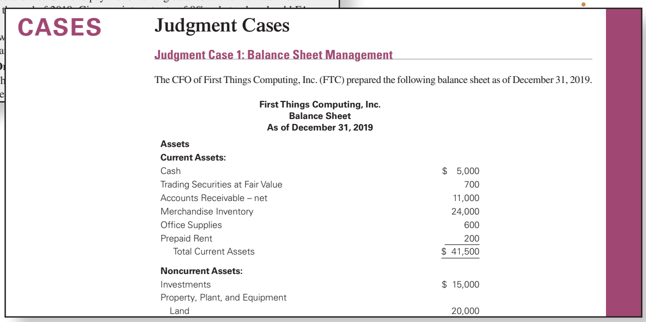
3 4 **P7-1. Present Value of an Ordinary Annuity, Future Value of an Ordinary Annuity.** FA Manufacturers must make several investment decisions related to its business operations. Interest is compounded annually. Analyze the following independent situations to help FA make a profitable investment.

a. FA Manufacturers reported a $150,000 debt that matures in eight years. In order to accumulate sufficient funds to pay for the debt, the company decided to make eight equal annual payments into a fund paying 5% interest. What amount must FA Manufacturers deposit into the fund at the *end* of each year so that the company will be able to liquidate its debt?

b. On January 1, 2019, FA Manufacturers decided to purchase a piece of heavy machinery. FA agreed to pay $50,000 on the date of purchase and would like to pay the remaining balance with six annual installments of $20,000 commencing at t
give to the machinery?

c. FA purchased a new machine and w
payments start in one year. Given a

2 4 **P7-2. Present Value, Present Value of an O**
tors needs to purchase a new truck. Th
on the market. Boyne's two alternative



CASES

Judgment Cases

Judgment Case 1: Balance Sheet Management

The CFO of First Things Computing, Inc. (FTC) prepared the following balance sheet as of December 31, 2019.

First Things Computing, Inc.
Balance Sheet
As of December 31, 2019

Assets	
Current Assets:	
Cash	$ 5,000
Trading Securities at Fair Value	700
Accounts Receivable – net	11,000
Merchandise Inventory	24,000
Office Supplies	600
Prepaid Rent	200
Total Current Assets	$ 41,500
Noncurrent Assets:	
Investments	$ 15,000
Property, Plant, and Equipment	
Land	20,000

Instructor Teaching Resources

This program comes with the following teaching resources.

Supplements Available to Instructors at www.pearsonhighered.com/gordon	Supplement Features
Instructor's Manual	**Course Content**

Created in collaboration with
Mary Cline from Rock Valley College
Regan Garey from Lock Haven University
	• Tips for Taking Your Course from Traditional to Hybrid, Blended, or Online
	• Standard Syllabi for Intermediate Accounting–2-semester course
	• Standard Syllabi for Intermediate Accounting–3-semester course
	• "First Day of Class" student handouts include
	  • Student Walk-Through to Set Up MAL
	  • Tips on How to Get an A in This Class

	Chapter Content
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Leslie Oakes, University of New Mexico
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Darlene Ely, Carroll Community College
James Emig, Villanova University
Ryan Enlow, University of Nevada, Las Vegas

Nancy Fan, California Polytechnic State University, Pomona
Patrick Fan, Virginia Tech
Magdy Farag, California Polytechnic State University, Pomona
Damon Fleming, San Diego State University
Marianne Fortuna, University of Georgia
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Micah Frankel, CSU East Bay
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Diane Franz, University of Toledo
Virginia Fullwood, Texas A&M University–Commerce
Regan Garey, Lock Haven University
Gregory Gaynor, University of Baltimore
Robin Gibson, Tri-County Community College
Lisa Gillespie, Loyola University Chicago
Hubert Glover, Drexel University
Giorgio Gotti, The University of Texas at El Paso
Pamela Graybeal, University of Central Florida
Amy Haas, Kingsborough Community College
Jan Hardesty, Pima Community College
Syed Hasan, George Mason University
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Susan Hughes, University of Vermont
Dave Hurtt, Baylor University
Mark Jackson, University of Nevada, Reno
Jeffrey Jones, College of Southern Nevada
Celina Jozsi, University of South Florida
John Karbens, Hawaii Pacific University
Mary Keener, The University of Tampa
Jerry Kreuze, Western Michigan University
Gaurav Kumar, University of Arkansas
Lisa Kutcher, Colorado State University
Jolene Lampton, Park University at Austin
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Ellen L. Landgraf, Loyola University Chicago
Nammy Lee, University of Virginia
Christy Lefevers, Catawba Valley Community College
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Ellen Lippman, University of Portland
Mary Loyland, University of North Dakota Bismarck
Ming Lu, Santa Monica College
James Lukawitz, University of Memphis
Marco Malandra, Temple University
Katie Maxwell, University of Arizona
Casey McNellis, University of Montana
Michelle Meckfessel, Case Western Reserve University
Linda Miller, Northeast Community College
Jose Miranda-Lopez, University of Tulsa
Joe Moran, College of DuPage
Laura Morgan, NHTI, Concord's Community College
Donald Minyard, University of Alabama
Volkan Muslu, University of Houston
Cory Ng, Temple University
Derek Oler, Texas Tech University
Kingsley Olibe, Kansas State University
Susan Pallas, Southeast Community College
Janet Papiernik, Indiana University–Purdue University Fort Wayne
Nancy Pasternack, University of Washington
Nori Pearson, Washington State University Pullman
Bonita Peterson Kramer, Montana State University
Marc Picconi, College of William and Mary
Catherine Plante, University of New Hampshire
Kristin Portz, St. Cloud State University
Richard Price, University of Oklahoma
Damian R. Prince, New Jersey City University
Lauren Psomostitis, North Seattle College
James Racic, Lakeland Community College
Raymond Reisig, Pace University
Cecile Roberti, Community College of Rhode Island
L. H. Rogero, University of Dayton
Eric Rothenburg, Kingsborough Community College
Brian Routh, University of Southern Indiana
Chris Ruderman, Linn-Benton Community College
Anwar Salimi, California Polytechnic State University, Pomona
Paul Schloemer, Ashland University
Kathleen Sevigny, Bridgewater State College
Marsha Shapiro, Park University
Praveen Sinha, California State University, Long Beach
Leonard Soffer, University of Chicago
Gregory Sommers, Southern Methodist University
Jalal Soroosh, Loyola University Maryland
Derinda Stiene, Caldwell Community College and Technical Institute
Stephen Strand, Southern Maine Community College
Joel Strong, St. Cloud State University
C. Daniel Stubbs, Rutgers University

Alan Styles, California State University San Marcos
Zane Swanson, University of Central Oklahoma
Robert Terrell, University of Central Oklahoma
Geoffrey Tickell, Indiana University of Pennsylvania
Paula Thomas, Middle Tennessee State University
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Norbert Tschakert, Salem State University
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Anna Froman, Metro State University of Denver
Gregory Gaynor, University of Baltimore
Drew Goodson, Central Carolina Community College
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Christine Kuglin, Metropolitan State University of Denver
Jolene Lampton, Park University
Christa Land, Catawba Valley Community College
Hui Lin, DePaul University
Ellen Lippman, University of Portland
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1 The Financial Reporting Environment

LEARNING OBJECTIVES

1. Define financial accounting and describe the demand for financial information, including the role of general-purpose financial statements, the information needs of financial statement users and other parties, and the factors that influence financial reporting.
2. Discuss the role of financial accounting standard setters in the United States and internationally.
3. Detail the standard-setting process.
4. Explain three recent trends in standard setting: principles-based, rules-based, and objectives-oriented standards; the asset/liability approach; and fair value measurements.

Introduction

WELL-DEVELOPED ACCOUNTING STANDARDS ENABLE WORLDWIDE capital markets to function effectively by providing credibility to published financial information used by investors, creditors, and others. Transparent financial information included in the financial statements allows these parties to make rational investment and credit decisions that direct capital to corporations that develop new products and technology, create employment, and encourage growth and development.

Andrew Burton/Getty Images

Consider ***Twitter, Inc.***, the social networking company, which raised capital of over $2.09 billion by issuing 80.5 million shares of stock in its initial public offering. Investors subsequently traded over 194 million shares of ***Twitter's*** stock valued at $8.2 billion during the first month after the initial public offering.[1] These investors based their decisions on the financial information provided by ***Twitter***. The capital provided by such investments fuels the overall economy and directs capital to its most productive uses.

Multiple factors in the overall accounting environment influence economic decisions at the firm level. For example, user groups such as investors and creditors impact the demand for accounting information and influence the standard-setting bodies. Financial reporting encompasses much more than the financial statements: Other key elements include the footnotes to the financial statements, the letter to the owners, management's discussion and analysis, the auditors' report, the management report, and press releases. Financial statement users rely on all categories of financial information to make rational economic decisions.

In this chapter, we first define *financial accounting* and discuss the demand and supply of financial information. We identify the economic entities that prepare financial information as well as the users of financial information. We then explore factors that shape accounting information. We also overview the historical development of the U.S. and international standard-setting bodies and discuss the standard-setting processes. We conclude the chapter with a review of recent trends in standard setting. «

[1]Twitter, Inc. is traded on the New York Stock Exchange. It made its initial public offering on November 7, 2013.

1 Define financial accounting and describe the demand for financial information, including the role of general-purpose financial statements, the information needs of financial statement users and other parties, and the factors that influence financial reporting.

Overview of Financial Reporting

Financial accounting is the process of identifying, measuring, and communicating financial information about an economic entity to various user groups within the legal, economic, political, and social environment. This definition contains four major elements:

1. Financial information
2. Economic entity
3. User groups
4. Legal, economic, political, and social environment

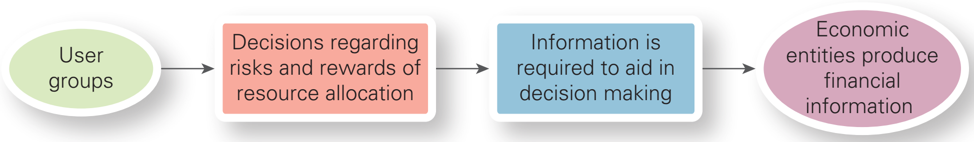
We will examine these elements in the following sections of the chapter.

Financial Information

Financial information falls into two categories: information that is or that is not governed by rules set forth by the accounting standard-setting bodies. Firms prepare the financial statements and the footnotes to the financial statements (also referred to as footnote disclosures) based on accounting standard setters' rules. In contrast, the letter to the owners, management's discussion and analysis, the auditors' report, the management report, and press releases are not governed by the accounting standard-setting bodies, although they are regulated to some degree by other authoritative bodies.[2]

Demand for Financial Information. The form, content, and extent that firms provide financial information is based on market participant demand. Financial accounting provides information that enables users to evaluate economic entities and make efficient resource allocation decisions based on the risks and returns of a particular investment. This process directs capital flows to their most productive uses. In this way, the demand for financial information is linked to the allocation of scarce resources, as illustrated in Exhibit 1.1.

EXHIBIT 1.1 Demand for Financial Information



Capital is a scarce resource. How do investors and creditors make decisions regarding the amount of capital to invest in a given entity? Accountants report the economic performance and financial position of the firm so that potential debt and equity investors can adequately assess the risks and returns of investing in the entity. Similarly, lenders can use the financial statements to assess the potential for payment. For example, a bank limited in the number of loans that it can make would clearly prefer to lend to a business that has been profitable over the last five years rather than one that has not.

Transparent and complete financial statements aid investors in assessing the amounts and timing of future cash flows, as well as the uncertainty of cash flow realization. However, financial statement users should be aware that performance-based compensation can create an incentive for managers to strategically manage—or to misreport—financial statements. Compensating managers based upon reported net income provides a financial incentive to inflate net income. For example, when the Securities and Exchange Commission found that the ***Computer Sciences Corporation (CSC)*** committed accounting fraud that increased net earnings in 2010 and 2011,

[2]For a discussion of the financial statements and many of these other items, see Chapters 5 and 6.

CSC's CEO agreed to pay back $3.7 million of compensation he received based on the fraudulent earnings.[3] Financial accounting standards seek to limit this type of management behavior. Most managers faithfully report their financial statements, but it is important for standard setters and auditors to be aware of incentives to alter net income.

Sources of Financial Information. The financial reporting process generates a significant amount of financial information that yields the four basic financial statements, as well as the footnote disclosures. In the chapters that follow, we examine the theory, rationale, and principles underlying the four basic financial statements:

- The balance sheet (also referred to as the statement of financial position)
- The statement of comprehensive income[4]
- The statement of cash flows
- The statement of shareholders' equity

Published financial statements are called **general-purpose financial statements** because they provide information to a wide spectrum of user groups: investors, creditors, financial analysts, customers, employees, competitors, suppliers, unions, and government agencies. Although considered general purpose, most financial information is provided to satisfy users with limited ability or authority to obtain additional information, which includes investors and creditors. The **Financial Accounting Standards Board (FASB),** which is the body responsible for promulgating U.S. GAAP, identifies investors, lenders, and other creditors as the primary users of the financial statements.

Financial statements are the culmination of the financial reporting process. These financial statements, along with the accompanying footnote disclosures, are the primary source of publicly available financial information for investors and creditors. None of the other sources of financial information—such as management forecasts, press releases, and regulatory reports—provide as much information as the financial statements.

The term financial information includes more information than the financial statements. The financial statements include the four basic financial statements and the related footnotes. However, financial information also includes items such as:

- A letter to the shareholders
- A formal discussion and analysis of the firm by the management of the firm
- Management report
- Auditors' report
- Financial summary

Therefore, the general-purpose financial statements and the related footnotes are subsets of financial information. The financial statements and the footnotes are governed by U.S. GAAP, which may not always be the case for all components of financial information.[5]

Economic Entity

The second element in the definition of financial accounting involves the *economic entity* for which the financial statements and other financial information are presented. An **economic entity** is an organization or unit with activities that are separate from those of its owners and other entities. Financial information always relates to a particular economic entity. Economic entities can be corporations, partnerships, sole proprietorships, or governmental organizations. Also, economic

[3]https://www.sec.gov/news/pressrelease/2015-111.html

[4]Entities may report comprehensive income either in one combined statement or in two statements—the statement of net income and the statement of comprehensive income.

[5]We discuss these other types of financial information more extensively in Chapter 6.

entities may be privately held or publicly held.[6] If the entity is publicly held, then its equity can be bought and sold by external parties on stock exchanges.

The management of a particular economic entity prepares its financial information, including the financial statements. While the management of the entity may also use the financial information to some extent, they are better classified as preparers than users of financial information.[7]

Financial Statement User Groups

The third element in the financial accounting definition involves identifying the primary user groups that demand financial information. Some users employ accounting information to make economic decisions for their own benefit while other users employ accounting information to make economic decisions for the benefit of others or to assist others in making investment or credit decisions. Exhibit 1.2 lists the user groups.

EXHIBIT 1.2 User Groups

Users	Description
Equity Investors	Shareholders of the company
Creditors and Other Debt Investors	Entities including banks and other financial institutions that lend money to the company either through a private agreement or through a public debt offering
Competitors	Companies that produce the same service or product
Financial Analysts	Individuals employed at investment banks, commercial banks, and brokerage houses that use financial information to provide guidance to individuals and other entities in making investment and credit decisions
Employees and Labor Unions	Individuals that work for the company and the organizations that represent the employees' interests
Suppliers and Customers	Organizations that provide the necessary inputs for the products or services produced by the entity and companies or individuals that purchase the goods or services from the entity
Government Agencies	Agencies representing the government that are in charge of reviewing and/or regulating the company

Equity Investors. **Equity investors** are the shareholders of the company. That is, an equity investor purchases a percentage ownership of the company. Equity investors include individuals, other corporations, partnerships, mutual funds, pension plans, and other financial institutions that expect to receive a return on their investment either through dividends (i.e., distributions of cash or other assets to owners) or in the form of an increase in the price of their equity shares.

Equity investors use financial information to determine a company's ability to generate earnings and cash flow, as well as to make an assessment of the potential risks and returns of their investments. Equity investors also use financial information to assess the ability of the entity to pay dividends and to grow over time. Firm growth in earnings and cash flow are important for the investor to sell his or her investment at a gain.

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[6] In this text book, we focus primarily on publicly traded entities. We use examples from the financial statements issued by manufacturing, retail, and service entities. We will not focus on financial statements from specialized industries such as insurance, banking, and other regulated industries.

[7] Managers of economic entities use accounting information for internal decision making as detailed in cost and managerial accounting courses.

Creditors and Other Debt Investors. **Creditors** and other debt investors are entities, including banks and other financial institutions, that lend money to the company. Debt can either be public or privately held. In the case of publicly traded debt, market participants invest in the entity's debt—specifically, the entity's bonds. In the case of privately held debt, companies obtain capital directly from lenders, such as commercial banks. Creditors typically receive a return on their investment in the form of interest income. However, in the case of public debt, they may also receive a return in the form of an increase in the price of the bonds.

Creditors use financial information to determine whether the principal and interest on their loans will likely be paid by debtors when due. Creditors are also concerned with the priority of claims against the assets of the debtor company. Some lenders have priority over others when determining the order of repayment. Finally, creditors can use financial information to assess the entity's current and future profitability and growth prospects.

Competitors. Competitors use financial information to determine their market position relative to the reporting entity. Companies analyze a competitor's financial information to identify its strategy and determine if it is possible to successfully compete with the company. An analysis of a competitor's financial information enables a financial statement user to identify that entity's objectives, assumptions, overall business strategy, and capabilities. For example, a pharmaceutical company would be interested in any increases in a rival's research and development expenses that could indicate new and competing products in the future.

Financial Analysts. **Financial analysts** employed at investment banks, commercial banks, and brokerage houses use financial information to provide guidance to individuals and other entities in making investment and credit decisions. Analysts use various techniques to estimate the value of an entity based on information obtained from the annual report and other publicly available information, as well as from interviews with company officers and outside industry or economic experts. Some financial analysts are equity analysts who follow an industry or certain companies and provide their opinions or recommendations on a regular basis. These reports result in a recommendation as to whether investors should buy or sell the stock of that company. For example, in the first quarter of 2017, there were 39 analyst recommendations issued for ***Twitter***—4 of which were buys, 27 were holds, and 8 were sells or underperforms.[8] Financial analysts act as market intermediaries in that they are trained to examine an extensive volume of financial data and reduce it to a manageable amount of information for use by investors.

Employees and Labor Unions. Employees and labor unions use financial statements to assess the economic performance and liquidity of entities employing members of the union. For example, the United Auto Workers represents employees in the automobile industry. Financial statement information can be useful during the negotiation of new labor agreements and compensation contracts.

Suppliers and Customers. Suppliers and customers use financial statements to determine a company's financial position. For suppliers, it is critically important to assess the company's ability to pay for goods and services provided. A company's financial condition indicates the quality of its products and its ability to honor warranties to potential customers. ***General Motors*** (***GM***) lost many prospective customers when it was in bankruptcy during the economic crisis of 2008. In this case, auto buyers were concerned that ***GM*** would not be in business long enough to fulfill its warranty obligation to its customers.

Government Agencies. Government agencies review the financial statements of publicly traded companies for a variety of reasons. For example, the U.S. Federal Trade Commission may review publicly available financial information to identify a potential monopoly or an entity in violation of antitrust laws.

[8] See http://www.nasdaq.com/symbol/twtr/recommendations

Other Parties Involved in the Preparation and Use of Financial Information

Another important group involved in the financial reporting process is the *preparers* themselves. **Financial statement preparers** are the companies that issue the financial statements.

In addition to preparers and users of the financial statements, other parties involved in the financial reporting process include:

- Auditors
- Accounting standard setters such as the Financial Accounting Standards Board and the *International Accounting Standards Board*
- Regulatory bodies such as the Securities and Exchange Commission and the Public Company Accounting Oversight Board
- Professional organizations such as the American Institute of Certified Public Accountants

Auditors can be *external* or *internal*. **External auditors** are independent of the company and are responsible for ensuring that management prepares and issues financial statements that comply with accounting standards and fairly present the financial position and economic performance of the company. Because external auditors are independent parties, they lend a significant amount of credibility to the financial statements. **Internal auditors** are employees of the company serving in an advisory role to management and providing information regarding the company's operations and proper functioning of its internal controls.

Accounting standard setters develop and promulgate accounting concepts, rules, and guidelines that provide information that is relevant and faithfully represents the economic performance and the financial position of the reporting entity. The Financial Accounting Standards Board (FASB), the primary standard setter in the United States, promulgates U.S. Generally Accepted Accounting Principles (U.S. GAAP). The **International Accounting Standards Board (IASB)** sets International Financial Reporting Standards (IFRS). We discuss the standard setters' role and the standard-setting process in more depth later in the chapter.

Regulatory bodies protect investors and oversee the accounting standard-setting process. In the United States, the U.S. Securities and Exchange Commission (SEC) regulates publicly traded companies.[9] Privately held companies are not required to comply with the SEC's regulations. The SEC gives the FASB the authority to issue U.S. GAAP. In addition, the SEC reviews the filings of public companies in the United States. The Public Company Accounting Oversight Board (PCAOB) sets auditing standards and oversees the audits of public companies in the United States.

Professional organizations such as the American Institute of Certified Public Accountants (AICPA) are also involved in the financial reporting process. The AICPA is the national professional association for Certified Public Accountants (CPAs) in the United States. The AICPA prepares and grades the Uniform CPA Examination. This organization also supports accounting professionals throughout their careers by providing training, professional skills development, and other resources.

Exhibit 1.3 summarizes the various groups involved in the financial reporting process.

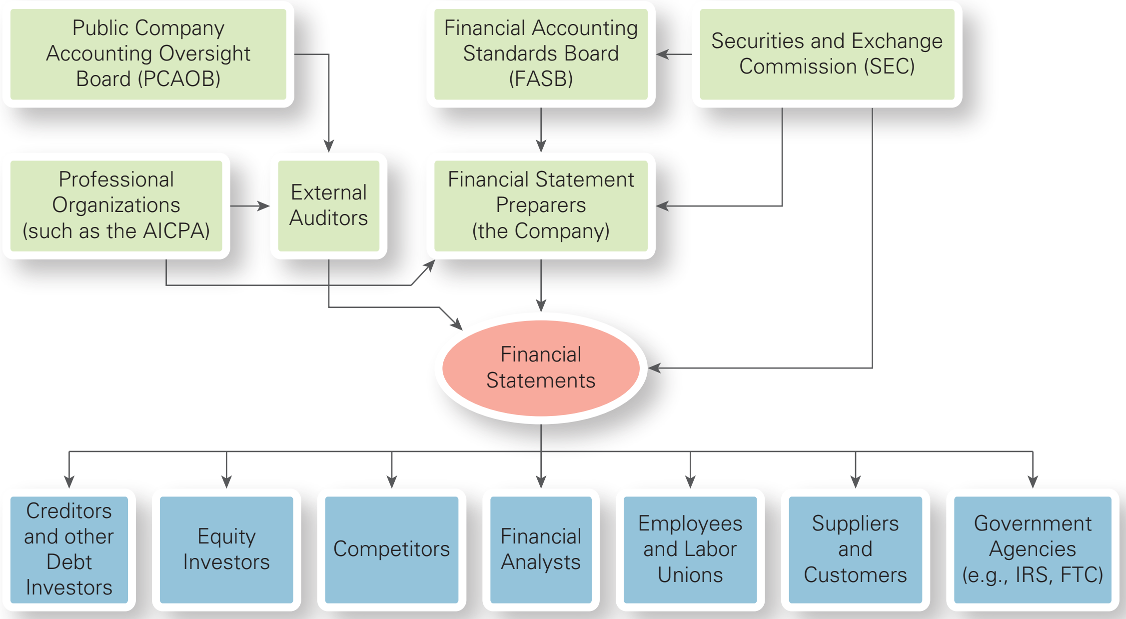
Legal, Economic, Political, and Social Environment

Financial reporting takes place in a complex and dynamic world: Financial statement users' information needs change as business evolves. So, it is natural that environmental factors—legal, economic, political, and social—shape and influence the financial reporting process. The environment is the fourth element of the financial accounting definition. Financial accounting interacts with its environment in both a reactive and a proactive fashion.

Reactive Factors. Financial accounting reacts to pressure (lobbying) from various groups and changes in its environment. Accounting theories and procedures evolve to meet the dynamic changes and demands from the environment. For example, FASB made changes in the accounting

[9]A company is regulated by the SEC if it has either debt or equity that is publicly traded.

EXHIBIT 1.3 Parties Involved in the Financial Reporting Process in the United States



for off-balance sheet subsidiaries following the discovery of the massive fraud scheme at ***Enron*** in the early 2000s.

In addition, accounting conforms to economic conditions, legal standards, and social values. Today, accounting disclosures highlight a company's policies regarding pollution control, community service, and diversity in business. For example, in the letter to shareholders in ***Johnson & Johnson's*** 2015 annual report, CEO Alex Gorsky highlighted ***Johnson & Johnson's*** "legacy of caring through strategic partnerships," as shown in Exhibit 1.4.

EXHIBIT 1.4 ***Johnson & Johnson Company's*** 2015 Letter to the Shareholders Discussion of Corporate Philanthropy

We understand the important role Johnson & Johnson plays in the world, and we continue to build on our 130-year legacy of caring through strategic philanthropy with hundreds of partner organizations worldwide. Our corporate philanthropy includes work with Operation Smile®—helping to provide safe surgeries for facial deformities in children; Save the Children®—providing care to tens of millions of children around the world in resource limited and crisis situations, including long-term support for Syrian refugees; and the Elizabeth Glaser Pediatric AIDS Foundation®—eliminating HIV infections in children around the world. We also partner with global health agencies and non-governmental organizations to battle some of the most deadly epidemics of our generation, like our commitment and partnership to rapidly develop a vaccine for Ebola. Through these commitments, we envision a world where everyone has the means to be healthy and can thrive. We are committed to using our capabilities, expertise, resources and partnerships to fulfill our role in making the world a better, healthier place for generations to come.

Source: Annual Report, 2015 Johnson and Johnson.

The development of accounting standards is also a political process that is heavily influenced by the various groups within the reporting environment. Lobby groups include investors, creditors, financial analysts, the financial community, academics, accounting organizations, and industry associations.

Proactive Factors. Financial accounting is proactive in that it can change or influence its environment by providing feedback information that is used by organizations and individuals to reshape the economy. Accounting information is used to efficiently allocate resources throughout the economy by directing capital flows to their most productive uses. For example, start-up capital is needed to develop new technology such as solar power and electric vehicles.

Accounting standards can also influence managerial behavior. For example, expensing research and development costs may slow investment in research during economic downturns because this accounting treatment results in lower earnings figures.

2 Discuss the role of financial accounting standard setters in the United States and internationally.

Role of Standard Setters

Standard setters work diligently to develop concepts, rules, and guidelines for financial reporting that will satisfy the requirement to accurately present the economic performance and financial position of the firm. These standards are designed to encourage transparent and truthful reporting. Publicly traded entities must follow the rules and guidelines set forth by the standard setters to maintain public trust and to ensure the efficient functioning of capital markets. The FASB promulgates accounting standards in the United States, and the IASB issues global accounting standards, called International Financial Reporting Standards (IFRS).

The Importance of Understanding International Accounting Standards

Although U.S. GAAP and IFRS are converged in many areas, some differences still remain. Throughout the text, we present the U.S. GAAP standards in detail and highlight pertinent differences with IFRS. Why is it important for an accountant in the United States to learn international accounting standards? There are several reasons:

- U.S. companies operate subsidiaries outside of the United States. Many of these subsidiaries report under IFRS in their home countries. Accountants must convert the subsidiaries' financial statements to U.S. GAAP when preparing consolidated financial statements. For example, ***Johnson & Johnson*** operates in over 60 countries throughout the world.
- Non-U.S. companies operate in the United States and prepare their financial statements using IFRS. Consequently, if you are working at or auditing an international firm, you will likely see IFRS. For example, ***GlaxoSmithKline*** is a worldwide pharmaceutical company based in the United Kingdom with 18% of its employees in the United States and a U.S. headquarters in Philadelphia.
- The SEC permits the use of IFRS-based financial statements by international companies with shares trading on U.S. stock exchanges.[10] U.S. accountants and auditors often assist these non-U.S. companies in preparing U.S. regulatory reports. As of September 2016, these companies represented a worldwide market capitalization in excess of $7 trillion across more than 500 companies.[11]
- The SEC promotes high-quality, globally accepted accounting standards. U.S. accountants and auditors need a working knowledge of IFRS to implement global standards in companies and perform audits.
- Many U.S. accountants now spend time working outside of the United States. IFRS is required or permitted in over 130 countries worldwide. Exhibit 1.5 presents a map that highlights the countries that require IFRS in red (as of May 2016).
- The accounting profession has determined that a working knowledge of IFRS is important for today's accountant. For example, the American Institute of Certified Public Accountants tests IFRS on the CPA exam.

To ensure that you are prepared to meet these challenges, we address both U.S. GAAP and IFRS in this text. We introduce accounting practices in the United States first. We then compare U.S. GAAP to IFRS in sections with green headings, focusing on similarities and differences. Where there are differences, we cover IFRS at the same level of detail as used for U.S. GAAP.

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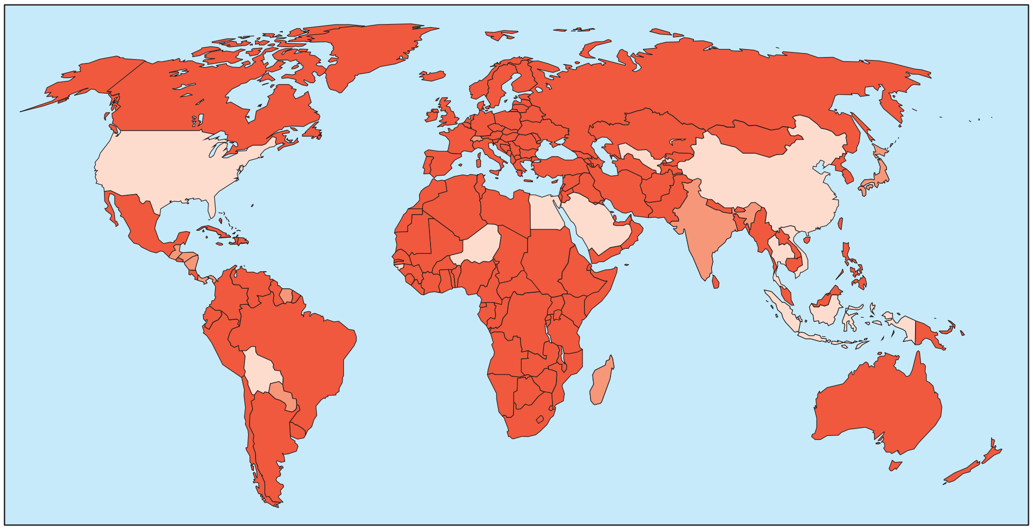
[10] The SEC eliminated the requirement that foreign issuers reconcile their financial statements from IFRS (or other accounting standards) to U.S. GAAP in 2007. To be clear, U.S. companies may not use IFRS in their financial statements. U.S. GAAP is required for U.S. companies.

[11] See Source: https://www.sec.gov/news/statement/white-2016-01-05.html

EXHIBIT 1.5 Global Usage of IFRS



IFRS required for all or most domestic publicly accountable entities

IFRS permitted

IFRS not currently in use

Source: Based on "The Global Financial Reporting Language," May 2016, IFRS Foundation table on p. 5. http://www.ifrs.org/Use-around-the-world/Documents/The-Global-Financial-Reporting-Language-May-2016.pdf

3 Detail the standard-setting process.

The Standard-Setting Process

We previously established that the FASB sets accounting standards in the United States and the IASB sets global accounting standards. The standard-setting processes are similar for the two Boards but there are some important differences that we will highlight.

Standard Setting

We begin with the history of U.S. standard setting, the structure of the standard-setting body, and the process of standard setting.

History of Standard Setting. U.S. financial reporting standard setting began with the 1934 Securities Exchange Act, which gave the SEC the power to promulgate accounting standards for all publicly traded firms. The SEC delegated its standard-setting power to the private sector, prompting the accounting profession to establish the first U.S. standard-setting board. The Committee on Accounting Procedures (CAP) was formed in 1939 as a subcommittee of the American Institute of Certified Public Accountants (AICPA) to reduce the number of accounting methods used in practice. Prior to the formation of the CAP, there were significant inconsistencies in the form and content of financial statements. For example, some companies would provide only a balance sheet while others would report only an income statement. During its tenure, the CAP produced 51 standards, referred to as Accounting Research Bulletins (ARBs or Bulletins).

The CAP accomplished its goal of reducing accounting alternatives and was replaced in 1959 by the Accounting Principles Board (APB). The APB, another subcommittee of the AICPA, issued pronouncements known as Opinions and Statements. The APB's primary objective was to respond to existing and emerging problems in financial reporting. The APB issued 31 APB Opinions and four APB Statements.

The APB was criticized for being slow to develop accounting standards and inactive on several controversial issues. The part-time board members were all CPAs still affiliated with their employers. As a result, board members were not viewed as independent. Further, the APB did not