

INTERMEDIATE ACCOUNTING

FOURTH
EDITION

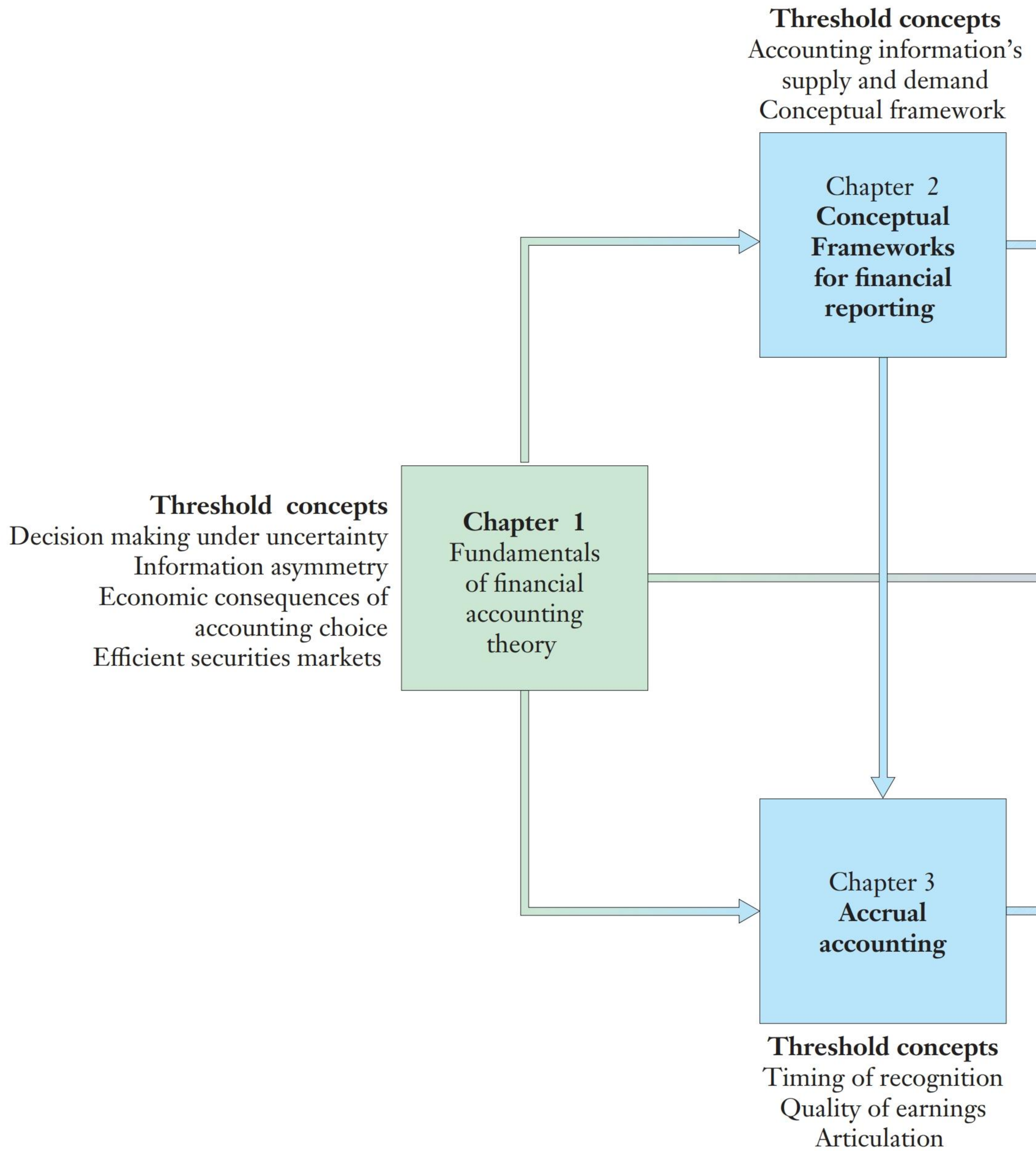
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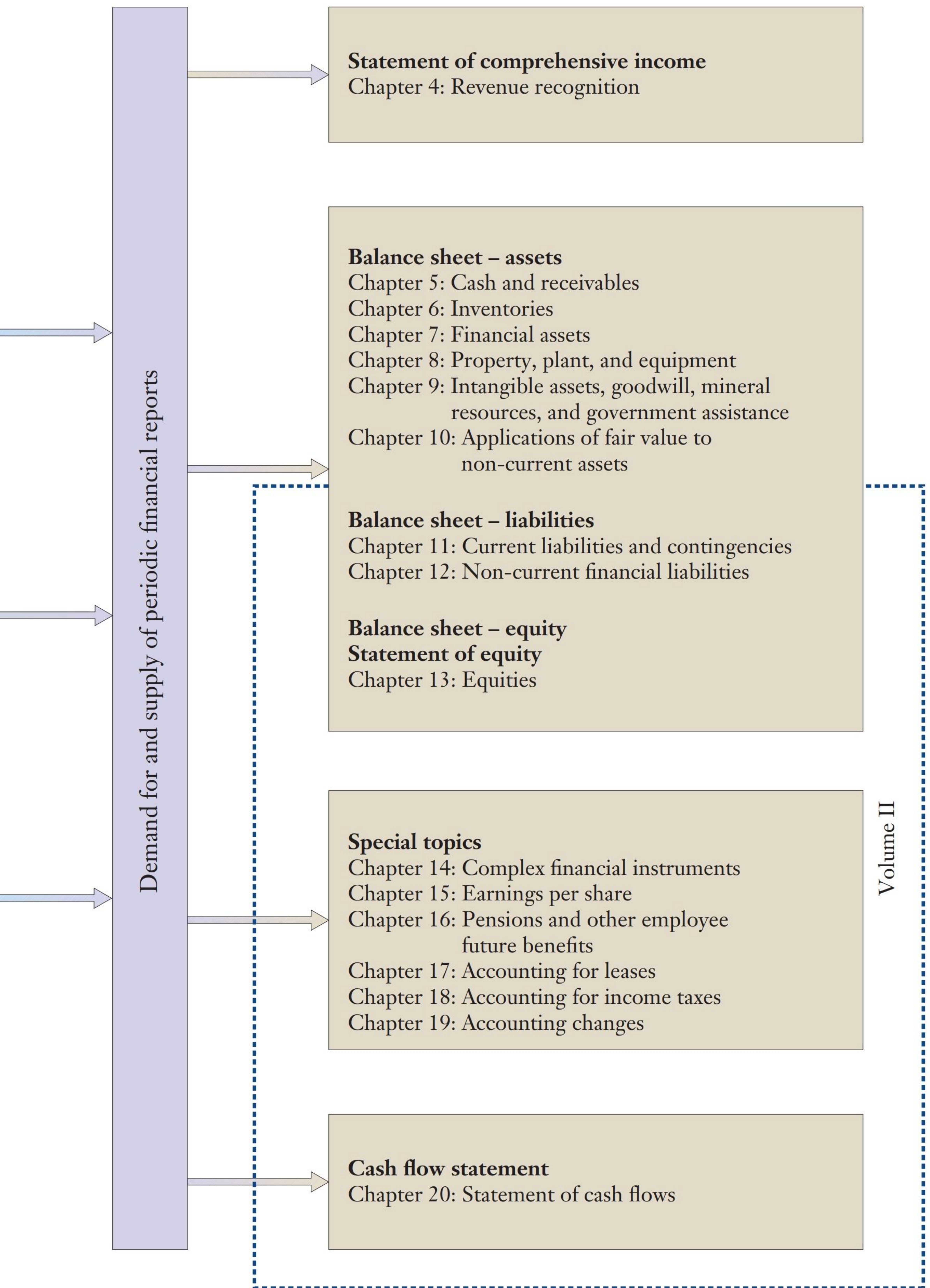
GEORGE
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INTERMEDIATE

**FOURTH
EDITION**

ACCOUNTING

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INTERMEDIATE ACCOUNTING

**FOURTH
EDITION**

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University of British Columbia

**GEORGE
FISHER**

Douglas College

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VOLUME

1

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Kin:

*In memory of my mother, who did not have the benefit of schooling,
but gave me the freedom to question, unconditional support of my pursuits,
and the humility to know that there is always more to learn.*

George:

*My passion for teaching has been richly rewarded by many opportunities
including the privilege of co-authoring this text. I dedicate this
book to my wife, Gail, and my family, friends, colleagues,
and students who have encouraged me along the way.*



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Preface



“There is too much material to learn!” is a complaint commonly heard among both students and instructors of intermediate-level financial accounting. The current environment in Canada involving multiple accounting standards certainly adds to the problem. However, this sentiment was prevalent even before the splintering of Canadian generally accepted accounting principles (GAAP) in 2011. So what is the source of the problem, and how do we best resolve it?

Regardless of one’s perspective—as an instructor of intermediate accounting, as a student, or as a researcher reading and writing papers—often *the problem of too much content is an illusion*. Instead, the issue is really one of *flow*, not just of words, but of *ideas*. Why does a class, research paper, or presentation appear to cover too much, and why is it difficult to understand? Most often, it is because the ideas being presented did not flow—they were not coherent internally within the class, paper, or presentation, or not well connected with the recipients’ prior knowledge and experiences.

Connecting new ideas to a person’s existing knowledge and efficiently structuring those new ideas are not just reasonable notions. Modern neuroscience tells us that for ideas to be retained they need to be logically structured and presented in ways that connect with a person’s prior knowledge and experiences.

OUR APPROACH

How can we better establish the flow of ideas in intermediate accounting? One way is to apply more accounting theory to help explain the “why” behind accounting standards and practices. Inherently, humans are inquisitive beings who want to know not just how things work, but also why things work a particular way. When students understand “why,” they are better able to find connections between different ideas and internalize those ideas with the rest of their accumulated knowledge and experiences.

This approach contrasts with that found in other intermediate accounting textbooks, which present accounting topics in a fragmented way, not only between chapters but within chapters. For example, how is the conceptual framework for financial reporting connected with other ideas outside of accounting? How do the components such as qualitative characteristics relate to the elements of financial statements? Fragmented ideas are difficult to integrate into the brain, which forces students to rely on memorization tricks that work only for the short term. For example, a frequently used memory aid for the conceptual framework is a pyramid; this is a poor pedagogical tool because the concepts within the diagram are not logically connected and the pyramid shape itself has no basis in theory. In contrast, we anchor the conceptual framework on the fundamental notions of economic demand and supply.

Also different from other textbooks, we do not aim to be encyclopedic—who wants to read an encyclopedia? This textbook is designed as a learning tool for students at the intermediate level, rather than as a comprehensive reference source they might use many years in the future. Being comprehensive burdens students with details that are

not meaningful to them. At the rate at which standards are changing, books become outdated rapidly, and students should learn to refer to official sources of accounting standards such as the *CPA Canada Handbook*.

ARE INTERMEDIATE ACCOUNTING STUDENTS READY FOR ACCOUNTING THEORY?

Most programs that offer an accounting theory course do so in the final year of their programs, with good reason—concepts in accounting theory are difficult. Thorough exploration of these concepts requires a solid grounding in accounting standards and practices and higher-level thinking skills. However, not exposing students to these concepts earlier is a mistake.

Other management (and non-management) disciplines are able to integrate theory with technical applications. For example, when finance students study investments and diversification, the capital asset pricing model is an integral component. Finance students also learn about firms' capital structure choices in the context of Modigliani and Miller's propositions, the pecking order theory, and so on. Students in operations management learn linear programming as an application of optimization theory. Relegating theory to the end of a program is an exception rather than the rule.

Accounting theory is too important to remain untouched until the end of an accounting program. This text exposes students to the fundamentals of accounting theory in the first chapter, which lays the foundation for a number of *threshold concepts* (see Meyer and Land, 2003¹).

THRESHOLD CONCEPTS

While by no means perfect, this textbook aims to better establish the flow of ideas throughout the book by covering several threshold concepts in the first three chapters. Threshold concepts in this case are the portals that connect accounting standards and practices with students' prior knowledge and experiences. As Meyer and Land suggest, these threshold concepts will help to *transform* how students think about accounting, help students to *integrate* ideas within and between chapters, and *irreversibly improve* their understanding of accounting. Introducing these concepts is not without cost, because threshold concepts will often be troublesome due to their difficulty and the potential conflict between students' existing knowledge and these new concepts.

The previous two pages of this Preface identify the threshold concepts and the layout of the chapters in both volumes of this text. Crucially, the first chapter in Volume 1 begins with the threshold concepts of *uncertainty* and *information asymmetry*. The need to make decisions under uncertainty and the presence of information asymmetries results in *economic consequences of accounting choice*. Those consequences differ depending on whether the accounting information interacts with *efficient securities markets*. These concepts open up the notion of *supply and demand for accounting information*, which forms the basis of the conceptual frameworks for financial reporting (Chapter 2). Decision making under uncertainty leads to the issues surrounding the *timing of recognition* under accrual accounting (Chapter 3), which in turn lead to the concept of *articulation* between financial statements. Accounting choices having economic consequences leads to considerations of the *quality of earnings* and the potential for earnings management (Chapter 3).

¹ Meyer, J.H.F., and R. Land. 2003. "Threshold Concepts and Troublesome Knowledge 1: Linkages to Ways of Thinking and Practicing." In *Improving Student Learning: Ten Years On*, C. Rust (Ed.), Oxford, UK: Oxford Centre for Staff and Learning Development.



These concepts then resurface at different points in the remaining 17 chapters. For example, the concept of information asymmetry is fundamental to understanding the reasons that companies issue complex financial instruments (Chapter 14). Another example is the important role of the moral hazard form of information asymmetry in explaining why accounting standards do not permit the recognition of gains and losses from equity transactions through net income. A third example is the influence of uncertainty and executives' risk aversion on the accounting standards for pension plans, which allow the gains and losses to flow through other comprehensive income rather than net income. A fourth example is the application of information asymmetry to the accounting for leases (Chapter 17).

As an aid for students, we have put threshold concepts icons in the margin to identify when these concepts appear in the various chapters. To further clarify these icons, we include the name of the specific concept next to the icon to ensure students understand which concepts are being referenced.



**THRESHOLD
CONCEPT**

ACCOUNTING STANDARDS AND PRACTICES

Along with the unique approach of introducing and integrating theory through the use of threshold concepts, this text also provides thorough coverage of accounting standards and practices typically expected of an intermediate accounting course. This edition reflects recently issued standards, including IFRS 15 on revenue recognition and IFRS 16 on leases.

Following an overview of the four financial statements in Chapter 3 in Volume 1, Chapter 4 explores revenue and expense recognition to highlight the connection financial reporting has to enterprises' value-creation activities. Chapters 5 to 10 in this book then examine, in detail, issues involving the asset side of the balance sheet.

The second volume begins with coverage of the right-hand side of the balance sheet in Chapters 11 to 13. Coverage in Chapters 14 to 18 then turns to special topics that cut across different parts of the balance sheet and income statement: complex financial instruments, earnings per share, pension costs, leases, and income taxes. Chapter 19 revisits the topic of accounting changes introduced in Chapter 3. Chapter 20 examines the statement of cash flows, which integrates the various topics covered in Chapters 4 through 19.

INTEGRATION OF IFRS

This is the first Canadian text written with International Financial Reporting Standards (IFRS) in mind throughout the development process, rather than as an afterthought. For example, we devote a separate chapter (Chapter 10) to exploring issues surrounding asset revaluation and impairment because these issues cut across different asset categories under IFRS. The complete integration of standards in the development process adds to the smooth flow of ideas in and between chapters. Another example is Chapter 10's coverage of agriculture activities, a topic covered by IFRS but not by past Canadian standards.

COVERAGE OF ASPE

While this text puts emphasis on IFRS, we do not neglect Accounting Standards for Private Enterprises (ASPE). Near the end of each chapter is a table that identifies differences between IFRS and ASPE. In contrast to other textbooks, we identify only substantive differences rather than every detail. In addition to the summary table, we carefully choose to discuss certain important differences in the main body of the chapters to create opportunities for understanding the subjective nature of accounting



A·S·P·E

standards, and the advantages and disadvantages of different standards. For example, Chapter 8 discusses the different treatments of interest capitalization under IFRS and ASPE. In the end-of-chapter Problems, we have placed icons in the margin to identify questions that apply ASPE instead of IFRS.

REFERENCE TO ACCOUNTING STANDARDS

Consistent with the threshold concepts described above, this textbook avoids treating accounting standards as written in stone and with only one interpretation. Ultimately, it is people who make accounting standards and it is important to analyze and evaluate the choices that standard setters make to understand the rationale behind the standards. Where appropriate, the chapters provide specific quotations from authoritative standards so that students begin to develop their ability to interpret the standards themselves rather than rely on the interpretations of a third party.

INTEGRATION OF LEARNING OBJECTIVES

To enhance the flow of material, each chapter fully integrates learning objectives from beginning to end. Each chapter enumerates four to six learning objectives that the chapter covers. The end of each chapter summarizes the main points relating to each of these learning objectives. We have also organized the Problems at the end of each chapter to match the order of these learning objectives as much as possible.

INTEGRATION OF CPA COMPETENCIES

To ensure students are building the knowledge and skills required for the CPA designation, we have integrated the competencies outlined in the CPA Competency Map and Knowledge Supplement. Each chapter now opens with a list of CPA Competencies, related Knowledge Items, and levels that are covered in that chapter; also, a master list of all the financial reporting Competencies and Knowledge Items is available at the end of this textbook. As well, all the Problems on MyLab Accounting for *Intermediate Accounting* 4e are mapped to the Competency, Knowledge Item, and level that is being assessed. These features will allow students and faculty interested in the CPA designation to become familiar with the Competency Map and the material covered in the book.

CHAPTER FEATURES

This text contains a number of features that augment the core text. We are mindful that too many “bells and whistles” only serve to distract students, so we have been selective and have included only features that reinforce student learning. The result is an uncluttered page layout in comparison to competing textbooks. We firmly believe that clean design supports clear thinking.

Opening Vignettes

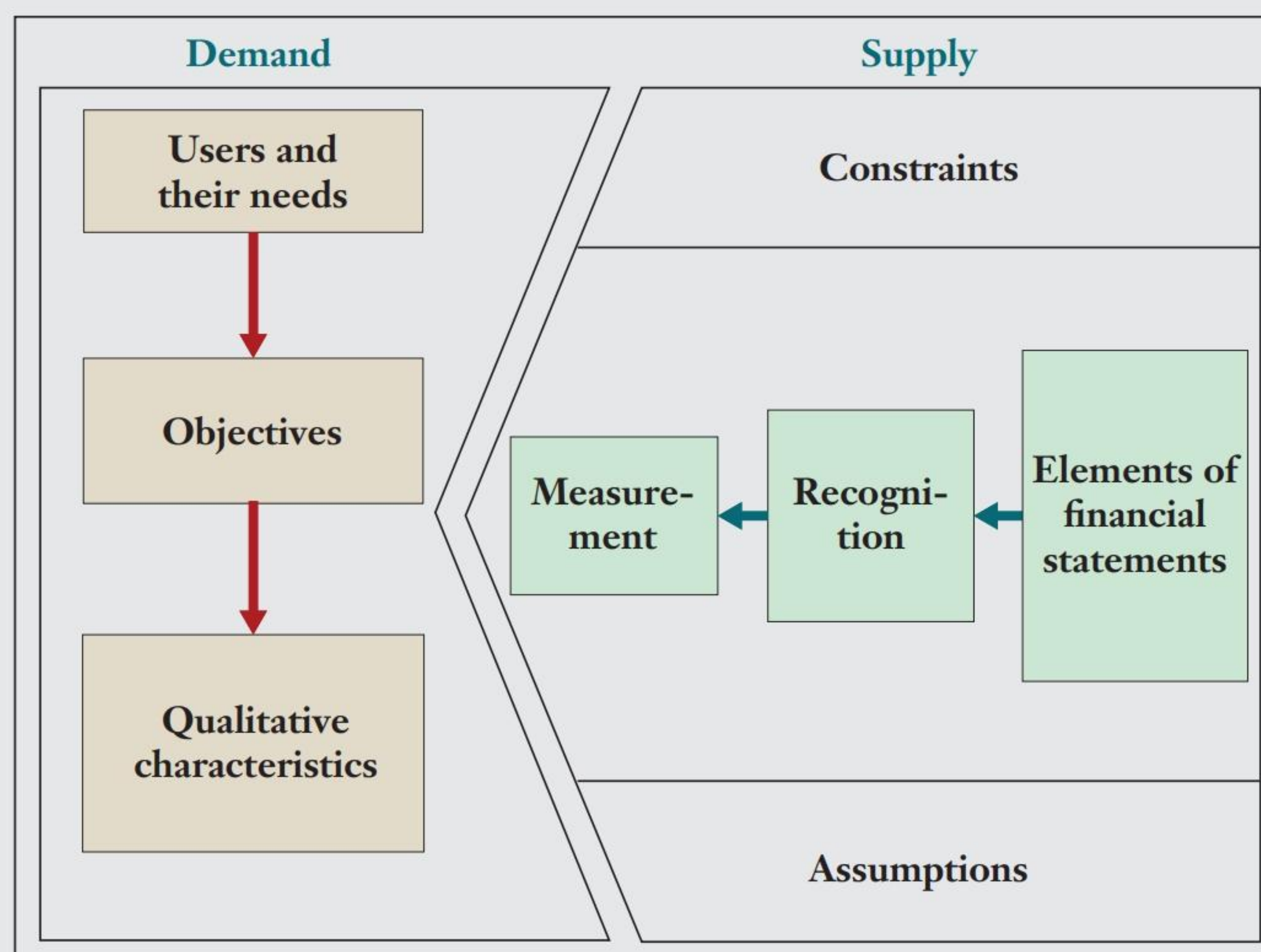
Each chapter opens with a short vignette of a real-world example that students will easily recognize and to which they will relate. These examples range from household names such as Bank of Montreal, Bombardier, and Telus, to car shopping and Christopher Columbus. As mentioned earlier, this connection to existing knowledge and experiences is crucial to learning new concepts. Each vignette serves to motivate interesting accounting questions that are later addressed in the chapter.



Charts and Diagrams

We have chosen to use graphics sparingly but deliberately. These graphics always serve to augment ideas in a logical way rather than to serve as memory “gimmicks” that lack meaning. For instance, it has been popular to use a triangle to organize the Conceptual Framework for financial reporting. We eschew the use of this triangle because that shape has no logical foundation or connection with the Conceptual Framework. Instead, we develop the Conceptual Framework from fundamental forces of supply and demand, so we provide a diagram that illustrates the interaction of those forces:

Exhibit 2-2 Outline of a conceptual framework for financial reporting



Feature Boxes

When warranted, we provide more in-depth discussions to reinforce the core message in the main body of the chapters. These discussions often take the form of alternative viewpoints or surprising research results that serve to broaden students’ perspectives on the issues. Compass icons identify these feature boxes to denote the different perspectives on various issues.



STILL WAITING...

In 1670, an incorporation under the British royal charter created “The Governor and Company of Adventurers of England trading into Hudson’s Bay.” The charter gave the company exclusive rights to the fur trade in the watershed flowing into Hudson Bay. The company continues to operate today as The Hudson’s Bay Company. It was publicly traded until January 2006, when it was purchased by private equity firm NRDC Equity Partners. In late 2012, the company became a public company again by issuing \$365 million of shares on the Toronto Stock Exchange (ticker HBC). If investors had to wait until dissolution to find out what happened to their investments, they would have been waiting for three and a half centuries—and counting!

Checkpoint Questions


At important transitional points in each chapter, we pose “Checkpoint Questions” to engage students to reflect upon what they have just read, and to review, if necessary, before proceeding to the next portion of the chapter. These questions appear



at the end of sections and there are five to ten such questions within each chapter. To encourage students to think about these questions before looking at the answers, we have placed the answers toward the end of each chapter, immediately after the chapter summary.

End-of-Chapter Problems

The end of each chapter contains many questions to help students to hone their skills. This edition features new questions, covering new chapter material and IFRS standards. We choose to use a single label—Problems—for all questions. This choice follows from our focus on learning objectives. We have organized the Problems in the order of the learning objectives, and within each learning objective according to the Problem’s level of difficulty (easy, medium, or difficult). This approach allows students to work on each learning objective progressively, starting with easier questions and then mastering more difficult questions on the same learning objective. This approach is much preferable to having students jump around from “exercises” to “discussion questions” to “assignments,” and so on. Problems in the textbook that are marked with a globe icon are also available on MyLab Accounting. Students have endless opportunities to practise many of these questions with new data and values every time they use MyLab Accounting.

MyLab Accounting Make the grade with **MyLab Accounting**: The problems marked with a  can be found on **MyLab Accounting**. You can practise them as often as you want, and most feature step-by-step guided instructions to help you find the right answer.

Cases

We have included Mini-Cases that are based on, or mimic, real business scenarios. The distinguishing feature of these cases is their focus on decision making. While they are technically no more challenging than Problems, cases bring in additional real-world subjective considerations that require students to apply professional judgment.

We have also included an appendix that provides case solving tips to students, as well as three comprehensive cases that cover topics across multiple chapters. MyLab Accounting for Volume 2 also contains two capstone cases that cover many of the topics in both volumes of the textbook. These cases simulate those on professional exams that require four to five hours of an entry-level professional accountant.

TECHNOLOGY RESOURCES

MyLab Accounting

MyLab delivers proven results in helping individual students succeed. It provides engaging experiences that personalize, stimulate, and measure learning for each student, including a personalized study plan.

MyLab Accounting for the fourth edition of *Intermediate Accounting* includes many valuable assessments and study tools to help students practise and understand key concepts from the text. Students can practise an expanded number of select end-of-chapter questions, review key terms with glossary flashcards, and review accounting fundamentals with the online, interactive Accounting Cycle Tutorial.



MyLab Accounting can be used by itself or linked to any learning management system. To learn more about how MyLab Accounting combines proven learning applications with powerful assessment, visit www.pearson.com/mylab.

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SUPPLEMENTS

These instructor supplements are available for download from a password-protected section of Pearson Canada's online catalogue (www.pearsoncanada.ca/highered). Navigate to your book's catalogue page to view a list of those supplements that are available. Speak to your local Pearson sales representative for details and access.

- **Instructor's Solutions Manual.** Created by Kin Lo and George Fisher, this resource provides complete, detailed, worked-out solutions for all the Problems in the textbook.
- **Instructor's Resource Manual.** The Instructor's Resource Manual features additional resources and recommendations to help you get the most out of this textbook for your course.
- **Computerized Test Bank.** Pearson's computerized test banks allow instructors to filter and select questions to create quizzes, tests, or homework. Instructors can revise questions or add their own, and may be able to choose print or online options. These questions are also available in Microsoft Word format.
- **PowerPoint® Presentations.** Approximately 30–40 PowerPoint® slides, organized by learning objective, accompany each chapter of the textbook.
- **Image Library.** The Image Library provides access to many of the images, figures, and tables in the textbook, organized by chapter for convenience. These images can easily be imported into Microsoft PowerPoint® to create new presentations or to add to existing ones.



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Kin Lo
George Fisher



CHAPTER 1

Fundamentals of Financial Accounting Theory



CPA competencies addressed in this chapter:

- 1.1.1 Evaluates financial reporting needs (Level B)
- 1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
- 1.1.3 Evaluates reporting processes to support reliable financial reporting (Level B)
- 1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)

A sailboat leaves port with its skipper and crew for a weekend cruise along the coast. During the trip, the sailors harness the wind, cope with waves, navigate around rocks and shallows, and avoid collisions with other vessels. However, *before departure*, they must familiarize themselves with how to operate all of the equipment onboard. *And even before that*, they must have a good understanding of the theory of sailing: the Bernoulli principle (lift from the airfoil effect that allows birds and planes to fly), drag, gravity, buoyancy, compass directions, theory of tides and tidal currents, ocean currents, and how all of these factors potentially affect the boat and its motion. These three stages, in chronological order, can be labelled as *theory*, *instrument*, and *application*.

Understanding accounting involves these same three stages. The actual practice of accounting is just the last step in the process—the *application* of accounting standards and the accounting framework to the situation at hand, in conjunction with the use of professional judgment. Before you can practise accounting, you need to thoroughly understand the *instrument* that you are using: the set of accounting standards and the framework that underlies those standards. But first of all, it is essential that you understand the *theory* behind why the accounting standards are the way they are so that you will be able to apply your judgment while using those standards to different circumstances that you face.

This chapter looks at the fundamental concepts in accounting theory, such as uncertainty, information asymmetry, and the demand and supply of information. This theory leads to Chapters 2 and 3, which discuss the conceptual framework and accrual accounting principles that underlie more specific accounting standards. The remainder of this book and Volume 2 (Chapters 11–20) cover the specific accounting standards and their application.

	Theory	Instrument		Application
Sailing	Lift, drag, gravity, buoyancy, compass directions, tides, and currents	General structure of sailboats	Components specific to the vessel	Sailing, navigating, avoiding collisions
Accounting	Uncertainty, information asymmetry, demand and supply	Conceptual framework, general principles	Specific accounting standards	Accounting for specific balances and transactions
Textbook structure	Chapter 1	Chapter 2 Chapter 3	Chapters 4 to 20	Introductory level accounting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

L.O. 1-1. Explain the sources of demand and supply of accounting information.

L.O. 1-2. Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

L.O. 1-3. Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.

L.O. 1-4. Evaluate whether and what type of earnings management is more likely in a particular circumstance.

L.O. 1-5. Explain how accounting information interacts with securities markets.