



INTERMEDIATE ACCOUNTING

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Intermediate Accounting

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For Paul, Andrew, Mary, and my parents

EAG

For Nicholas, Aidan, and Kevin

JSR

For Ayden Alexander

AJS

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Preface

Our new textbook is based on the belief that success in today's business environment requires an intuitive understanding of financial reporting and an ability to interpret and apply changing standards.

The financial crisis, movement toward global accounting standards, and the passage of the Sarbanes-Oxley Act have brought dramatic changes and increased complexity to financial reporting. 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 shed misperceptions about the mechanical nature of accounting and 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 accountants require to critically evaluate 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 tradeoffs 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 is 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 Zynga, the social game service company, 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 managers make 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, Apple, 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 on 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 and name brand companies such as Microsoft and Kraft Foods—as well as members of standard-setting boards.

Problem-Solving Skills

We emphasize problem solving within the chapter 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* revolve 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, revenue recognition for multiple-element deliverables, and revaluations of long-term operating assets under IFRS).

Revenue Recognition—UPDATE

The new standard represents a radical change in the way revenue is recognized. Students need to begin understanding and applying these changes as early as possible in their college curriculum to be prepared for the CPA exam and practice when they graduate. We cover revenue recognition early in the text to form a solid foundation that is critical to working in several subsequent chapters in the book.

We provide comprehensive coverage of the newly adopted revenue recognition standards in the printed chapter. We understand that the effective date of the new standard may be delayed for a few years. However, we provide an easy alternative to cover the prior rules: a parallel Chapter 8, available online and in MyAccountingLab, that can be used by any instructor who would like to cover the prior standards on revenue recognition.

Get Students Ready . . .

Accounting Cycle Tutorial

Accessed through MyAccountingLab by computer, smartphone, or tablet, the Accounting Cycle tutorial provides a refresher on the basics so students are ready for Intermediate-level work.



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.

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, while 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, but \$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.

THE CONCEPTUAL FRAMEWORK CONNECTION: Inventory Valuation Methods

While U.S. GAAP allows LIFO, many argue that this method is generally not a conceptually sound assumption for the cost flow of inventory. It is rare for a company to sell its most recent purchases before its earlier purchases. A concrete plant might use the most recent cement first because it is on the top of the pile—but in reality few other types of companies would operate this way. IFRS does not permit the use of LIFO for this reason.

FIFO measures inventory on the balance sheet more accurately than LIFO because it values ending inventory using the most recent purchases and thus more closely reflects current costs. Some argue that LIFO better measures the cost of goods sold because it uses the most recent purchases and thus matches these current costs with current selling prices. However, this benefit is not always achieved with the LIFO method in practice.

In addition to being theoretically deficient, LIFO is the most difficult and costly method to implement in practice. So, why do a significant number of U.S. firms continue to use the LIFO method? The primary reason is that LIFO can provide significant tax benefits for a firm. Before the LIFO conformity rule, many firms adopted LIFO for tax purposes, while continuing to use FIFO for financial reporting. This dual approach allowed firms to report higher income to their shareholders, while reducing income for tax purposes. Congress believed that this was misleading because if LIFO is used for tax, then LIFO must be viewed by a company to be the proper valuation of inventory. As a result, the IRS LIFO conformity rule requires that if a company

minimize tax benefits (i.e., lower taxable income) by using LIFO for tax purposes, it must also use LIFO for financial reporting.

As discussed in Chapter 17, inventory valued using the LIFO method is one of the few tax and financial reporting methods are required to conform.

To Think Like Accountants . . .

Worked Examples

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

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.

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

EXHIBIT 10.8 Inventory Disclosure from *Deere & Company* Annual Report, October 31, 2013

NOTE 16: Inventories

Most inventories owned by Deere & Company and its U.S. equipment subsidiaries are valued at cost, on the "last-in, first-out" (LIFO) basis. Remaining inventories are generally valued at the lower of cost, on the "first-in, first-out" (FIFO) basis, or market. The value of gross inventories on the LIFO basis represented 63 percent and 61 percent of worldwide gross inventories at FIFO value at October 31, 2013 and 2012, respectively. If all inventories had been valued on the FIFO basis, the value of gross inventories would have increased by \$4.9 billion at October 31 in millions of dollars as follows:

	2013
Raw materials and supplies	\$1,300
Work-in-process	700
Finished goods and parts	3,700
Total FIFO value	6,400
Less adjustment to LIFO value	1,500
Inventories	\$4,900

Source: Deere & Company. http://www.deere.com/en_US/docs/financialdata/reports/2014/2013_annual_report.pdf, page 47.

In its October 31, 2013, balance sheet, *Deere & Company* reported inventories of \$4,935 million on a LIFO basis. If it had reported inventories on a FIFO basis, the value would have increased to \$6,464 million, which is a 31% increase. This substantial management decision. The LIFO effect of \$108 million reduced the beginning and ending LIFO reserve balances, \$1,500 million and \$1,400 million, respectively.

Classification of Dividends, Interest, and Taxes: IFRS

IFRS differs from U.S. GAAP in the classifications 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 above 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

Activities	Standard	
	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 in-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.

interview

BARBARA J. WIGHT
TAYLOR GUITARS,
EL CAJON, CALIFORNIA »



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.

apply different methodologies to different types of inventory or different business segments. For example, if a company's different business segments have different underlying raw 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 high-turnover models are in stock at all times.

From the First Day of Class and Into Their Careers




Becker

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

Multiple Choice

In partnership with:



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

5 MC15-1. Boone Corporation's outstanding capital stock on December 15 consisted of the following:
30,000 shares of 5% cumulative preferred stock, par value \$10 per share, fully participating as to dividends. No dividends were in arrears.
200,000 shares of common stock, par value \$1 per share.
On December 15, Boone declared dividends of \$100,000. What was the amount of dividends payable to Boone's common stockholders?
a. \$10,000 b. \$34,000 c. \$47,500 d. \$40,000

8 MC15-2. At its date of incorporation, The McCarty Company issued 100,000 shares of its \$10 par common stock at \$11 per share. During the current year, The McCarty Company acquired 30,000 shares of its common stock at a price of \$16 per share and accounted for them by the cost method. Subsequently, these shares were reissued at a price of \$12 per share. There have been no other issuances or acquisitions of its own common stock. What effect does the reissuance of the stock have on the following accounts?

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

Keyed to learning goals, the items 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.

- 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?
- On January 1, 2014, 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 the end of 2014. Given an interest rate of 8%, what value should FA give to the machinery?
- FA purchased a new machine and wants to pay for it using five equal annual installments of \$40,000. The payments start in one year. Given an interest rate of 10%, at what amount should FA value the machine?

2 4 P7-2. **Present Value, Present Value of an Annuity.** Boyne needs to purchase a truck. Boyne's two choices are:

Truck A: Boyne can

CASES

Judgment Cases

X Judgment Case 1: Balance Sheet Management

The CFO of First Things Computing, Inc. (FTC) prepared the following balance sheet as of December 31, 2016.

First Things Computing, Inc. Balance Sheet As of December 31, 2016	
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	<u>41,500</u>
Noncurrent Assets:	
Investments	\$ 15,000
Property, Plant, and Equipment	
Land	20,000
Buildings	80,000
Machinery and Equipment	70,000
Less: Accumulated Depreciation	<u>(62,000)</u>
Total Property, Plant, and Equipment – net	<u>108,000</u>

Instructor and Student Resources

MyAccountingLab For Students

<http://www.myaccountinglab.com> Online Homework and Assessment Manager

- Pearson eText
- Accounting Cycle Tutorial
- Excel in Practice **X**
- Dynamic Study Modules
- Help Me Solve This
- Student PowerPoint® Presentations
- Adaptive Study Plan Powered by Knewton
- Flash Cards

For Instructors

Instructor Resource Center: <http://www.pearsonhighered.com/gordon>

For the instructor's convenience, the instructor resources can be downloaded from the textbook's catalog page (<http://www.pearsonhighered.com/gordon>) and MyAccountingLab. Available resources include the following:

Online Instructor's Resource Manual:

Course Content

- 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

- Chapter Overview—contains a brief synopsis and overview of each chapter
- Learning Goals
- Teaching Outline with Lecture Notes walks instructors through what material to cover and what examples to use when addressing certain items within the chapter.
- IFRS Breakaways outline when IFRS diverges and addresses the key conceptual differences in these separate sections.
- Student Supplement to Teaching Outline can be printed for (or emailed to) students. This outline will aid students in following the class and taking notes.
- Assignment Grid indicates, for each question, exercise, and problem, the corresponding Learning Goal, the estimated completion time, and availability of Final Answer Questions and Worked Solutions in MyAccountingLab.
- Suggestions for Class Activities are organized by Learning Goals, allowing instructors to choose activities that fit with each day's discussions.
- Guidance on Incorporating IFRS Material offers instructors direction on how to discuss the IFRS with their students.

Online Instructor's Solutions Manual: Contains solutions to all end-of-chapter questions, including short exercises, exercises, problems, and Excel in Practice data set solutions.

All solutions were thoroughly reviewed by all co-authors and accuracy checkers.

Test Bank: *Question Types* True/False, Multiple-Choice, Essays, and Problems make up more than 2,500 questions in this test bank. Most question types consist of both conceptual and computational problems, to ensure students are understanding both the theory and the application.

Algorithmic test bank is available in MyAccountingLab. Most computational questions are formulated with an algorithm so that the same question is available with unique values. This offers instructors a greater pool of questions to pull from and will help ensure each student has a different test.

PowerPoint Presentations: *Instructor PowerPoint Presentations* mirror the organization of the text and include key exhibits, worked examples, and lecture notes. Instructors can download PowerPoint presentations that best match their teaching style.

- *Lecture Support Only* presentations consist of the chapter outline mirroring the text and include all main headings, key terms, key figures, and key tables.
- *Worked Examples Only* presentations consist of selected Worked Examples from the text for use as in-class demonstration problems.
- *Combined* presentations consist of both the lecture support and the examples organized to correspond to the text.

Modifying supplied PowerPoint presentations to correspond with classes can be a time consuming task. To aid in this task, instructors can download a Table of Contents of the PowerPoint presentations. These documents will list the slide numbers for chapter content for quick removal of content which will not be covered in class.

Student PowerPoint Presentations are abridged versions of the Instructor PowerPoint Presentations and can be used as a study tool or note-taking tool for students.

Image Library contains all image files from the text to assist instructors in modifying our supplied PowerPoint presentations or in creating their own PowerPoint presentations.

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1

The Financial Reporting Environment

LEARNING GOALS

- 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.



Andrew Burton/Getty Images

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.

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 November, 2013 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. 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 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

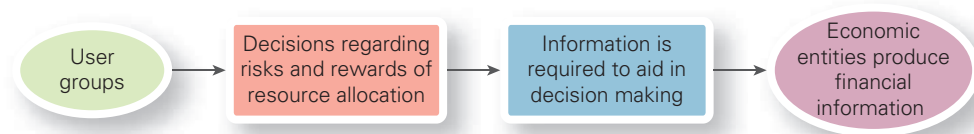
We will examine these elements in the following sections of the chapter.

Financial Information

Financial information falls into two categories: information that is or 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.¹

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.

¹For a discussion of the financial statements and many of these other items, see Chapters 5 and 6.

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 *CSK Auto Corporation* committed accounting fraud that increased net earnings from 2002 through 2004, *CSK's* CEO agreed to pay back \$2.8 million of the over \$4 million in bonus and stock compensation he received based on the fraudulent earnings.² 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 income³
- The statement of cash flows
- The statement of shareholders' equity⁴

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 a subset 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

²<https://www.sec.gov/news/press/2011/2011-243.htm>

³Entities may report comprehensive income either in one combined statement or in two statements—the statement of net income and the statement of comprehensive income.

⁴Throughout the text, we cover 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.

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

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 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 who 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.

⁶In this textbook, we focus primarily on publicly traded entities.

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

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.

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 fourth quarter of 2014, there were 28 analyst recommendations issued for *Twitter*—14 of which were strong buys, one was a buy, 12 were holds, and one was a sell.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

⁸Source: See <http://www.nasdaq.com/symbol/twtr/recommendations>

its products and its ability to honor warranties to potential customers. **General Motors** 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.

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 an independent party, 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.

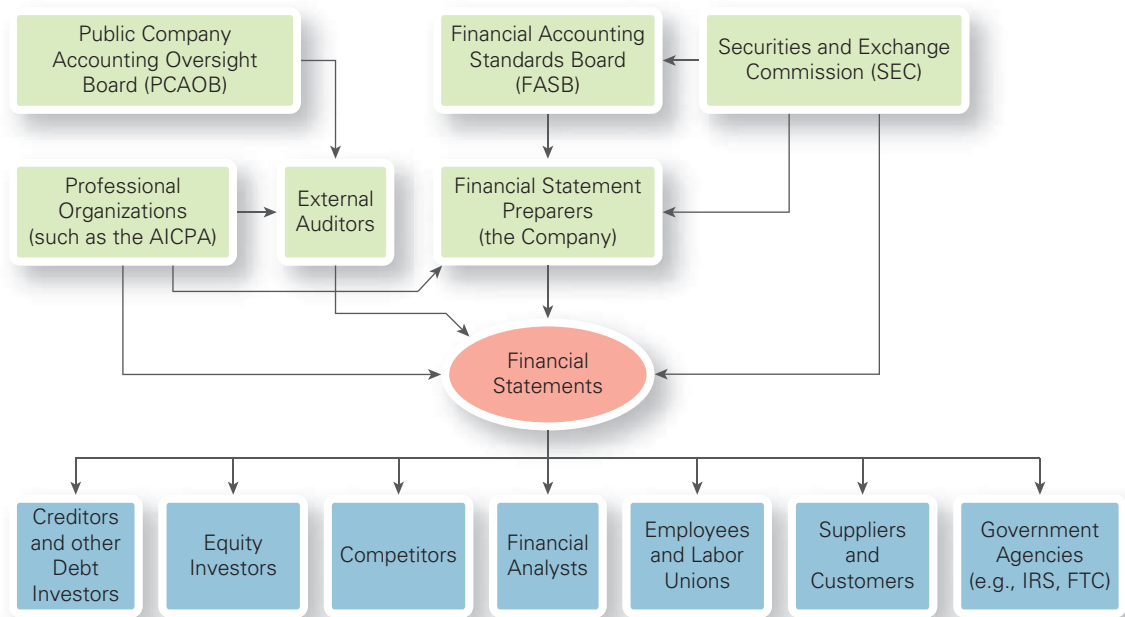
Accounting standard setters develop and promulgate accounting concepts, rules, and guidelines that provide information that is relevant and faithfully represents the economic performance and the financial position of the reporting entity. The Financial Accounting Standards Board (FASB), the primary standard 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 on the next page summarizes the various groups involved in the financial reporting process.

⁹A 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

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 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 its 2013 annual report, *Johnson & Johnson* highlighted its partnership with Operation Smile to provide corrective surgery to children born with cleft palates, as shown in Exhibit 1.4.

EXHIBIT 1.4 Discussion of Partnership with Operation Smile, *Johnson & Johnson Company*, Financial Statements, December 29, 2013

Healing the Smiles of Children

It's said that a child smiles 400 times a day. But every three minutes, a child is born with a facial cleft.

Thanks to the *Johnson & Johnson* partnership with Operation Smile, *Johnson & Johnson* Medical in Asia Pacific was able to help more than 1,400 children smile for the first time after having their cleft conditions repaired in 2013. Globally, *Johnson & Johnson* has helped to restore more than 3,600 smiles.

During the missions, physicians surgically repaired each child's cleft, which is an opening in the lip, the roof of the mouth or the soft tissue in the back of the mouth. One in 10 children born with a cleft will die before his or her first birthday. Those who survive are often shunned by society, and their families are unable to afford the reconstructive surgeries needed to give their children a healthy, productive life.

Source: Johnson & Johnson Discussion of Partnership with Operation Smile, December 29, 2013, Financial Statements. See <http://2013annualreport.jnj.com/stories/Healing-the-Smiles-of-Children>, December 29, 2013, Financial Statements.

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).

Convergence Status

Currently, U.S. GAAP and IFRS differ in important areas such as accounting for revenue recognition, financial instruments, and leases. The FASB and IASB have been working together to eliminate the differences—or *converge*—these areas. For example, the Boards have agreed on a new revenue recognition standard that U.S. companies will start using in annual reporting periods beginning after December 15, 2016. In the future, the Boards may determine new areas to converge. By working together, the goal is to improve both U.S. GAAP and IFRS and to develop one set of high-quality accounting standards that can be used for global business and investing.

The Importance of Understanding International Accounting Standards

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:

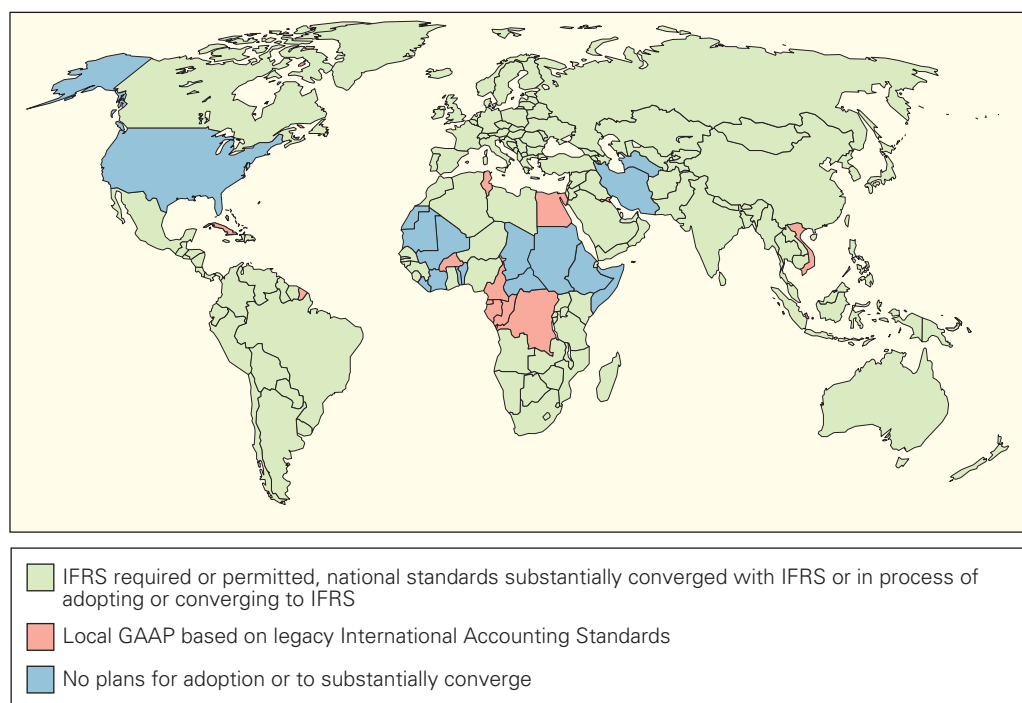
- U.S. companies operate subsidiaries outside of the United States. Many of these subsidiaries report under IFRS in their home countries. Accountants must convert the subsidiaries' financial statements to U.S. GAAP when preparing consolidated financial statements. For example, **Johnson & Johnson** operates 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.

¹⁰The SEC eliminated the requirement that foreign issuers reconcile their financial statements from IFRS (or other accounting standards) to U.S. GAAP in 2007.

- The SEC is currently deliberating if IFRS will be required to be used by U.S. companies. If approved, U.S. accountants and auditors will need a working knowledge of IFRS to implement these 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 120 countries worldwide. Exhibit 1.5 presents a map that highlights the IFRS nations in green (as of 2014).
- 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.

EXHIBIT 1.5 Global Usage of IFRS



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- 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,