

# INTERMEDIATE ACCOUNTING

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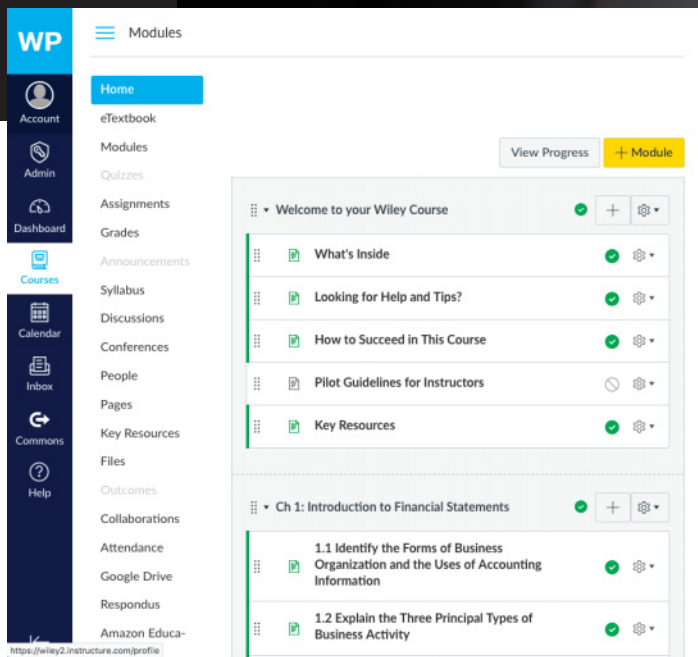
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# Intermediate Accounting

17th Edition

**DONALD E. KIESO PhD, CPA**

Northern Illinois University  
DeKalb, Illinois

**JERRY J. WEYGANDT PhD, CPA**

University of Wisconsin—Madison  
Madison, Wisconsin

**TERRY D. WARFIELD, PhD**

University of Wisconsin—Madison  
Madison, Wisconsin

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# From the Authors

Through many editions, this text has continued to reflect the constant changes taking place in the GAAP environment. This edition continues this tradition, which has become even more significant as the financial reporting environment is exploding with major change. Here are three areas of major importance that are now incorporated extensively into this edition of the text.

**CONVERGENCE OF GAAP AND IFRS** One of the most important innovations shaping our capital markets was the idea of GAAP. It might be said that it would be even better if

“If this text helps you appreciate the challenges, worth, and limitations of financial reporting, if it encourages you to evaluate critically and understand financial accounting concepts and practice, and if it prepares you for advanced study, professional examinations, and the successful and ethical pursuit of your career in accounting or business in a global economy, then we will have attained our objectives.”

we had one common set of accounting rules for the whole world, which would make it easier for international investors to compare the financial results of companies from different countries. Fortunately, GAAP and international accounting standards have converged to result in a number of common standards between GAAP and **International Financial Reporting Standards (IFRS)**. And you have the chance to be on the ground floor as we develop for you the similarities and differences in the two systems that ultimately will be one.

**A FAIR VALUE MOVEMENT** The FASB believes that fair value information is more relevant to users than historical cost. As a result, there is more information that is being reported on this basis, and even more will occur in the future. The financial press is full of articles discussing how financial institutions must fair value their assets, which has led to massive losses during the financial crisis. In addition, additional insight into the reliability related to fair values is being addressed and disclosed to help investors make important capital allocation decisions. We devote a considerable amount of material that discusses and illustrates fair value concepts in this edition, including its relevance to three major accounting standards updates: revenue, leases, and financial instruments.

**A NEW WAY OF LOOKING AT GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)** Learning GAAP used to be a daunting task, as it is comprised of many standards that vary in form, completeness, and structure. Fortunately, the profession has developed the Financial Accounting Standards Board Codification (often referred to as the Codification). This Codification provides in one place all the GAAP related to a given topic. This textbook is the first to incorporate this Codification—it will make learning GAAP easier and more interesting!

*Intermediate Accounting* is the market-leading text in providing the tools needed to understand what GAAP is and how it is applied in practice. With this Seventeenth Edition, we strive to continue to provide the material needed to understand this subject area. The text is comprehensive and up-to-date. We also include proven pedagogical tools, designed to help you learn more effectively and to answer the changing needs of this course.

We are excited about *Intermediate Accounting*, Seventeenth Edition. We believe it meets an important objective of providing useful information to educators and students interested in learning about both GAAP and IFRS. Suggestions and comments from users of this text will be appreciated. Please feel free to e-mail any one of us.

**Donald E. Kieso**  
Somonauk, Illinois

**Jerry J. Weygandt**  
Madison, Wisconsin

**Terry D. Warfield**  
Madison, Wisconsin



# About the Authors



## Don Kieso

**DONALD E. KIESO, PhD, CPA**, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done post-doctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, then AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, as a member of the Board of Directors of Kishwaukee Community Hospital, and as Treasurer and Director of Valley West Community Hospital. From 1989 to 1993, he served as a charter member of the National Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvano Award of Merit, the NIU Foundation's Humanitarian Award for Service to Higher Education, a Distinguished Service Award from the Illinois CPA Society, and in 2003 an honorary doctorate from Aurora University.



## Jerry Weygandt

**JERRY J. WEYGANDT, PhD, CPA**, is the Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review*, *Journal of Accounting Research*, *Accounting Horizons*, *Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the *Accounting Review*; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001, he received the American Accounting Association's Outstanding Educator Award.



## Terry Warfield

**TERRY D. WARFIELD, PhD**, is the PwC Professor in Accounting at the University of Wisconsin—Madison. He received a B.S. and M.B.A. from Indiana University and a Ph.D. in accounting from the University of Iowa. Professor Warfield's area of expertise is financial reporting, and prior to his academic career, he worked for five years in the banking industry. He served as the Academic Accounting Fellow in the Office of the Chief Accountant at the U.S. Securities and Exchange Commission in Washington, D.C. from 1995–1996. Professor Warfield's primary research interests concern financial accounting standards and disclosure policies. He has published scholarly articles in *The Accounting Review*, *Journal of Accounting and Economics*, *Research in Accounting Regulation*, and *Accounting Horizons*, and he has served on the editorial boards of *The Accounting Review*, *Accounting Horizons*, and *Issues in Accounting Education*. He has served as president of the Financial Accounting and Reporting Section, the Financial Accounting Standards Committee of the American Accounting Association (Chair 1995–1996), and on the AAA-FASB Research Conference Committee. He also served on the Financial Accounting Standards Advisory Council of the Financial Accounting Standards Board and as a trustee of the Financial Accounting Foundation. Professor Warfield has received teaching awards at both the University of Iowa and the University of Wisconsin, and he was named to the Teaching Academy at the University of Wisconsin in 1995. Professor Warfield has developed and published several case studies based on his research for use in accounting classes. These cases have been selected for the AICPA Professor-Practitioner Case Development Program and have been published in *Issues in Accounting Education*.

# New to This Edition

## Content Changes by Chapter

### Chapter 1: Financial Accounting and Accounting Standards

- Generally updated for content and recent developments.

### Chapter 2: Conceptual Framework for Financial Reporting

- New footnote detailing most recent FASB updates related to disclosures.
- Completely updated *IFRS Insights* section for the most recent information concerning the IASB and FASB conceptual statements.

### Chapter 3: The Accounting Information System

- New section on the chart of accounts, as well as increased explanation and graphics of the recording process.
- Updated opening story on economic crime to reflect latest data and trends.
- New “What Do the Numbers Mean?” (WDNM) box on blockchain.
- New Analytics in Action activity on collecting financial data from a variety of sources.

### Chapter 4: Income Statement and Related Information

- New WDNM box on how and why companies use earnings management to misrepresent company performance.
- Updated information about joint FASB-IASB project on financial statement presentation (currently on hold).
- Updated Evolving Issue box on most recent information concerning non-GAAP reporting.

### Chapter 5: Balance Sheet and Statement of Cash Flows

- Rewrote “Additional Information” section for most recent FASB updates and recommendations on note disclosures regarding accounting policies, contractual situations, contingencies, and fair value.
- New Analytics in Action activity on ratio analysis for companies in the Dow Jones average.

### Chapter 6: Accounting and the Time Value of Money

- New Analytics in Action activity on analyzing business alternatives, with consideration of time value of money concepts.

### Chapter 7: Cash and Receivables

- New opening story, discussing current effect of the Tax Cuts and Jobs Act of 2017 in terms of amounts of company cash parked overseas.
- New Evolving Issue, on what companies should include as part of cash and cash equivalents on the balance sheet, such as cryptocurrencies.
- Updated discussion of allowance method for uncollectible accounts per latest FASB standards (i.e., net amount expected to be collected instead of net realizable value).

- New Analytics in Action activity on estimating the allowance for doubtful accounts and conducting financial analysis of the collectibility of accounts receivable.

### Chapter 8: Valuation of Inventories: A Cost-Basis Approach

- Generally updated for content and recent developments.

### Chapter 9: Inventories: Additional Valuation Issues

- New WDNM boxes on (1) corporate barter to handle problem inventory and (2) importance of identifying markdown method (cost versus retail) used by retailers.
- New Analytics in Action activity on analyzing inventory balances for possible impairment.

### Chapter 10: Acquisition and Disposition of Property, Plant, and Equipment

- Moved contributions discussion as a new appendix, expanding its discussion per recent FASB guidance.
- New WDNM box on importance for companies to effectively manage capital spending.

### Chapter 11: Depreciation, Impairments, and Depletion

- Updated opening story on technical and environmental issues affecting recognition of impaired assets.
- Updated footnote 15 to include the financial impacts of the most recent legislation, Tax Cuts and Jobs Act of 2017.
- New WDNM box on how changes in tax depreciation rules related to bonus depreciation.
- New Analytics in Action activity on analyzing company information related to depreciation and impairment of property, plant, and equipment.

### Chapter 12: Intangible Assets

- Updated discussion of goodwill impairment test per recent FASB.
- New WDNM box on how goodwill impairments reported by companies can signal their future cash flows.
- New Analytics in Action activity on analyzing goodwill for companies in the Dow Jones average.

### Chapter 13: Current Liabilities and Contingencies

- New WDNM boxes on (1) advantages of increased employee benefits over wage growth and (2) how Penn Central Railroad provides example of need for rules for liabilities expected to be refinanced.
- Updated Refinancing Criteria section for short-term obligations expected to be refinanced due to latest proposed FASB Accounting Standards Update.
- New Analytics in Action activity on analyzing current liabilities as part of a valid analysis of liquidity.
- New case illustration on determining whether a lawsuit liability should be recognized.

**Chapter 14: Long-Term Liabilities**

- New WDNM box on why some companies are issuing 100-year and even longer-duration bonds.

**Chapter 15: Stockholders' Equity**

- Generally updated for content and recent developments.
- New Analytics in Action activity on analyzing ROE using the DuPont method.

**Chapter 16: Dilutive Securities and Earnings per Share**

- New discussion and illustrations on stock compensation costs.

**Chapter 17: Investments**

- New opening story on how new FASB standard on reporting loans at amortized cost and equity investments at fair value is resulting in wins for banks and losses for companies.
- Updated discussion of impairments for receivables, available-for-sale and held-to-maturity debt investments, and equity investments.
- Deleted dated WDNM box on disclosure of equity investments.

**Chapter 18: Revenue Recognition**

- Generally updated for content and recent developments.

**Chapter 19: Accounting for Income Taxes**

- Chapter updated throughout to reflect the Tax Cuts and Jobs Act of 2017, including a new opening story that discusses its most important provisions.
- Loss carrybacks now discussed in a new Appendix 19B.
- New WDNM box on impact of a lower corporate tax rate.

## Improved Digital Assets

*Intermediate Accounting* is completely integrated with WileyPLUS, featuring a suite of teaching and learning resources developed under the close review of the authors. Driven by the same basic beliefs as the text, WileyPLUS allows students to create a personalized study plan, assess their progress along the way, and access the content and resources needed to master the material. Features of the WileyPLUS course include the following:

- **NEW Integrated CPA Exam Test Prep:** Each chapter in the text now includes additional content from Wiley CPAexcel, which is designed to help students pass the CPA exam efficiently. Integrated within WileyPLUS, this new content includes CPA exam video lessons, CPA exam practice questions, and assignable task-based simulations (TBSs), which are the primary form of assessment used by the American Institute of Certified Public Accountants (AICPA) to assess mastery of the content at the analysis and evaluation cognitive level.
- **NEW Data Analytics:** Analytics in Action activities include corresponding data sets and assignments in WileyPLUS. These resources further prepare and enhance data

**Chapter 20: Accounting for Pensions and Postretirement Benefits**

- Moved up last part of the continuing pension expense worksheet example earlier in the chapter, for improved continuity.
- Completely updated section on the reporting and disclosure requirements for pensions, now discussed in four categories: (1) assets and liabilities, (2) net income, (3) comprehensive income, and (4) notes to the financial statements.

**Chapter 21: Accounting for Leases**

- Chapter consists of Updated Chapter 21 available with Kieso 16e.
- Opening story updated per most recent information on impact of new lease standard on companies' balance sheets.

**Chapter 22: Accounting Changes and Error Analysis**

- New WDNM box on how substantial depreciation-related changes might affect financial information.
- Completely updated discussion of converting to the equity method in Appendix 22A, given the recent FASB standard.

**Chapter 23: Statement of Cash Flows**

- Expanded WDNM boxes to include recent FASB rule for classifying operating cash flows.

**Chapter 24: Full Disclosure in Financial Reporting**

- New discussion of FASB Disclosure Framework project on improving the effectiveness of disclosures in financial statements, which has resulted in a new concepts statement in August 2018.
- New discussion of recent controversy regarding “short-termism” of interim reporting.
- Moved “Errors, Fraud, and Illegal Acts” section later in chapter under “Fraudulent Reporting” for improved presentation of topics.

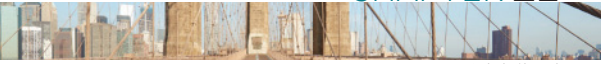
analytics skills that students will need in their future accounting careers. *Intermediate Accounting* also includes a “Data Analytics and Accounting” module within WileyPLUS that contains seven interactive lessons with industry-validated content to prepare students for the evolving workforce, video tutorials of real-world data analytics applications, and a case study using Excel that allows students to manipulate and think critically about data.

- **NEW Solution Walkthrough Videos:** The library of solution walkthrough videos has been expanded with the addition of approximately 45 new videos. Question-usage data helped determine which assessment content to highlight, ensuring that this student-favorite resource is available for the most frequently assigned content.
- **Accessible Lecture PowerPoints:** PowerPoints are a hallmark of many lectures as well as an important study tool for students. In addition to the fully accessible WileyPLUS course, we have also improved the lecture PowerPoints to be accessible, including high-quality alt text and screen-reader capabilities.

# Proven Pedagogical Framework

This edition continues to provide numerous key learning aids to help you master the text material and prepare you for a successful career in accounting.

## CHAPTER 21



# Accounting for Leases

**LEARNING OBJECTIVES**

After studying this chapter, you should be able to:

1. Describe the environment related to leasing transactions.
2. Explain the accounting for finance leases.
3. Explain the accounting for operating leases.
4. Discuss the accounting and reporting for special features of lease arrangements.

**PREVIEW OF CHAPTER 21** The following opening story indicates the increased significance and prevalence of lease arrangements. As a result, the need for uniform accounting and informative reporting of these transactions has intensified. In this chapter, we look at the accounting issues related to leasing. The content and organization of this chapter are as follows.

This chapter also includes numerous conceptual and global discussions that are integral to the topics presented here.

**ACCOUNTING FOR LEASES**

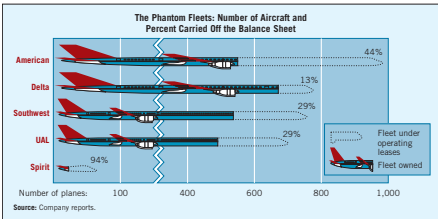
The Leasing Environment	Finance Leases	Operating Leases	Special Lease Accounting Problems
<ul style="list-style-type: none"> <li>• Lessees</li> <li>• Lessee lease advantages</li> <li>• Lessors</li> <li>• Lessor lease advantages</li> <li>• Conceptual nature of a lease</li> <li>• Finance and operating leases</li> <li>• Lease classification</li> </ul>	<ul style="list-style-type: none"> <li>• Lessee accounting and finance lease example</li> <li>• Lessor accounting</li> <li>• Sales-type lease example</li> </ul>	<ul style="list-style-type: none"> <li>• Lessee accounting</li> <li>• Lessor accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Residual values</li> <li>• Other lease adjustments</li> <li>• Bargain purchase options</li> <li>• Short-term leases</li> <li>• Presentation, disclosure, and analysis</li> </ul>

**Times Are A-Changing**

Sir David Tweedie, a former IFRS chairperson, is known for making the following observation about airline accounting. He noted that one day he would like to fly on an airplane that appears on a company's balance sheet. What Sir David was referring to is that many of the airlines such as **United**, **Delta**, and **Southwest** sometimes do not own their aircraft. The airlines lease many of their airplanes due to the favorable accounting treatment they received

**Review and Practice**

Go to the **Review and Practice** section at the end of the chapter for a targeted summary review and practice problem with solution. Multiple-choice questions with annotated solutions as well as additional exercises and practice problem with solutions are also available online.



Airline	Number of Planes	Percent Carried Off the Balance Sheet
American	~800	44%
Delta	~400	13%
Southwest	~600	29%
UAL	~600	29%
Spirit	~100	94%

when they leased rather than purchased. Presented below are the lease percentages for major U.S. airlines in a recent year.

The same held true for many other industries as well. What was this favorable accounting treatment? The previous FASB standard on leasing depended on whether a lease qualified as an operating lease or a finance lease. In an operating lease, companies did not report an asset on their balance sheet for the item they leased, nor did they report a related liability for their lease obligation. Only if the company had a finance lease would companies have to report an asset and a related liability on the balance sheet. However, the FASB has recently issued a standard on leasing that mandates that all companies will have to report both assets and related liabilities for practically all lease arrangements.

The accounting change will have significant impact on many companies' balance sheets. The top 1,000 U.S. public companies alone have nearly \$1 trillion in operating lease liabilities. Companies with large off-balance-sheet operating leases will be most affected. For example, here is a list of companies that will have to capitalize a significant number of operating leases.

Balance Sheet Impact Assets and Liabilities Increases (in millions)			
Walgreens Boots Alliance	\$32,811	FedEx	\$17,874
CVS Health	27,151	United Continental Holdings	16,254
AT&T	25,928	Delta Air Lines	16,236
Amazon	22,848	Walmart	15,366
Verizon Communications	20,734	Bank of America	14,500

So Sir David Tweedie, what we can now say is get ready as your wish is about to come true.

Source: Adapted from Seth Lubere and Elizabeth MacDonald, "Diet? Who, Me?" *Forbes* (February 18, 2002), p. 56; A. Catanach and E. Ketz, "Still Searching for the 'Rite' Stuff," *Crain's Old Accountant* (April 30, 2012), <http://blogs.smeal.psu.edu/~who-is-most-impacted-by-the-new-lease-accounting-standards/>; An Analysis of the Fortune 500's Leasing Obligations," *Lease Accelerator* (2016); and Sue Lloyd, "A New Lease on Life," *Investor Perspective* (January 2016).

## Chapter Opener Vignettes

The Chapter Opener Vignettes provide an engaging introduction as well as place the content of the chapter's topics in context in terms of recent accounting, economic, and political developments.

## Chapter Preview

The Chapter Preview summarizes the major issues discussed in the chapter, and provides students with a visual outline of the key topics.

## Review and Practice

The Review and Practice section, placed after the text discussion, offers students the opportunity to assess their understanding of the chapter's topics before tackling homework assignments.

## NEW MORE Illustration Walk-Throughs

These unique illustrations include mini-cases so that students can immediately understand how to apply the accounting concepts and procedures to specific situations.

**ILLUSTRATION 21.3**  
Variable Lease Payments

**INCLUDING VARIABLE LEASE PAYMENTS**

*Facts:* On January 1, 2020, Jose Company leases an airplane for 6 years. The annual lease payments are \$1,000,000 per year, payable at the beginning of each year (annuity-due basis). In addition, the lease agreement specifies that the lease payment increases by \$30,000 every year.

**Question:** What are the lease payments in 2021?

*Solution:* On January 1, 2021, the lease payment is \$1,030,000 (\$1,000,000 + \$30,000), which is considered a variable payment. Given that the amount of the variable payment is known from year to year (the rate is set at commencement of the lease and in substance fixed), such variable payments are included in calculating the present value of the lease liability.

**ILLUSTRATION 21.4**  
Variable Lease Payments

**EXPENSING VARIABLE LEASE PAYMENTS**

*Facts:* Assume the same information as in Illustration 21.3, except that the lease payments are adjusted each year by a change in the Consumer Price Index (CPI).

**Question:** If the CPI is 100 at January 1, 2020, and increases to 104 on January 1, 2021, what is the payment on January 1, 2021?

*Solution:* The variable payment on January 1, 2021, is \$1,040,000 (\$1,000,000 × 1.04). Because the amount of the variable payment from year to year is not known at the lease commencement date, this payment is not included in determining the present value of the lease liability. This additional payment (\$40,000) is recognized as an expense in the period it is incurred. Similarly, when lease payments vary with a performance measure (e.g., sales at a store location, asset usage), the variable amounts will be expensed in the period incurred.

Lerch records this loss as follows.		
Loss on Impairment	40,000,000	
Patents		40,000,000

After recognizing the impairment, the reduced carrying amount of the patents is its new cost basis (see **Underlying Concepts**). Lerch should amortize the patent's new cost over its remaining useful life or legal life, whichever is shorter. Even if shale-oil prices increase in subsequent periods and the value of the patent increases, Lerch **may not recognize restoration of the previously recognized impairment loss**.

**Underlying Concepts**

The basic attributes of intangibles, their uncertainty as to future benefits, and their uniqueness have discouraged valuation in excess of cost.

**Underlying Concepts**

The Underlying Concepts highlight and explain major conceptual topics in the chapter.

## Global View

Global Views provide students with specific examples of how global companies (and countries) implement key accounting regulations. They also provide examples of how and where IFRS differs from GAAP.

Two difficulties arise in accounting for R&D expenditures: (1) identifying the costs associated with particular activities, projects, or achievements, and (2) determining the magnitude of the future benefits and length of time over which such benefits may be realized. Because of these latter uncertainties, the FASB has simplified the accounting practice in this area. **Companies must expense all research and development costs when incurred** (see **Global View**). [14]

**Global View**

IFRS requires the capitalization of certain development expenditures. This conflicts with GAAP.

**What Do the Numbers Mean? Not So Fast**

As an illustration of the importance of the control criteria, consider the case of computer leasing companies, which at one time bought **IBM** equipment, leased the equipment to their customers, and removed the leased assets from their balance sheets. In leasing the assets, the computer lessors stated that they would substitute new IBM equipment if obsolescence occurred (a sales return provision). However, when IBM introduced a new computer line, IBM refused to sell it to the computer leasing companies. As a result, a number of the lessors could not meet their contracts with their customers and had to take back the old equipment. Thus, control had not been fully transferred and the computer leasing companies therefore had to reinstate the assets they had taken off the books. Such a case demonstrates one reason why the lessor classification tests must be aligned with those for revenue recognition.

**What Do the Numbers Mean?**

The “What Do the Numbers Mean?” boxes further students’ understanding of key concepts with practical, real-world examples.

## Evolving Issue

The Evolving Issue feature introduces and discusses a current topic in the accounting industry in which the profession may be encountering controversy or nearing resolution. The feature shows how the key standard-setting organizations make decisions to adjust to the changing global business environment.

**Evolving Issue Recognition of R&D and Internally Generated Intangibles**

The requirement that companies expense immediately all R&D costs (as well as start-up costs) incurred internally is a practical solution. It ensures consistency in practice and uniformity among companies. But the practice of immediately writing off expenditures made in the expectation of benefiting future periods is conceptually incorrect.

Proponents of immediate expensing contend that from an income statement standpoint, long-run application of this standard frequently makes little difference. They argue that because of the ongoing nature of most companies’ R&D activities, the amount of R&D cost charged to expense each accounting period is about the same, whether there is immediate expensing or capitalization and subsequent amortization.

Others criticize this practice. They believe that the balance sheet should report an intangible asset related to expenditures that have future benefit. To preclude capitalization of all R&D expenditures removes from the balance sheet what may be a company’s most valuable asset.

Indeed, research findings indicate that capitalizing R&D costs may be helpful to investors. For example, one study showed a significant relationship between R&D outlays and subsequent benefits in the form of increased productivity, earnings, and shareholder value for R&D-intensive companies. Another study found that there was a significant decline in earnings’ usefulness for companies that were forced to switch from capitalizing to expensing R&D costs, and that the decline appears to persist over time.

The current accounting for R&D and other internally generated intangible assets represents one of the many trade-offs made among relevance, faithful representation, and cost-benefit considerations. The FASB and IASB have completed some limited-scope projects on the accounting for intangible assets, and the Boards have contemplated a project on the accounting for identifiable intangible assets (i.e., excluding goodwill). Such a project would address concerns that the current accounting requirements lead to inconsistent treatments for some types of intangible assets depending on how they arise.

**Sources for research studies:** Baruch Lev and Theodore Sougiannis, “The Capitalization, Amortization, and Value-Relevance of R&D,” *Journal of Accounting and Economics* (February 1996); and Martha L. Louderer and Bruce K. Behn, “Alternative Income Determination Rules and Earnings Usefulness: The Case of R&D Costs,” *Contemporary Accounting Research* (Fall 1995). See also the recent critique of the accounting for intangible assets in Baruch Lev and Feng Gu, *The End of Accounting* (Hoboken, NJ: John Wiley & Sons, 2016).

# End-of-Chapter Pedagogy

## Review and Practice

Review and Practice section includes Key Terms Review, Learning Objectives Review, and a Practice Problem with Solution. In addition, multiple-choice questions with solutions, review exercises with solutions, and a full glossary of all key terms are available online.

### Review and Practice

---

#### Key Terms Review

amortization 12-4 bargain purchase 12-14 business combination 12-4(n) copyright 12-8 development activities 12-19 fair value test 12-15 franchise 12-8 goodwill 12-11	impairment 12-14 indefinite-life intangibles 12-4 intangible assets 12-3 license (permit) 12-9 limited (finite)-life intangibles 12-4 master valuation approach 12-13 organizational costs 12-21 patent 12-9	recoverability test 12-14 research activities 12-19 research and development (R&D) costs 12-19 start-up costs 12-21 trademark, trade name 12-6
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#### Learning Objectives Review

**1 Discuss the characteristics, valuation, and amortization of intangible assets.**

**3 Explain the accounting issues for recording goodwill.**

Unlike receivables, inventories, and patents that a company can sell or exchange individually in the marketplace, goodwill can be identified only with the company as a whole. **Goodwill is a “going con-**

### Practice Problem

Sky Co., organized in 2020, provided you with the following information.

1. Purchased a license for \$20,000 on July 1, 2020. The license gives Sky exclusive rights to sell its services in the tri-state region and will expire on July 1, 2028.
2. Purchased a patent on January 2, 2021, for \$40,000. It is estimated to have a 5-year life.
3. Costs incurred to develop an exclusive Internet connection process as of June 1, 2021, were \$45,000. The process has an indefinite life.

## Practice Problem

The Practice Problem offers students a comprehensive exercise, incorporating many of the chapter’s topics, followed by a detailed, step-by-step solution.

## Using Your Judgment

The Using Your Judgment section provides students with real-world homework problems including (1) a financial reporting problem, (2) a comparative analysis case, (3) financial statement analysis cases, and (4) an accounting, analysis, and principles problem.

### Using Your Judgment

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#### Financial Reporting Problem

**The Procter & Gamble Company (P&G)**  
 The financial statements of **P&G** are presented in Appendix B. The company’s complete annual report, including the notes to the financial statements, is available online.

#### Comparative Analysis Case

**The Coca-Cola Company and PepsiCo, Inc.**  
 The financial statements of **Coca-Cola** and **PepsiCo** are presented in Appendices C and D, respectively. The companies’ complete annual reports, including the notes to the financial statements, are available online.

**Instructions**  
 Use the companies’ financial information to answer the following questions.

- a. **1.** What amounts for intangible assets were reported in their respective balance sheets by Coca-Cola and PepsiCo at year-end 2017?

### Analytics in Action

Accounting software systems collect vast amounts of data about the economic events experienced by a company and about the parties with whom the company engages, such as suppliers and customers. Business decision-makers take advantage of this wealth of information by using data analytics, which often employs both software and statistics, to draw inferences and make more informed business decisions. As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies.

For example, consider goodwill, which has been rising briskly since 2011, to a total of \$3.408 trillion among all corporate filers in 2015. The bad news is that impairments have plummeted further during this same period, from a low of \$34.66 billion in 2013 to \$83.02 billion in 2015 (see <http://www.radicalcompliance.com/2016/05/04/impairments-hinting-at-bigger-problems-ahead/>). So are goodwill impairments more likely as goodwill balances rise? Business decision-makers would definitely want to investigate this trend further using data analytics.

**Instructions** Go to WileyPLUS for a data analytics exercise focusing on goodwill for companies in the Dow Jones average.

## Data Analytics

Analytics in Action activities discuss how data analytics are used for specific accounting situations as well as offer hands-on experience so that students understand the power and value of analytical tools.

### Bridge to the Profession

#### FASB Codification References

- [1] FASB ASC 350-10-05. [Predecessor literature: "Goodwill and Other Intangible Assets," *Statement of Financial Accounting Standards No. 142* (Norwalk, Conn.: FASB, 2001).]
- [2] FASB ASC 350-30-35. [Predecessor literature: "Goodwill and Other Intangible Assets," *Statement of Financial Accounting Standards No. 142* (Norwalk, Conn.: FASB, 2001), par. 11.]

- [15] FASB ASC Master Glossary. [Predecessor literature: "Accounting for Research and Development Costs," *Statement of Financial Accounting Standards No. 2* (Stamford, Conn.: FASB, 1974), par. 8.]
- [16] FASB ASC 805-10. [Predecessor literature: "Business Combinations," *Statement of Financial Accounting Standards No. 141-Revised* (Norwalk, Conn.: FASB, 2007), par. E11.]
- [17] FASB ASC 730-10-25-2. [Predecessor literature: "Accounting for Research and Development Costs," *Statement of Financial*

## Bridge to the Profession

This section includes FASB Codification References, Codification Exercises, and a Codification Research Case, all designed to refer students to the relevant FASB literature for key concepts in the text and provide assessment of their understanding.

## IFRS Insights

IFRS Insights offer students a detailed discussion and assessment material (including IFRS Self-Test Questions, IFRS Concepts and Application, and an International Financial Reporting Problem) of international accounting standards at the end of each chapter.

### IFRS Insights

#### LEARNING OBJECTIVE 6

Compare the accounting for intangible assets under GAAP and IFRS.

There are some significant differences between IFRS and GAAP in the accounting for both intangible assets and impairments. IFRS related to intangible assets is presented in *IAS 38* ("Intangible Assets"). IFRS related to impairments is found in *IAS 36* ("Impairment of Assets").

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## Seventeenth Edition

Maggie Atkinson  
*Stark State College*

Michael Bitter  
*Stetson University*

Stephen Brown  
*University of Maryland*

Sudheer Kumar Chella  
*Hurix*

Timothy Coville  
*St. John's University*

Bill Davenport  
*CPA*

Charmaine Felder  
*Brandman University*

Kristen Fuhremann  
*Wisconsin School of Business*

Liz Grant  
*Northern Illinois University*

Vicki Greshik  
*University of Jamestown*

Michael Gurevitz  
*Montgomery College*

Coby Harmon  
*University of California—Santa Barbara*

James Hay  
*Wilson College*

Michelle Hodgen-Smith  
*Gun-Ho Joh*

Gun-Ho Joh  
*San Diego State University*

Katie Landgraf  
*University of Hawaii—West Oahu*

Jim Leisenring  
*FASB*

Lisa Ludlum  
*Western Illinois University*

Dan Lynch  
*Wisconsin School of Business*

David Massaglia  
*Bemidji State University*

Monica McElhane  
*Bellevue University*

Cynthia Mille  
*University of Kentucky*

Allison Moreno  
*Texas Tech University*

Kingsley Olibe  
*Kansas State University*

Pete Poznanski  
*Cleveland State University*

Gregory Prescott  
*University of South Alabama*

Ada Rodriguez  
*Lehman College*

Mark Ross  
*Western Kentucky University*

David Scott  
*Purdue University*

Paula Thomas  
*Middle Tennessee State University*

Bruce Wampler  
*Louisiana State University Shreveport*

Jeff Wang  
*San Diego State University*

Dave Weber  
*University of Connecticut*

Donna Whitten  
*Purdue University Northwest*

Melanie Yonn

Allie Zimmerman  
*Northern Illinois University*

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## Codification Cases

Katie Adler  
*Deloitte LLP, Chicago*

Jack Cathey  
*University of North Carolina—Charlotte*

Erik Frederickson  
*Madison, Wisconsin*

Danielle Griffin  
*KPMG, Chicago*

Jason Hart  
*Deloitte LLP, Milwaukee*

Frank Heflin  
*University of Georgia*

Mike Katte  
*SC Johnson, Racine, WI*

Kelly Krieg  
*Ernst & Young, Milwaukee*

Jeremy Kunicki  
*Walgreens*

Courtney Meier  
*Deloitte LLP, Milwaukee*

Andrew Prewitt  
*KPMG, Chicago*

Jeff Seymour  
*KPMG, Minneapolis*

Matt Sullivan  
*Northwestern Mutual*

Matt Tutaj  
*Deloitte LLP, Chicago*

Jen Vaughn  
*PricewaterhouseCoopers, Chicago*

Erin Viel  
*PricewaterhouseCoopers, Milwaukee*

## Ancillary Authors, Contributors, Proofers, and Accuracy Checkers

Ellen Bartely  
*St. Joseph's University (NYC)*

LuAnn Bean  
*Florida Institute of Technology*

Jack Borke  
*University of Wisconsin—Platteville*



Melodi Bunting  
*Edgewood College*

Bea Chiang  
*The College of New Jersey*

Susetta Emery  
*York College of Pennsylvania*

Jim Emig  
*Villanova University*

Larry Falcetto  
*Emporia State University*

Kim Hurt  
*Central Community College*

Derek Jackson  
*St. Mary's University of Minnesota*

Mark Kohlbeck  
*Florida Atlantic University*

Cynthia Lovick  
*Austin Community College*

Kirk Lynch  
*Sandhills Community College*

Anthony Masino  
*East Tennessee University*

Jill Misuraca  
*University of Tampa*

Barb Muller  
*Arizona State University*

Alison Parker  
*Camosun College*

Yvonne Phang  
*Borough of Manhattan Community College*

Tim Potsaid  
*Madison, Wisconsin*

Laura Prosser  
*Blackhills State University*

Mark Riley  
*Northern Illinois University*

Alice Sineath  
*University of Maryland University College*

Lynn Stallworth  
*Appalachian State University*

Sheila Viel  
*University of Wisconsin—Milwaukee*

Dick Wasson  
*Southwestern College*

Suzanne Wright  
*Pennsylvania State University*

Lori Zaher  
*Bucks County Community College*

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Barbara Durham  
*University of Central Florida*

Pamela Graybeal  
*University of Central Florida*

Jeffery Hales  
*Georgia Institute of Technology*

Melissa Larson  
*Brigham Young University—Provo*

Ming Lu  
*Santa Monica College*

Linda Matuszewski  
*Northern Illinois University*

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*Marquette University*

Angela Spencer  
*Oklahoma State University—Stillwater*

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Donald E. Kieso    Jerry J. Weygandt    Terry D. Warfield  
*Somonauk, Illinois    Madison, Wisconsin    Madison, Wisconsin*

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# Financial Accounting and Accounting Standards

## LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the financial reporting environment.
2. Identify the major policy-setting bodies and their role in the standard-setting process.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the role of the Codification for GAAP.
4. Describe major challenges in the financial reporting environment.

**PREVIEW OF CHAPTER 1** As the following opening story indicates, the U.S. system of financial reporting has long been the most robust and transparent in the world. However, to ensure that it continues to provide the most relevant and reliable financial information to users, a number of financial reporting issues must be resolved. These issues include such matters as evaluating global standards, increasing fair value reporting, and meeting multiple user needs. This chapter explains the environment of financial reporting and the many factors affecting it, as follows.

This chapter also includes numerous conceptual and global discussions that are integral to the topics presented here.

## FINANCIAL ACCOUNTING AND ACCOUNTING STANDARDS

### Financial Reporting Environment

- Accounting and capital allocation
- Objective of financial reporting
- Need to develop standards

### Parties Involved in Standard-Setting

- Securities and Exchange Commission
- American Institute of CPAs
- Financial Accounting Standards Board

### Generally Accepted Accounting Principles

- FASB Codification

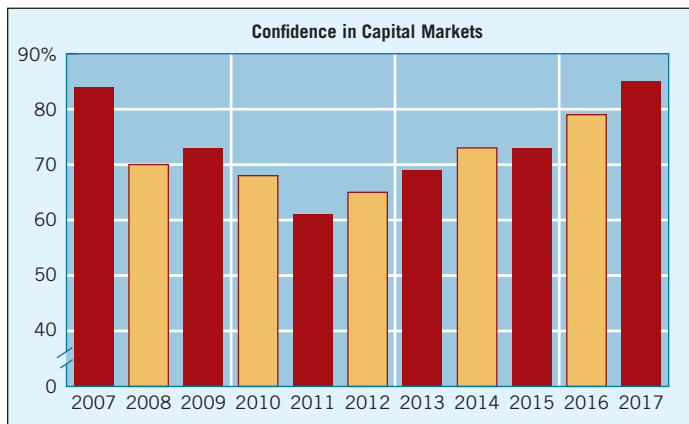
### Major Challenges in Financial Reporting

- Political environment
- Expectations gap
- Financial reporting issues
- International accounting standards
- Ethics

## Exciting Times

A recent report says it best: “Accounting information is central to the functioning of international capital markets and to managing small businesses, conducting effective government, understanding business processes, and . . . how economic decisions are made. . . . Across the globe, a common characteristic of economies that flourish is the presence of reliable accounting information.”

Many in the United States take pride in our system of financial reporting as being the most robust and transparent in the world. Yet even with continued improvement in financial reporting over the last 20 years, we have had many accounting scandals occurring at companies like **Enron**, **AIG**, **WorldCom**, and **Lehman**, as well as the financial crisis of 2008. However, as with many difficulties, there is often a silver lining. As one commentator noted, “Those



accounting scandals were a crisis we should be thankful for; we got through it and a law was passed (Sarbanes-Oxley Act), and it works.” A key feature of this law is that company executives are required to attest to the accuracy of their companies’ financial statements.

To better understand where we are, the Center for Audit Quality conducts a yearly survey that measures investor confidence in such categories as U.S. capital markets, audited financial information, and U.S. publicly traded companies. As shown in the chart, the results indicate that the 2008 financial crisis took a bite out of investor confidence. However, investor confidence has rebounded dramatically and is at its highest level since the survey was initiated—perhaps because of Sarbanes-Oxley.

The question now is how can we continue to improve? Here are some possibilities on how we can enhance the existing system of financial reporting.

1. Today, equity securities are broadly held, with approximately half of American households investing in stocks. This presents a challenge—investors have expressed concerns that **one-size-fits-all financial reports do not meet the needs of the spectrum of investors** who rely on those reports. While many individual investors are more interested in summarized, plain-English reports, market analysts and other investment professionals may desire information at a far more detailed level than is currently provided. Technology may help customize the information that the different types of investors desire.
2. Companies also express concerns with the complexity of the financial reporting system. Companies assert that **when preparing financial reports, it is difficult to ensure compliance with the voluminous and complex requirements contained in U.S. GAAP and SEC reporting rules**. This is a particularly heavy burden on smaller, non-public companies, which may have fewer resources to comply with the wide range of rules.
3. We also need to consider the broader array of information that investors need to make informed decisions. For example, the percentage of a company’s market value that can be attributed to accounting book value has declined significantly from the days of a bricks-and-mortar economy. **Thus, we may want to consider a more comprehensive business reporting model, including both financial and nonfinancial key performance indicators.**
4. Finally, we must also consider **how to deliver all of this information in a more timely manner**. In a world where messages can be sent across the world in a blink of an eye, it is ironic that the analysis of financial information is still subject to many manual processes, resulting in delays, increased costs, and errors.

Thus, improving financial reporting involves more than simply trimming or reworking the existing accounting literature. In some cases, major change is already underway. For example:

- The FASB and IASB have recently issued less-complex, more-understandable standards in the important areas of revenue recognition, leasing, and financial instruments.