NINTH EDITION

INTERMEDIATE ACCOUNTING

J. DAVID SPICELAND
MARK W. NELSON
WAYNE B. THOMAS

McGraw Hill Education

Intermediate Accounting

NINTH EDITION

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Dedicated to:

David's wife Charlene, daughters Denise and Jessica, and sons Michael David, Michael, and David
Mark's wife Cathy, and daughters Liz and Clara
Wayne's wife Julee, daughter Olivia, and three sons Jake, Eli, and Luke

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About the Authors

DAVID SPICELAND

David Spiceland is professor of accounting at the University of Memphis, where he teaches intermediate accounting and other financial accounting courses at the undergraduate and master's levels. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals, including *The Accounting Review, Accounting and Business Research, Journal of Financial Research,* and *Journal of Accounting Education,* and is an author of McGraw-Hill's *Financial Accounting* with Wayne Thomas and Don Herrmann. Professor Spiceland has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom.

MARK NELSON

Mark Nelson is the Anne and Elmer Lindseth Dean and Professor of Accounting at Cornell University's S. C. Johnson Graduate School of Management. He received his BBA degree from Iowa State University and his MA and PhD degrees from The Ohio State University. Professor Nelson has won ten teaching awards, including an inaugural Cook Prize from the American Accounting Association.

Professor Nelson's research focuses on decision making in financial accounting and auditing. His research has been published in the *Accounting Review;* the *Journal of Accounting Research; Contemporary Accounting Research; Accounting, Organizations and Society;* and several other journals. He has received the American Accounting Association's Notable Contribution to Accounting Literature Award, as well as the AAA's Wildman Medal for work judged to make a significant contribution to practice.

Professor Nelson served three terms as an area editor of *The Accounting Review* and is a member of the editorial boards of several journals. He also served for four years on the FASB's Financial Accounting Standards Advisory Council.

WAYNE THOMAS

Wayne Thomas is the John T. Steed Chair and Professor of Accounting at the University of Oklahoma's Price College of Business. He received his BS degree from Southwestern Oklahoma State University and his MS and PhD from Oklahoma State University. He has received teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. He is an author of McGraw-Hill's *Financial Accounting* with David Spiceland and Don Herrmann.

His research focuses on various financial reporting issues and has been published in *The Accounting Review, Journal of Accounting Research, Journal of Accounting and Economics, Contemporary Accounting Research, Review of Accounting Studies, Accounting Organizations and Society,* and others. He has served as an editor for *The Accounting Review* and has won the American Accounting Association's Competitive Manuscript Award and Outstanding International Accounting Dissertation.

Professor Thomas enjoys various activities such as tennis, basketball, golf, and crossword puzzles, and most of all, he enjoys spending time with his wife and kids.

Intermediate Accounting Ninth Edition:

Welcome to the fastest-growing learning program in intermediate accounting! Instructors recognize the "Spiceland advantage" in content that's intensive and thorough, as well as in writing that's fluid and precise—together, these combine to form a resource that's rigorous yet readable. By blending a comprehensive approach, clear conversational tone, current updates on key standards, and the market-leading technological innovations of Connect®, the Spiceland team delivers an unrivaled experience. As a result of Spiceland's rigorous yet readable learning system, students develop a deeper and more complete understanding of intermediate accounting topics.

> "The chapters are well written in a style that makes difficult materials approachable for students."
>
> **—Kathy Hsiao Yu Hsu, *University of Louisiana–Lafayette***

The *Intermediate Accounting* learning system is built around four key attributes: current, comprehensive, clear, and Connect®

Current: Few disciplines see the rapid changes that accounting experiences. The Spiceland team is committed to keeping instructors' courses up to date. The ninth edition fully integrates the latest FASB updates, including:

- **NEW** Chapter 15, covering the latest standard on leases (ASU No. 2016–02, Leases (Topic 842)).
- ASU No. 2016–01, Financial Instruments—Overall (Subtopic 825–10): Recognition and Measurement of Financial Assets and Financial Liabilities
- ASU No. 2016–013, Financial Instruments—Credit Losses (Topic 326) on "Current Expected Credit Loss" (CECL) model for accounting for credit losses, as well as current GAAP requirements for recognizing impairments of investments.
- ASU No. 2015–17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes
- ASU No. 2015–03, Interest—Imputation of Interest (Subtopic 835–30)
- ASU No. 2016–10, Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing (Topic 606)
- ASU No. 2016–09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation—Stock Compensation.

Current events regularly focus public attention on the key role of accounting in providing information useful to financial decision makers. The CPA exam, too, has changed to emphasize the professional skills needed to critically evaluate accounting method alternatives. *Intermediate Accounting* provides a **decision makers' perspective,** highlighting the professional judgment and critical thinking skills required of accountants in today's business environment.

> "The *Spiceland Intermediate Accounting* provides a truly up to date view of financial reporting. The authors explain complex topics in a very relevant, engaging, easy to follow approach for students with excellent examples and illustrations."
>
> **— Celina Jozsi, *Florida Southern University***

Comprehensive: The Spiceland team ensures comprehensive coverage and quality throughout the learning system by building content and assets with a unified methodology that meets rigorous standards. Students are challenged through diverse examples and carefully crafted problem sets which promote in-depth understanding and drive development of critical-thinking skills.

The author team is committed to providing a learning experience that fully prepares students for the future by solidifying core comprehension and enabling confident application of key concepts. Students can feel confident that the conceptual underpinnings and practical skills conveyed in the ninth edition will prepare them for a wide range of real world scenarios.

Rigorous yet readable

Clear: Reviewers, instructors, and students have all hailed *Intermediate Accounting's* ability to explain both simple and complex topics in language that is coherent and approachable. The author team's highly acclaimed conversational writing style establishes a friendly dialogue—establishing the impression of a conversation with students, as opposed to lecturing at them.

This tone remains consistent throughout the learning system, as authors Spiceland, Nelson, and Thomas write not only the primary content, but also every major supplement: study guide, instructor's resource manual, solutions manual, and test bank. All end-of-chapter material, too, is written by the author team and tested in their classrooms. *Intermediate Accounting* is written to be the most complete, coherent, and student-oriented resource on the market.

> "This textbook is written in a way that is easy to read, provides clear examples, includes thorough coverage of necessary topics, and provides ample opportunity for practice and mastery of the material through end of chapter problems."
>
> **—Terra Brown, *University of Texas–Arlington***

Connect: Today's accounting students expect to learn in multiple modalities. As a result, the ninth edition of Spiceland's learning system features the following: Connect, SmartBook's adaptive learning and reading experience, **NEW** Concept Overview Videos, Guided Examples, **NEW** Excel® simulations, and General Ledger problems.

Quality assessment continues to be a focus of Connect, with over **2,500 questions** available for assignment, including more than 1,125 algorithmic questions.

McGraw-Hill Education is continually updating and improving our digital resources. To that end, we have a new partnership with Roger CPA, providing multiple choice practice questions directly within our Connect banks, as well as links to the Roger CPA site for complementary selected simulations.

> "Connect is a great resource for any course, but the new updates to the General Ledger and Excel Simulations allow this package to go above and beyond; students will exit the intermediate series with a strong foundation in Excel and the accounting cycle."
>
> **—Joshua Neil, *University of Colorado–Boulder***

Spiceland's Financial Accounting Series

Intermediate Accounting forms a complete learning system when paired with *Financial Accounting* by authors David Spiceland, Wayne Thomas, and Don Herrmann. Now in its fourth edition, *Financial Accounting* uses the same proven approach that has made *Intermediate Accounting* a success—a conversational writing style with real-world focus and author-prepared supplements, combined with Connect's market leading technology solutions and assessment.

> "If you like Spiceland's intermediate text, you will be thrilled with the financial accounting text. It is written in the same conversational style, addresses topics directly and clearly, and the illustrations are terrific too."
>
> **—Nancy Snow, *University of Toledo***

What Keeps SPICELAND Users Coming Back?

Where We're Headed

These boxes describe the potential financial reporting effects of many of the FASB and IASB joint projects intended to further align U.S. GAAP and IFRS, as well as other projects the Boards are pursuing separately. Where We're Headed boxes allow instructors to deal with ongoing projects to the extent they desire.

Financial Reporting Cases

Each chapter opens with a Financial Reporting Case that places the student in the role of the decision maker, engaging the student in an interesting situation related to the accounting issues to come. Then, the cases pose questions for the student in the role of decision maker. Marginal notations throughout the chapter point out locations where each question is addressed. The case questions are answered at the end of the chapter.

Decision Makers' Perspective

These sections appear throughout the text to illustrate how accounting information is put to work in today's firms. With the CPA exam placing greater focus on application of skills in realistic work settings, these discussions help your students gain an edge that will remain with them as they enter the workplace.

Where We're Headed

In 2004, the FASB and IASB began working together on a project, Financial Statement Presentation, to establish a common standard for presenting information in the financial statements, including classifying and displaying line items and aggregating line items into subtotals and totals. This project could have a dramatic impact on the format of financial statements. An important part of the proposal involves the organization of elements of the balance sheet (statement of financial position), statement of comprehensive income (including the income statement), and statement of cash flows into a common set of classifications.

Progress was slow, and in 2011 both Boards suspended activity on the project to concentrate on other convergence projects. In 2014, the project was moved back on the FASB's agenda. It is not known if the project will retain its original scope of encompassing all of the financial statements or if it will focus on one or two statements. In August 2016, the FASB issued an Exposure Draft to propose adding "Chapter 7: Presentation" to *Cor*...

"Where We're Headed boxes allow the students to be updated with the most current accounting changes without inundating them with needless technical specifications. A perfect balance!"

—Cheryl Bartlett, *Indiana University—South Bend*

Financial Reporting Case Solution


© goodluz/123RF

1. **What purpose do adjusting entries serve?** *(p. 63)* Adjusting entries help ensure that all revenues are recognized in the period goods or services are transferred to customers, regardless of when cash is received. In this instance, for example, $13,000 cash has been received for services that haven't yet been performed. Also, adjusting entries enable a company to recognize all expenses incurred during a period, regardless of when cash is paid. Without depreciation, the friends' cost of using the equipment is not taken into account. Conversely, without adjustment, the cost of rent is overstated by $3,000 paid in advance for part of next year's rent.

With adjustments, we get an accrual income statement that provides a more complete measure of a company's operating performance and a better measure for predicting future operating cash flows. Similarly, the balance sheet provides a more complete assessment of assets and liabilities as sources of future cash receipts and disbursements.

"The case at the beginning of each chapter is very captivating. After I read the case, I wanted to get paper and pencil and answer the questions."

—Carol Shaver, *Louisiana Tech University*

Decision Makers' Perspective

Cash often is referred to as a *nonearning* asset because it earns no interest. For this reason, managers invest idle cash in either cash equivalents or short-term investments, both of which provide a return. Management's goal is to hold the minimum amount of cash necessary to conduct normal business operations, meet its obligations, and take advantage of opportunities. Too much cash reduces profits through lost returns, while too little cash increases risk. This trade-off between risk and return is an ongoing choice made by management (internal decision makers). Whether the choice made is appropriate is an ongoing assessment made by investors and creditors (external decision makers).

A company must have cash available for the compensating balances we discussed in the previous section as well as for planned disbursements related to normal operating, investing, and financing cash flows. However, because cash inflows and outflows can vary from planned amounts, a company needs an additional cash cushion as a precaution against unexpected events. The size of the cushion depends on the company's ability to convert cash equivalents and short-term investments into cash quickly...

Companies hold cash to pay for planned and unplanned transactions and to satisfy compensating balance requirements.

"This is an excellent feature of the book. It is so important to know why and how information is used and not just memorizing the 'right' answers."

—Jeff Mankin, *Lipscomb University*

In talking with so many intermediate accounting faculty, we heard more than how to improve the book—there was much, much more that both users and nonusers insisted we not change. Here are some of the features that have made Spiceland such a phenomenal success in its previous editions.

Additional Consideration

Discounts in Contracts with Multiple Performance Obligations. Note that Illustration 5–7 shows that Tri-Box systems are sold at a discount—TrueTech sells the system for a transaction price ($250) that's less than the $300 sum of the stand-alone selling prices of the Tri-Box module ($240) and the subscription to Tri-Net ($60). Because there is no evidence that the discount relates to only one of the performance obligations, it is spread between them in the allocation process. If TrueTech had clear evidence from sales of those goods and services that the discount related to only one of them, the entire discount would be allocated to that good or service.

"This is a good technique that I actually use in my class and it's good to see it in a book!"

—Ramesh Narasimhan, *Montclair State University*

Ethical Dilemma

You recently have been employed by a large retail chain that sells sporting goods. One of your tasks is to help prepare periodic financial statements for external distribution. The chain's largest creditor, National Savings & Loan, requires quarterly financial statements, and you are currently working on the statements for the three-month period ending June 30, 2018.

During the months of May and June, the company spent $1,200,000 on a hefty radio and TV advertising campaign. The $1,200,000 included the costs of producing the commercials as well as the radio and TV time purchased to air the commercials. All of the costs were charged to advertising expense. The company's chief financial officer (CFO) has asked you to prepare a June 30 adjusting entry to remove the costs from advertising expense and to set up an asset called *prepaid advertising* that will be expensed in July. The CFO explained that "This advertising campaign has led to significant sales in May and June and I think it will continue to bring in customers through the month of July. By recording the ad costs as an asset, we can match the cost of the advertising with the additional July sales. Besides, if we expense the advertising in May and June, we will show an operating loss on our income

"Having ethical dilemma boxes in every chapter is much more significant than having a separate chapter devoted to ethics. Students can relate to the importance of being ethical in every aspect of business dealings."

—Gloria Worthy, *Southwest Tennessee Community College*

Broaden Your Perspective

Apply your critical-thinking ability to the knowledge you've gained. These cases will provide you an opportunity to develop your research, analysis, judgment, and communication skills. You also will work with other students, integrate what you've learned, apply it in real-world situations, and consider its global and ethical ramifications. This practice will broaden your knowledge and further develop your decision-making abilities.

Judgment Case 4–1
Earnings quality
● LO4–2, LO4–3

The financial community in the United States has become increasingly concerned with the quality of reported company earnings.

Required:

1. Define the term *earnings quality.*
2. Explain the distinction between permanent and temporary earnings as it relates to the concept of earnings quali

"I think students would benefit tremendously from the cases."

—Joyce Njoroge, *Drake University*

Additional Consideration Boxes

These are "on the spot" considerations of important, but incidental or infrequent, aspects of the primary topics to which they relate. Their parenthetical nature, highlighted by enclosure in Additional Consideration boxes, helps maintain an appropriate level of rigor of topic coverage without sacrificing clarity of explanation.

Ethical Dilemmas

Because ethical ramifications of business decisions impact so many individuals as well as the core of our economy, Ethical Dilemmas are incorporated within the context of accounting issues as they are discussed. These features lend themselves very well to impromptu class discussions and debates.

Broaden Your Perspective Cases

Finish each chapter with these powerful and effective cases, a great way to reinforce and expand concepts learned in the chapter.

Star Problems

In each chapter, particularly challenging problems, designated by a ★, require students to combine multiple concepts or require significant use of judgment.

Connect

Required=Results

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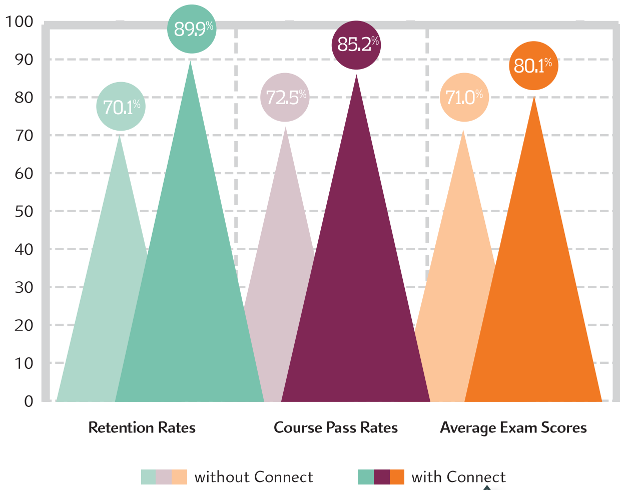
McGraw-Hill Connect®
Learn Without Limits

Connect is a teaching and learning platform that is proven to deliver better results for students and instructors.

Connect empowers students by continually adapting to deliver precisely what they need, when they need it, and how they need it, so your class time is more engaging and effective.

73% of instructors who use **Connect** require it; instructor satisfaction **increases** by 28% when **Connect** is required.

Connect's Impact on Retention Rates, Pass Rates, and Average Exam Scores



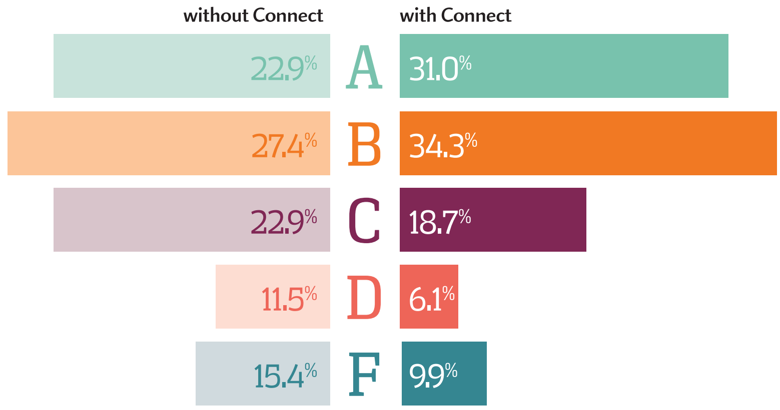
Using **Connect** improves retention rates by **19.8%**, passing rates by **12.7%**, and exam scores by **9.1%.**

Analytics

Connect Insight®

Connect Insight is Connect's new one-of-a-kind visual analytics dashboard that provides at-a-glance information regarding student performance, which is immediately actionable. By presenting assignment, assessment, and topical performance results together with a time metric that is easily visible for aggregate or individual results, Connect Insight gives the user the ability to take a just-in-time approach to teaching and learning, which was never before available. Connect Insight presents data that helps instructors improve class performance in a way that is efficient and effective.

Impact on Final Course Grade Distribution



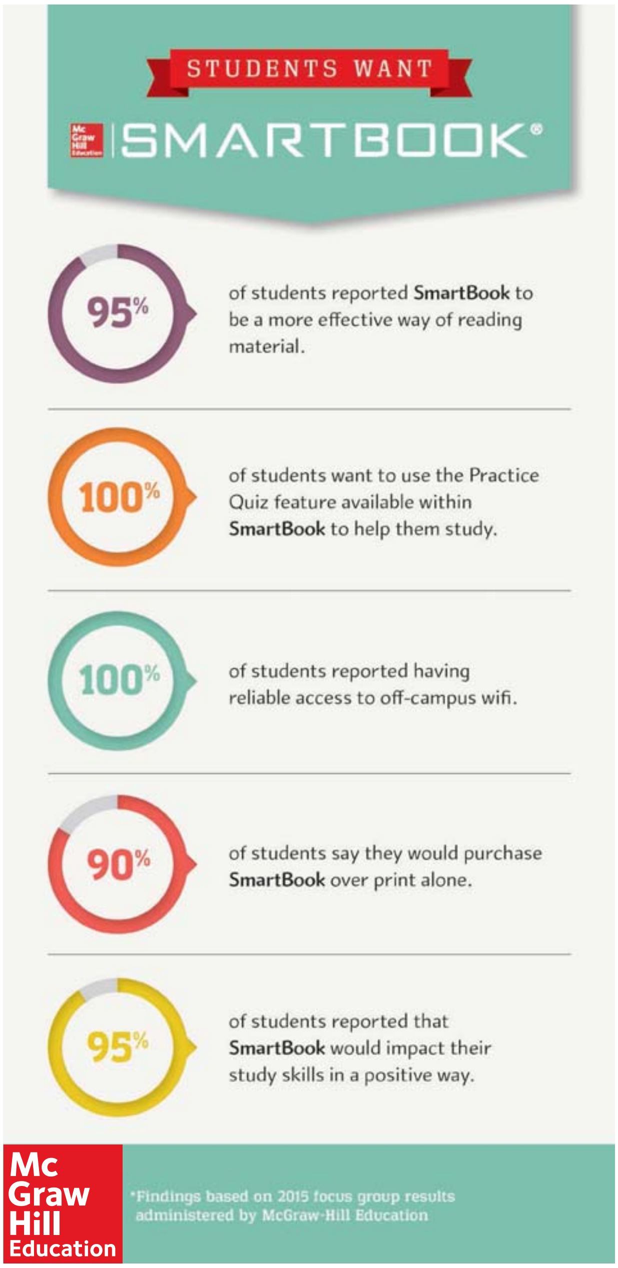
Adaptive

THE **ADAPTIVE READING EXPERIENCE** DESIGNED TO TRANSFORM THE WAY STUDENTS READ

More students earn **A's** and **B's** when they use McGraw-Hill Education **Adaptive** products.

SmartBook®

Proven to help students improve grades and study more efficiently, SmartBook contains the same content within the print book, but actively tailors that content to the needs of the individual. SmartBook's adaptive technology provides precise, personalized instruction on what the student should do next, guiding the student to master and remember key concepts, targeting gaps in knowledge and offering customized feedback, and driving the student toward comprehension and retention of the subject matter. Available on tablets, SmartBook puts learning at the student's fingertips—anywhere, anytime.



Over **8 billion questions** have been answered, making McGraw-Hill Education products more intelligent, reliable, and precise.

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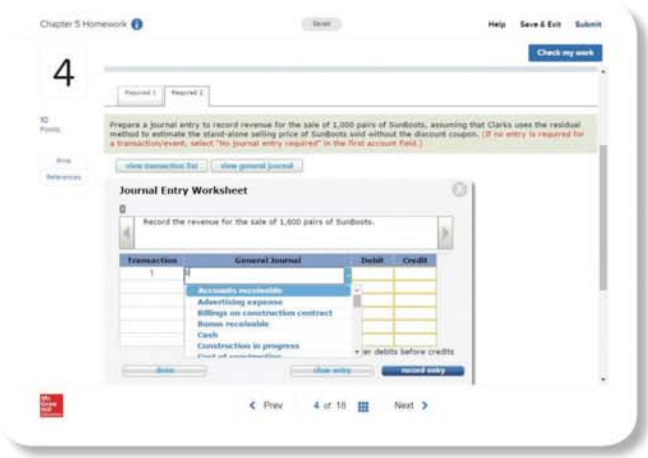
ONLINE ASSIGNMENTS



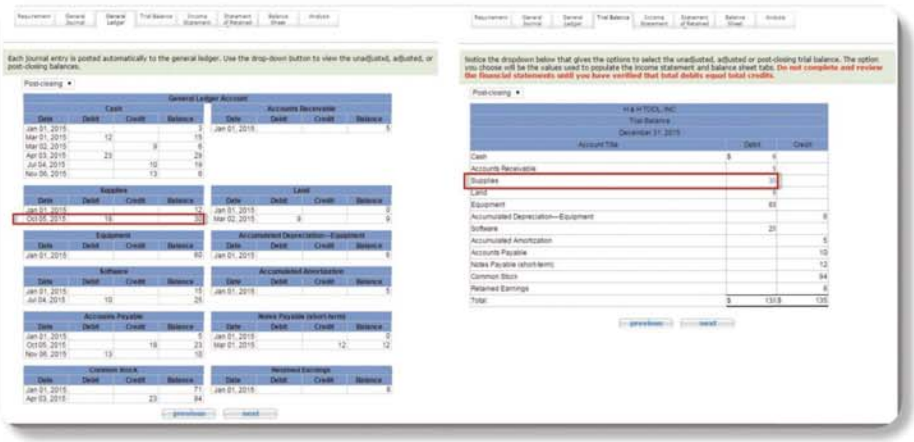
Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

End-of-chapter questions in Connect include:

- Brief Exercises
- Exercises
- Problems

> "The textbook's General Ledger, Concept Overview Videos, and Excel Simulations are outstanding."
>
> —**Professor Kaye Sheridan, *Troy University***

NEW! GENERAL LEDGER PROBLEMS



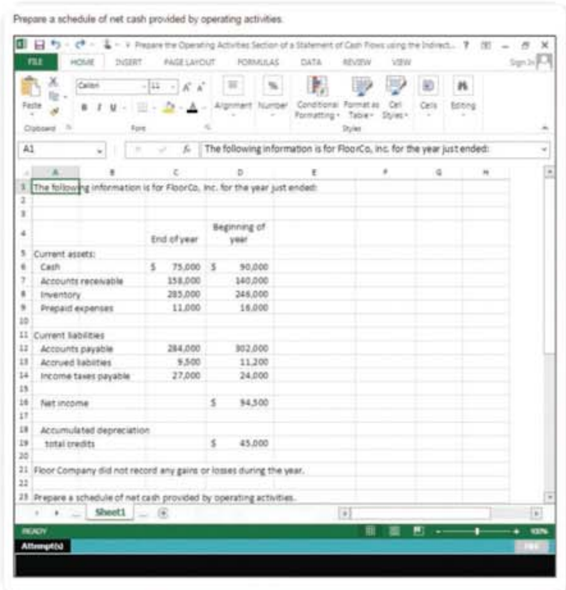
New **General Ledger Problems** provide a much-improved student experience when working with accounting cycle questions, offering improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and can see how the numbers flow through the various financial statements. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

NEW! CONCEPT OVERVIEW VIDEOS

The **Concept Overview Videos** provide engaging narratives of key topics in an assignable and interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Intermediate Accounting.* The Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.

NEW! EXCEL SIMULATIONS

Simulated Excel Questions, assignable within Connect, allow students to practice their Excel skills—such as basic formulas and formatting—within the content of financial accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled), as well as automatic feedback and grading for both students and professors.



GUIDED EXAMPLES

The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.

> "As a student I need to interact with course material in order to retain it, and **Connect** offers a perfect platform for this kind of learning. Rather than just reading through textbooks, **Connect** has given me the tools to feel engaged in the learning process."
>
> **—Jennah Epstein Kraus, student, *Bunker Hill Community College***

CPA SIMULATIONS

McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw-Hill materials will have access to sample CPA Exam Multiple-Choice questions and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel and functionality of the actual exam. McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements and exam content, visit www.rogercpareview.com.

"*Intermediate Accounting* is current, complete, well written, and highly detailed. It belongs in the library of anyone who is preparing for the CPA exam."

—Barbara K. Parks, *American Intercontinental University—Online*

Other Student Supplements

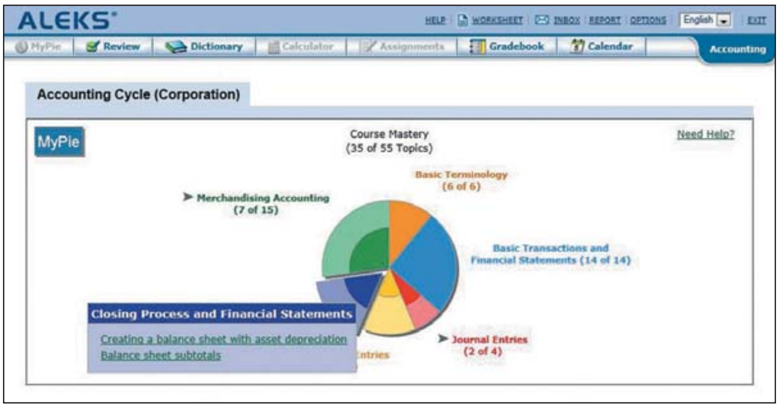
Study Guide

Volume 1: ISBN-13: 9781260030259 (MHID: 1260030253)
Volume 2: ISBN-13: 9781260030266 (MHID: 1260030261)

The Study Guide, written by the text authors, provides chapter summaries, detailed illustrations, and a wide variety of self-study questions, exercises, and multiple-choice problems (with solutions).

ALEKS®

ALEKS ACCOUNTING CYCLE



ALEKS Accounting Cycle is a web-based program that provides targeted coverage of prerequisite and introductory material necessary for student success in Intermediate Accounting. ALEKS uses artificial intelligence and adaptive questioning to assess precisely a student's preparedness and deliver personalized instruction on the exact topics the student is **most ready to learn.** Through comprehensive explanations, practice, and immediate feedback, ALEKS enables students to quickly fill individual knowledge gaps in order to build a strong foundation of critical accounting skills. Better prepared students saves you valuable time at the beginning of your course!

Use ALEKS Accounting Cycle as a pre-course assignment or during the first three weeks of the term to see improved student confidence and performance, as well as fewer drops.

ALEKS Accounting Cycle Features:

- **Artificial Intelligence:** Targets Gaps in Prerequisite Knowledge
- **Individualized Learning and Assessment:** Ensure Student Preparedness
- **Open-Response Environment:** Avoids Multiple-Choice and Ensures Mastery
- **Dynamic, Automated Reports:** Easily Identify Struggling Students

For more information, please visit: www.aleks.com/highered/business.

Read ALEKS Success Stories: www.aleks.com/highered/business/success_stories.

"With ALEKS, the issues that our finance majors were having with *Intermediate Accounting* have practically disappeared."

—Eric Kelley, *University of Arizona*

INSTRUCTOR LIBRARY

The Connect Instructor Library is a repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The Connect Instructor Library includes:

- Presentation slides
- Animated PowerPoint® exercises
- Solutions manual
- Test bank available in Connect and TestGen
  - TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's test bank content. The instructors can then organize, edit, and customize questions and answers to rapidly generate tests for paper **or online administration.** Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. TestGen's random generator provides the option to display different text or calculated number values each time questions are used. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a complete test generator system for today's educators.
- Instructor's resource manual
- Instructor Excel templates. Solutions to the student Excel Templates used to solve selected end-of-chapter exercises and problems. These assignments are designated by the Excel icon.

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At McGraw-Hill Education, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support website. For Customer Support, call **800-331-5094,** or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

ASSURANCE OF LEARNING READY

Many educational institutions today are focused on the notion of *assurance of learning,* an important element of some accreditation standards. *Intermediate Accounting* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *Intermediate Accounting* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of Connect to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

AACSB STATEMENT

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Intermediate Accounting* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the test bank to the eight general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Intermediate Accounting* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Intermediate Accounting* and the teaching package make no claim of any specific AACSB qualification or evaluation, within the Test Bank to accompany *Intermediate Accounting* we have labeled selected questions according to the eight general knowledge and skill areas.

What's New in the Ninth Edition?

Revising a program as successful as *Intermediate Accounting* takes careful consideration and a strong vision for how the print and digital content work together to provide a robust learning solution. The Spiceland team only implements changes that constitute real improvements as identified through extensive research with users. The result is a program that never loses its original strengths, continuing to gain usefulness and flexibility with each revision.

Pervasive changes throughout the program include the following:

- **Updated content to reflect the latest GAAP and Accounting Standards Updates including:**
  - **Leases**
  - **Coverage of financial instruments**
  - **Revenue recognition**
- **New partnership with Roger CPA Review,** with new assignable multiple-choice CPA Exam Review questions in Connect and access to CPA simulations.
- Updated and revised all real-world illustrations, amounts, and discussions.
- **Revised** Air France–KLM IFRS case to reflect financial statements for the year ended December 31, 2015.
- Added a **new Continuing Case featuring Target Corporation** and a variety of characteristics of financial statements prepared using U.S. GAAP. A comprehensive version of the case is available in Appendix B.
- Reviewed, updated, and introduced new end-of-chapter material in each chapter to support new topics and learning objectives.
- Incorporated the latest technology, including a **new Connect interface for students,** along with **Connect Insight for students,** an updated SmartBook, and **new Connect problem formats** include **General Ledger Problems** that auto-post from journal entries to T-accounts to trial balances, **Excel Simulations,** and **Concept Overview Videos.**

Chapter 1

ENVIRONMENT AND THEORETICAL STRUCTURE OF FINANCIAL ACCOUNTING

- Changed opening case to introduce Target, and featured Target throughout the chapter.
- Added Pathways visualization "THIS is accounting!" and related discussion.
- Improved discussion of cash basis vs. accrual basis accounting.
- Enhanced description of IFRS organizational structure and convergence process.
- Added a Where We're Headed box regarding the FASB's materiality exposure draft.

Chapter 2

REVIEW OF THE ACCOUNTING PROCESS

- Replaced all CPA Exam Questions with current ones from Roger CPA Review.
- Added a Target case.
- Added an Air France case.

Chapter 3

THE BALANCE SHEET AND FINANCIAL DISCLOSURES

- Revised introduction to include reference to SEC's EDGAR filing system.
- Added reference to the accounting equation in Illustration 3–1.
- Updated discussion of assets, liabilities, and shareholders' equity to include those of Nike.
- Updated discussion of operating cycle to include distinction between merchandising and manufacturing company.
- Revised discussion of categories of long-term assets, including consideration of management intent.
- Added discussion and key term for accumulated other comprehensive income component of shareholders' equity.
- Revised discussion of auditors' report to clearly distinguish the different report types.
- Moved discussion of management compensation to be included with other management-related disclosures.

Chapter 4

THE INCOME STATEMENT, COMPREHENSIVE INCOME, AND THE STATEMENT OF CASH FLOWS

- Revised introduction to make clear the difference in reporting perspective for the balance sheet (point in time) versus the income statement and statement of cash flows (interval of time).
- Revised discussion of earnings quality, income smoothing, and classification shifting.
- Revised section on "Operating Income and Earnings Quality" to include analysis of The Hershey Company.
- Created separate section on non-GAAP earnings, discussing HP.
- Clarified discussion of what constitutes of a discontinued operation.
- Clarified discussion and added new Additional Consideration box on presentation of discontinued operations.
- Added discussion of the modified retrospective approach for accounting changes.
- Revised introduction to the discussion of earnings per share.
- Provided additional discussion of comprehensive income.
- Moved discussion of profitability analysis from chapter 5 to chapter 4, including all related end-of-chapter material.

Chapter 5

REVENUE RECOGNITION

- Added learning objective regarding differences between U.S. GAAP and IFRS, IFRS boxes that meet the objective, and related end-of-chapter material.
- Changed discussion of identifying separate performance obligations to incorporate ASU 2016–10.
- Added Additional Consideration for shipping costs to incorporate ASU 2016–10.
- Changed discussion of licenses to incorporate ASU 2016–10.
- Added IFRS box discussing differences in licensing criteria.

- Moved discussion of Profitability Analysis and related end-of-chapter material to Chapter 4 to focus Chapter 5 more tightly on revenue recognition.
- Added significant new end-of-chapter material to incorporate ASU 2016–10 and various IFRS differences.

Chapter 6

TIME VALUE OF MONEY CONCEPTS

- Replaced all CPA Exam Questions with current ones from Roger CPA Review.
- Added a Target case.
- Added an Air France case.

Chapter 7

CASH AND RECEIVABLES

- Added new opening case: Community Health Systems.
- Completely revised coverage of initial and subsequent valuation of accounts receivable, including discussions of time value of money, discounts, sales returns, accounting for bad debts, and accounting for notes receivable, to tie coverage more tightly to revenue recognition and impairment recognition criteria and practice.
- In chapter, as well as Appendix 7B, included coverage of ASU 2016–013's CECL model for accounting for credit losses, as well as current GAAP requirements for recognizing impairments of receivables.
- Revised Illustration 7–24 and related discussion of analysis of accounts receivable.
- Added or updated cases relevant to Microsoft, Nike, Avon Products, Tyson Foods, and Pilgrim's Pride Corp.

Chapter 8

INVENTORIES: MEASUREMENT

- Changed feature story to Kroger Company.
- Revised discussion of goods in transit.
- Revised discussion of accounting for transactions that affect net purchases related to freight-in, returns, and discounts, including revisions to Illustration 8–6.
- Incorporated beginning inventory into Illustration 8–7 to clarify calculation of goods available for sale and to better link to Illustrations 8–7B through 8–7H.
- Revised discussion of the LIFO reserve adjustment.
- Clarified discussion and added calculation to demonstrate dollar-value LIFO.

Chapter 9

INVENTORIES: ADDITIONAL ISSUES

- Revised section on subsequent measurement of inventory to include both lower of cost or market (LCM) and lower of cost or net realizable value (LCNRV).
- Clarified discussion of which companies are required to use LCNRV versus LCM.
- Added new end-of-chapter material for LCM – BE 9–3, BE 9–4, E 9–4, E 9–5, E 9–6, E 9–7, P 9–3, and P 9–4.

Chapter 10

PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS: ACQUISITION

- Moved discussion of asset dispositions and related end-of-chapter material to chapter 11.
- Moved discussion of noncash acquisitions (deferred payments, stock issuances, and donations) to Part B with nonmonetary exchanges.
- Added Illustration 10–16 to summarize effects of different types of nonmonetary exchanges.
- Provided additional discussion to clarify accounting for software development costs.
- Reorganized section on R&D to include more real-world examples and clarification of which R&D-type costs are capitalized.
- Added end-of-chapter material for fixed asset turnover (BE 10–9), software development costs (BE 10–17), various types of research and development costs (BE 10–18), and start-up costs (BE 10–19 and E 10–33).

Chapter 11

PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS: UTILIZATION AND DISPOSITION

- Revised discussion of the conceptual meaning of cost allocation.
- Added Illustration 11–3A and related discussion of depreciation expense versus accumulated depreciation.
- Added discussion and illustrations of asset dispositions, as well as related end-of-chapter material from chapter 10.
- Added a Decision Maker's Perspective box to explain in more detail the interpretation of gains and losses on the sale of depreciable assets.
- Modified Illustration 11–12 to include disposal of an intangible asset.
- Revised discussion of intangible assets not subject to amortization.
- Revised discussion of two-step process for goodwill impairment.
- Added a Where We're Headed box to explain the FASB's current proposal to simplify measurement of goodwill impairment.

Chapter 12

INVESTMENTS

- Reorganized Chapter to include Part A (Accounting for Debt Investments) and Part B (Accounting for Equity Investments).
- Revised coverage of debt investments, including improved treatment of trading securities and available-for-sale investments to enhance student understanding and better reflect practice and the ASC.
- Revised coverage of equity investments to incorporate ASU 2016–01 (prohibiting AFS treatment and requiring "fair value through net income" treatment of most insignificant-influence investments).
- Revised coverage of the equity method to enhance and clarify examples.
- Revised IFRS boxes for differences between IFRS and U.S. GAAP.
- In chapter, as well as Appendix 12B, included coverage of ASU 2016–013's CECL model for accounting for credit losses, as well as current GAAP requirements for recognizing impairments of investments.
- Revised end-of-chapter material to incorporate ASU 2016–013's CECL model for accounting for credit losses.

Chapter 13

CURRENT LIABILITIES AND CONTINGENCIES

- Updated General Mills example used in Illustration 13–1 and throughout the chapter.
- Added Additional Consideration box regarding escheatment laws relevant to gift cards.
- Updated contingent liability examples.
- Added new Trueblood cases.

Chapter 14

BONDS AND LONG-TERM NOTES

- Revised discussion of debt issue costs to conform with Accounting Standards Update 2015–03, *Interest—Imputation of Interest* (Subtopic 835–30).
- Added and revised end-of-chapter material pertaining to debt issue costs.

Chapter 15

LEASES

- Rewrote the entire chapter to conform to Accounting Standards Update 2016–02, *Leases* (Topic 842).
- Created a Chapter Supplement—Leases: GAAP in Effect Prior to ASU No. 2016–02.
- Developed all-new ancillaries (Connect, Test bank, Instructors' resource manual, Solutions manual, PowerPoint presentations, and videos) to conform to the new Leases standard.

Chapter 16

ACCOUNTING FOR INCOME TAXES

- Added new version of Real World "Shoe Carnival" case covering linkage between tax expense journal entry and changes in deferred tax assets, liabilities, and the valuation allowance.
- Revised coverage of balance sheet presentation of deferred tax accounts to incorporate ASU 2015–17.
- Added or modified end-of-chapter material to incorporate ASU 2015–17.

Chapter 17

PENSIONS AND OTHER POSTRETIREMENT BENEFIT PLANS

- Added a Real World Case involving Microsoft's pension plan.
- Added discussion of new FASB requirement to report service cost separate from other components of pension expense.

Chapter 18

SHAREHOLDERS' EQUITY

- Replaced all CPA Exam Questions and Simulation with current ones from Roger CPA Review.
- Revised Research Case involving Cisco's accumulated other comprehensive income in its balance sheet as a component of shareholders' equity.

Chapter 19

SHARE-BASED COMPENSATION AND EARNINGS PER SHARE

- Revised discussion and illustration of graded vesting stock options.
- Revised discussion of forfeitures of stock options and restricted stock to conform with Accounting Standards Update No. 2016–09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.
- Added and revised end-of-chapter material pertaining to forfeitures of stock options and restricted stock.
- Revised discussion of tax issues related to share-based compensation to conform with Accounting Standards Update No. 2016–09—Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.
- Revised end-of-chapter material pertaining to tax issues related to share-based compensation.

Chapter 20

ACCOUNTING CHANGES AND ERROR CORRECTIONS

- Revised discussion of approaches to account for accounting changes to include the modified retrospective approach.

Chapter 21

STATEMENT OF CASH FLOWS REVISITED

- Revised a CVS Caremark Corp illustration of presenting cash flows from operating activities by the direct method.
- Added an enhanced Additional Consideration box on reporting bad debt expense in the SCF.
- Added a Toys "R" Us illustration of presenting cash flows from operating activities by the indirect method.
- Revised a Research Case related to FedEx's investing and financing activities.
- Added a Real World Case on Staples reporting of its SCF.

Appendix A

DERIVATIVES

- Revised a Real World Case related to the Chicago Mercantile Exchange.
- Revised a Johnson & Johnson Real World Case on hedging transactions.

Acknowledgments

Intermediate Accounting is the work not just of its talented authors, but of the more than 750 faculty reviewers who shared their insights, experience, and insights with us. Our reviewers helped us to build *Intermediate Accounting* into the very best learning system available. A blend of Spiceland users and nonusers, these reviewers explained how they use texts and technology in their teaching, and many answered detailed questions about every one of Spiceland's 21 chapters. The work of improving *Intermediate Accounting* is ongoing—even now, we're scheduling new symposia and reviewers' conferences to collect even more opinions from faculty.

We would like to acknowledge and highlight the Special Reviewer role that Ilene Leopold Persoff of Long Island University (LIU Post) took on the ninth edition. Utilizing her accounting and reviewing expertise, Ilene verified the accuracy of the manuscript and promoted our efforts toward quality and consistency. Her deep subject-matter knowledge, keen eye for detail, and professional excellence in all aspects were instrumental in ensuring a current, comprehensive, and clear edition. Her contributions are deeply appreciated.

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David Spiceland *Mark Nelson* *Wayne Thomas*

Contents in Brief

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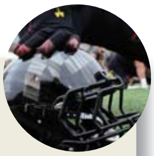

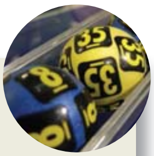

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CHAPTER

1 Environment and Theoretical Structure of Financial Accounting

OVERVIEW

The primary function of financial accounting is to provide useful financial information to users who are external to the business enterprise, particularly investors and creditors. These users make critical resource allocation decisions that affect the global economy. The primary means of conveying financial information to external users is through financial statements and related notes.

In this chapter you explore such important topics as the reason why financial accounting is useful, the process by which accounting standards are produced, and the conceptual framework that underlies financial accounting. The perspective you gain in this chapter serves as a foundation for more detailed study of financial accounting.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- **LO1–1** Describe the function and primary focus of financial accounting. (*p. 3*)
- **LO1–2** Explain the difference between cash and accrual accounting. (*p. 7*)
- **LO1–3** Define generally accepted accounting principles (GAAP) and discuss the historical development of accounting standards, including convergence between U.S. and international standards. (*p. 9*)
- **LO1–4** Explain why establishing accounting standards is characterized as a political process. (*p. 13*)
- **LO1–5** Explain factors that encourage high-quality financial reporting. (*p. 15*)
- **LO1–6** Explain the purpose of the conceptual framework. (*p. 19*)
- **LO1–7** Identify the objective and qualitative characteristics of financial reporting information and the elements of financial statements. (*p. 21*)
- **LO1–8** Describe the four basic assumptions underlying GAAP. (*p. 24*)
- **LO1–9** Describe the recognition, measurement, and disclosure concepts that guide accounting practice. (*p. 26*)
- **LO1–10** Contrast a revenue/expense approach and an asset/liability approach to accounting standard setting. (*p. 33*)
- **LO1–11** Discuss the primary differences between U.S. GAAP and IFRS with respect to the development of accounting standards and the conceptual framework underlying accounting standards. (*p. 14* and *20*)

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FINANCIAL REPORTING CASE

Misguided Marketing Major

During a class break in your investments class, a marketing major tells the following story to you and some friends:

The chief financial officer (CFO) of a large company is interviewing three candidates for the top accounting position with his firm. He asks each the same question:

CFO:	What is two plus two?
First candidate:	Four.
CFO:	What is two plus two?
Second candidate:	Four.
CFO:	What is two plus two?
Third candidate:	What would you like it to be?
CFO:	You're hired.

After you take some good-natured ribbing from the non-accounting majors, your friend says, "Seriously, though, there must be ways the accounting profession prevents that kind of behavior. Aren't there some laws, or rules, or something? Is accounting based on some sort of theory, or is it just arbitrary?"

QUESTIONS

By the time you finish this chapter, you should be able to respond appropriately to the questions posed in this case. Compare your response to the solution provided at the end of the chapter.

1. What should you tell your friend about the presence of accounting standards in the United States and the rest of the world? Who has the authority for standard setting? Who has the responsibility? (*p. 8*)
2. What is the economic and political environment in which standard setting occurs? (*p. 13*)
3. What is the relationship among management, auditors, investors, and creditors that tends to preclude the "What would you like it to be?" attitude? (*p. 15*)
4. In general, what is the conceptual framework that underlies accounting principles? (*p. 20*)

Financial Accounting Environment

PART A

LO1–1

In 1902, George Dayton took ownership of the Dayton Dry Goods Company, the fourth largest department store in Minneapolis, Minnesota. Successive generations of Daytons were innovative managers, flying in inventory to prevent shortages (1920), committing to giving five percent of profits back to the community (1946), and creating the nation's first enclosed shopping mall (1956). In 1962, George's grandchildren transformed Dayton's, by then a regional department store chain, into the **Target Corporation**, promising "a quality store with quality merchandise at discount prices".[1] Today Target has grown to be the second largest general merchandise retailer in America, with over 1,800 stores, almost 350,000 employees, and **www.target.com** reaching the online market. However, Target still stands by its "Expect More, Pay Less" motto, and still donates five percent of profits back to the community (giving more than $4 million per week, mostly in support of education).

[1]"Target Through the Years" at https://corporate.target.com/about/history/Target-through-the-years.

Many factors contributed to Target's success. The Daytons were visionary in their move into the upscale discount retail market. The company's commitment to quality products, customer service, and community support also played an important role. But the ability to raise money from investors and lenders at various times also was critical to Target's evolution. Target used proceeds from its 1967 initial public stock offering to expand nationally. Creditors (lenders) also supplied needed capital at various times. In fact, without access to capital, the Target Corporation we know today likely would not exist.

Investors and creditors use many different kinds of information before supplying capital to businesses like Target. They use the information to predict the future risk and potential return of their prospective investments or loans.[2] For example, information about the enterprise's products and its management is key to this assessment. Investors and creditors also rely on various kinds of accounting information.

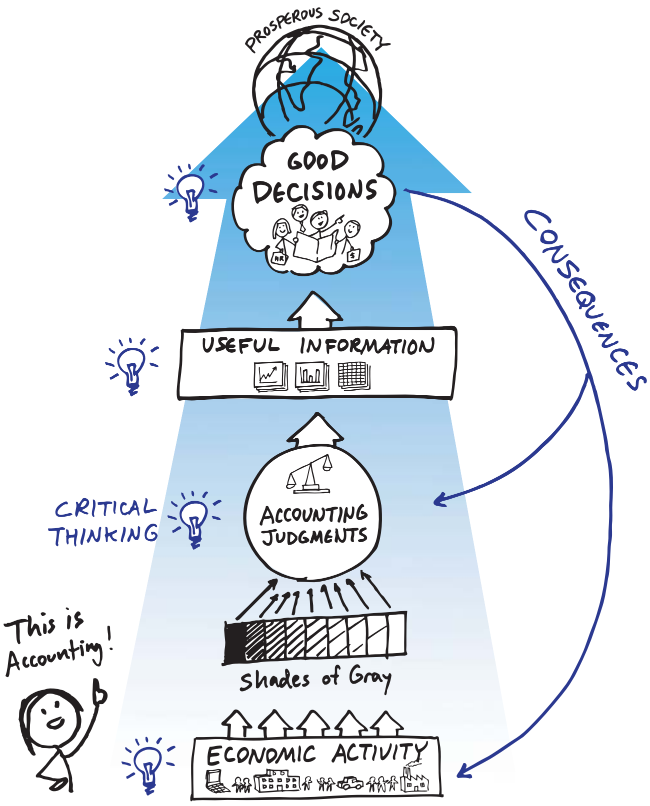
Think of accounting as a special "language" that companies like Target use to communicate financial information to help people inside and outside of the business to make decisions. The Pathways Commission of the American Accounting Association developed an illustration to help visualize this important role of accounting.[3] As shown in Illustration 1-1, accounting provides useful information about economic activity to help produce good decisions and foster a prosperous society. Economic activity is complex, and decisions have real consequences, so critical thinking and many judgments are needed to produce the most useful accounting information possible.

The primary focus of *financial accounting* is on the information needs of investors and creditors.

This book focuses on **financial accounting**, which is chiefly concerned with providing financial information to various *external* users.[4] The chart in Illustration 1–2 lists a number of groups that provide financial information as well as several external user groups.

Illustration 1–1

Pathways Commission visualization: "THIS is accounting!"



[2]Risk refers to the variability of possible outcomes from an investment. Return is the amount received over and above the investment.
[3]Reprinted with permission from the American Accounting Association. This work is by The Pathways Commission and is licensed under a Creative Commons Attribution-NoDerivs 3.0 Unported License.
[4]In contrast, *managerial* accounting deals with the concepts and methods used to provide information to an organization's *internal users,* that is, its managers. You study managerial accounting elsewhere in your curriculum.

Illustration 1–2

Financial Information Providers and External User Groups

PROVIDERS OF FINANCIAL INFORMATION

- Profit-oriented companies
- Not-for-profit entities (e.g., government entities, charitable organizations, schools)
- Households

→

USERS OF FINANCIAL INFORMATION

- Investors
- Creditors (banks, bondholders, other lenders)
- Employees
- Labor unions
- Customers
- Suppliers
- Government regulatory agencies (e.g., Internal Revenue Service, Securities and Exchange Commission)
- Financial intermediaries (e.g., financial analysts, stockbrokers, mutual fund managers, credit-rating organizations)

For these groups, the primary focus of financial accounting is on the financial information provided by *profit-oriented companies to their present and potential investors and creditors.* One external user group, often referred to as *financial intermediaries,* includes financial analysts, stockbrokers, mutual fund managers, and credit rating organizations. These users provide advice to investors and creditors and/or make investment-credit decisions on their behalf.

The primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related disclosure notes. The financial statements most frequently provided are (1) the balance sheet, also called the statement of financial position, (2) the income statement, also called the statement of operations, (3) the statement of cash flows, and (4) the statement of shareholders' equity. Also, companies must either provide a statement of other comprehensive income immediately following the income statement, or present a combined statement of comprehensive income that includes the information normally contained in both the income statement and the statement of other comprehensive income.[5] As you progress through this book, you will review and expand your knowledge of the information in these financial statements, the way the elements in these statements are measured, and the concepts underlying these measurements and related disclosures. We use the term **financial reporting** to refer to the process of providing this information to external users. Keep in mind, though, that external users receive important financial information in a variety of other formats as well, including news releases and management forecasts, prospectuses, and reports filed with regulatory agencies.

Target's financial statements for the fiscal year ended January 30, 2016, and related disclosure notes are provided in Connect. You also can access these statements and notes under the Investor Relations link at the company's website (**Target.com**). A Target case is included among the Real-Word Cases that accompany each chapter, so you can see how each chapter's topics relate to a single familiar company.

The Economic Environment and Financial Reporting

In the United States, we have a highly developed free-enterprise economy with the majority of productive resources privately owned rather than government owned. For the economy to operate efficiently, these resources should be allocated to private enterprises that will use

[5]FASB ASC 220-45: Comprehensive Income-Other Presentation Matters (originally "Presentation of Comprehensive Income," *Accounting Standards Update No. 2011-05* (Norwalk, CT: FASB, June 2011)).

The *capital markets* provide a mechanism to help our economy allocate resources efficiently.

them best to provide the goods and services desired by society, and not to enterprises that will waste them. The mechanisms that foster this efficient allocation of resources are the **capital markets**. We can think of the capital markets simply as a composite of all investors and creditors.

Businesses go to the capital markets to get the cash necessary for them to function. The three primary forms of business organization are the sole proprietorship, the partnership, and the corporation. In the United States, sole proprietorships and partnerships outnumber corporations. However, the dominant form of business organization, in terms of the ownership of productive resources, is the **corporation**. Investors provide resources, usually cash, to a corporation in exchange for an ownership interest, that is, shares of stock. Creditors lend cash to the corporation, either by making individual loans or by purchasing publicly traded debt such as bonds.

***Corporations* acquire capital from investors in exchange for ownership interest and from creditors by borrowing.**

Stocks and bonds usually are traded on organized security markets such as the New York Stock Exchange and the NASDAQ. New cash is provided by **initial market transactions** in which the corporation sells shares of stock or bonds to individuals or other entities that want to invest in it. For example, **Target** first "went public" in 1967, selling shares to finance its expansion. Subsequent transfers of these stocks and bonds between investors and creditors are referred to as **secondary market transactions**. Corporations receive no new cash from secondary market transactions. Nevertheless, secondary market transactions are very important to the efficient allocation of resources in our economy. These transactions help establish market prices for additional shares and for bonds that corporations may wish to issue in the future to acquire additional capital. Also, many investors and creditors might be unwilling to buy stocks and bonds if they thought they couldn't eventually sell those securities to others in the future.

***Initial market transactions* involve issuance of stocks and bonds by the corporation.**

***Secondary market transactions* involve the transfer of stocks and bonds between individuals and institutions.**

What information do investors and creditors need when determining which companies will receive capital? We explore that question next.

The Investment-Credit Decision—A Cash Flow Perspective

While the decisions made by investors and by creditors are somewhat different, they are similar in at least one important way. Investors and creditors are willing to provide capital to a corporation (buy stocks or bonds) only if they expect to receive more cash in return at some time in the future. A corporation's shareholders will receive cash from their investment through the ultimate sale of the ownership shares of stock. In addition, many corporations distribute cash to their shareholders in the form of periodic dividends. For example, if an investor provides a company with $10,000 cash by purchasing stock at the end of 2017, receives $400 in dividends from the company during 2018, and sells the ownership interest (shares) at the end of 2018 for $10,600, the investment would have generated a **rate of return** of 10% for 2018, calculated as follows:

The expected rate of return and the uncertainty, or risk, of that return are key variables in the investment decision.

$$\frac{\$400 \text{ dividends} + \$600 \text{ share price appreciation}}{\$10{,}000 \text{ initial investment}} = 10\%$$

All else equal, investors and creditors would like to invest in stocks or bonds that provide the highest expected rate of return. However, there are many variables to consider before making an investment decision. For example, the *uncertainty,* or *risk,* of that expected return also is important. To illustrate, consider the following two investment options:

1. Invest $10,000 in a savings account insured by the U.S. government that will generate a 5% rate of return.
2. Invest $10,000 in a profit-oriented company.

While the rate of return from option 1 is known with virtual certainty, the return from option 2 is uncertain. The amount and timing of the cash to be received in the future from option 2 are unknown. The company in option 2 will be able to provide investors with a return only if it can generate a profit. That is, it must be able to use the resources provided by investors and creditors to generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service. Therefore, potential investors require

A company will be able to provide a positive return to investors and creditors only if it can generate a profit from selling its products or services.

information about the company that will help them estimate the potential for future profits, as well as the return they can expect on their investment and the risk that is associated with it. If the potential return is high enough, investors will prefer to invest in the profit-oriented company, even if that return has more risk associated with it.

In summary, the primary objective of financial accounting is to provide investors and creditors with information that will help them make investment and credit decisions. That information should help investors and creditors evaluate the *amounts, timing,* and *uncertainty* of the enterprise's future cash receipts and disbursements. The better this information is, the more efficient will be investor and creditor resource allocation decisions. But financial accounting doesn't only benefit companies and their investors and creditors. By providing key information to capital market participants, financial accounting plays a vital role that helps direct society's resources to the companies that will utilize those resources most effectively.

The objective of financial accounting is to provide investors and creditors with useful information for decision making.

Cash versus Accrual Accounting

● LO1–2

Even though predicting future cash flows is the primary goal of many users of financial reporting, the model best able to achieve that goal is the **accrual accounting** model. A competing model is **cash basis accounting**. Each model produces a periodic measure of performance that could be used by investors and creditors for predicting future cash flows.

CASH BASIS ACCOUNTING. Cash basis accounting produces a measure called **net operating cash flow**. This measure is the difference between cash receipts and cash payments from transactions related to providing goods and services to customers during a reporting period.

***Net operating cash flow* is the difference between cash receipts and cash disbursements from providing goods and services.**

Over the life of a company, net operating cash flow definitely is the measure of concern. However, over short periods of time, operating cash flows may not be indicative of the company's long-run cash-generating ability. Sometimes a company pays or receives cash in one period that relates to performance in multiple periods. For example, in one period a company receives cash that relates to prior period sales, or makes advance payments for costs related to future periods.

To see this more clearly, consider Carter Company's net operating cash flows during its first three years of operations, shown in Illustration 1–3. Carter's operations for these three years included the following:

1. Credit sales to customers were $100,000 each year ($300,000 total), while cash collections were $50,000, $125,000 and $125,000. Carter's customers owe Carter nothing at the end of Year 3.
2. At the beginning of Year 1, Carter prepaid $60,000 for three years' rent ($20,000 per year).
3. Employee salaries of $50,000 were paid in full each year.
4. Utilities cost was $10,000 each year, but $5,000 of the cost in Year 1 was not paid until Year 2.
5. In total, Carter generated positive net operating cash flow of **$60,000**.

Illustration 1–3
Cash Basis Accounting

	Year 1	Year 2	Year 3	Total
Sales (on credit)	$100,000	$100,000	$100,000	$300,000
Net Operating Cash Flows				
Cash receipts from customers	$ 50,000	$125,000	$125,000	$300,000
Cash disbursements:				
Prepayment of three years' rent	(60,000)	–0–	–0–	(60,000)
Salaries to employees	(50,000)	(50,000)	(50,000)	(150,000)
Utilities	(5,000)	(15,000)	(10,000)	(30,000)
Net operating cash flow	**$ (65,000)**	$ 60,000	$ 65,000	**$ 60,000**

Over short periods of time, operating cash flow may not be an accurate predictor of future operating cash flows.

Is the three-year pattern of net operating cash flows indicative of the company's year-by-year performance? No. Sales to customers and costs of operating the company (rent, salaries, and utilities) occurred evenly over the three years, but net operating cash flows occurred at an uneven rate. Net operating cash flows varied each year because Carter (a) didn't collect cash from customers in the same pattern that sales occurred and (b) didn't pay for rent and utilities in the same years in which those resources were actually consumed. This illustration also shows why operating cash flows may not predict the company's long-run cash-generating ability. Net operating cash flow in Year 1 (negative **$65,000**)[6] is not an accurate predictor of Carter's future cash-generating ability in Year 2 (positive $60,000) or Year 3 (positive $65,000).

***Net income* is the difference between *revenues* and *expenses*.**

ACCRUAL ACCOUNTING. If we measure Carter's activities by the accrual accounting model, we get a more accurate prediction of future operating cash flows and a more reasonable portrayal of the periodic operating performance of the company. The accrual accounting model doesn't focus only on cash flows. Instead, it also reflects other resources provided and consumed by operations during a period. The accrual accounting model's measure of resources provided by business operations is called *revenues,* and the measure of resources sacrificed to produce revenues is called *expenses.* The difference between revenues and expenses is **net income**, or net loss if expenses are greater than revenues.[7]

Illustration 1–4 shows how we would measure revenues and expenses in this very simple situation.

Net income is considered a better indicator of future operating cash flows than is current net operating cash flow.

Revenue for year 1 is the $100,000 sales. Given that sales eventually are collected in cash, the year 1 revenue of $100,000 is a better measure of the inflow of resources from company operations than is the $50,000 cash collected from customers. Also, net income of **$20,000** for year 1 appears to be a reasonable predictor of the company's cash-generating ability, as total net operating cash flow for the three-year period is a positive **$60,000**. Comparing the three-year pattern of net operating cash flows in Illustration 1–3 to the three-year pattern of net income in Illustration 1–4, the net income pattern is more representative of Carter Company's steady operating performance over the three-year period.[8]

While this example is somewhat simplistic, it allows us to see the motivation for using the accrual accounting model. Accrual income attempts to measure the resource inflows and outflows generated by operations during the reporting period, which may not correspond to cash inflows and outflows. Does this mean that information about cash flows from operating activities is not useful? No. Indeed, one of the basic financial statements—the statement of cash flows—reports information about cash flows from operating, investing and financing activities, and provides important information to investors and creditors.[9] Focusing on

Illustration 1–4
Accrual Accounting

CARTER COMPANY
Income Statements

	Year 1	Year 2	Year 3	Total
Revenues	$100,000	$100,000	$100,000	$300,000
Expenses:				
Rent	20,000	20,000	20,000	60,000
Salaries	50,000	50,000	50,000	150,000
Utilities	10,000	10,000	10,000	30,000
Total expenses	80,000	80,000	80,000	240,000
Net Income	**$ 20,000**	$ 20,000	$ 20,000	**$ 60,000**

[6]If cash flow from operating the company is negative, the company can continue to operate by using cash obtained from investors or creditors to make up the difference.
[7]Net income also includes gains and losses, which are discussed later in the chapter.
[8]Empirical evidence that accrual accounting provides a better measure of short-term performance than cash flows is provided by Patricia Dechow, "Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accrual Accounting," *Journal of Accounting and Economics* 18 (1994), pp. 3–42.
[9]The statement of cash flows is discussed in detail in Chapters 4 and 21.

accrual accounting as well as cash flows provides a more complete view of a company and its operations.

The Development of Financial Accounting and Reporting Standards

LO1–3

Accrual accounting is the financial reporting model used by the majority of profit-oriented companies and by many not-for-profit companies. The fact that companies use the same model is important to investors and creditors, allowing them to *compare* financial information among companies. To facilitate these comparisons, financial accounting employs a body of standards known as **generally accepted accounting principles**, often abbreviated as **GAAP** (and pronounced *gap*). GAAP is a dynamic set of both broad and specific guidelines that companies should follow when measuring and reporting the information in their financial statements and related notes. The more important concepts underlying GAAP are discussed in a subsequent section of this chapter and revisited throughout this book in the context of particular accounting topics.

FINANCIAL Reporting Case

Q1, p. 3

Historical Perspective and Standards

Pressures on the accounting profession to establish uniform accounting standards began after the stock market crash of 1929. Some felt that insufficient and misleading financial statement information led to inflated stock prices and that this contributed to the stock market crash and the subsequent depression.

The 1933 Securities Act and the 1934 Securities Exchange Act were designed to restore investor confidence. The 1933 Act sets forth accounting and disclosure requirements for initial offerings of securities (stocks and bonds). The 1934 Act applies to secondary market transactions and mandates reporting requirements for companies whose securities are publicly traded on either organized stock exchanges or in over-the-counter markets.[10]

The 1934 Act also created the **Securities and Exchange Commission (SEC)**. Congress gave the SEC the authority to set accounting and reporting standards for companies whose securities are publicly traded. However, the SEC, a government appointed body, has *delegated* the task of setting accounting standards to the private sector. It is important to understand that the power still lies with the SEC. If the SEC does not agree with a particular standard issued by the private sector, it can force a change in the standard. In fact, it has done so in the past.[11]

The Securities and Exchange Commission (SEC) has the authority to set accounting standards for companies, but it relies on the private sector to do so.

EARLY U.S. STANDARD SETTING. The first private sector body to assume the task of setting accounting standards was the **Committee on Accounting Procedure (CAP)**. The CAP was a committee of the **American Institute of Accountants (AIA)**. The AIA was renamed the **American Institute of Certified Public Accountants (AICPA)** in 1957, which is the national professional organization for certified professional public accountants.

From 1938 to 1959, the CAP issued 51 *Accounting Research Bulletins (ARBs)* which dealt with specific accounting and reporting problems. No theoretical framework for financial accounting was established. This piecemeal approach of dealing with individual issues without a framework led to criticism.

In 1959 the **Accounting Principles Board (APB)** replaced the CAP. The APB operated from 1959 through 1973 and issued 31 *Accounting Principles Board Opinions (APBOs),* various *Interpretations,* and four *Statements.* The *Opinions* also dealt with specific accounting and reporting problems. Many *ARBs* and *APBOs* still represent authoritative GAAP.

The APB suffered from a variety of problems. It was never able to establish a conceptual framework for financial accounting and reporting that was broadly accepted. Also, members

[10]Reporting requirements for SEC registrants include Form 10-K, the annual report form, and Form 10-Q, the report that must be filed for the first three quarters of each fiscal year.

[11]The SEC issues *Financial Reporting Releases (FRRs),* which regulate what information companies must report to it. The SEC staff also issues *Staff Accounting Bulletins* that provide the SEC's interpretation of standards previously issued by the private sector. To learn more about the SEC, consult its Internet site at www.sec.gov.