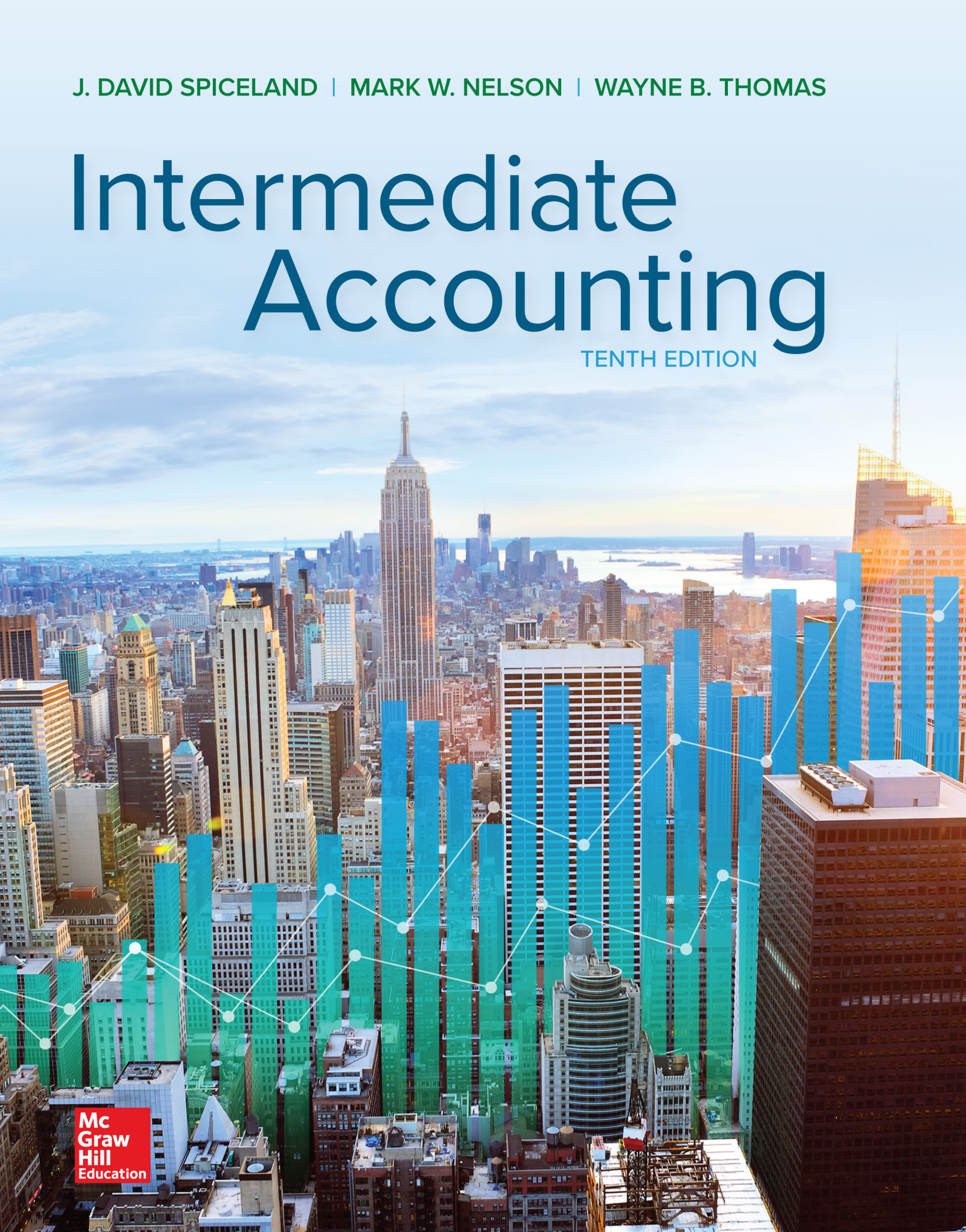


J. DAVID SPICELAND | MARK W. NELSON | WAYNE B. THOMAS

Intermediate Accounting

TENTH EDITION



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Intermediate Accounting

TENTH EDITION

J. DAVID SPICELAND

University of Memphis

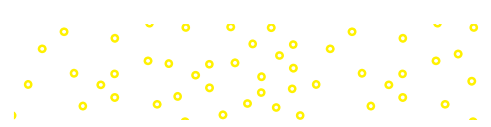
MARK W. NELSON

Cornell University

WAYNE B. THOMAS

University of Oklahoma

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Dedicated to:

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

INTERMEDIATE ACCOUNTING, TENTH EDITION

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About the Authors

DAVID SPICELAND

David Spiceland is Professor Emeritus in the School of Accountancy where he taught financial accounting at the undergraduate, master's, and doctoral levels for 36 years. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.



Professor Spiceland has published articles in a variety of academic and professional journals including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*, and is an author of McGraw-Hill's *Financial Accounting* with Wayne Thomas and Don Herrmann. Professor Spiceland has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom.

MARK NELSON

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



Professor Nelson's research focuses on decision making in financial accounting and auditing. His research

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

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

WAYNE THOMAS

Wayne Thomas is the W.K. Newton Chair and George Lynn Cross Research Professor of Accounting at the University of Oklahoma's Price College of Business. He received his BS degree from Southwestern Oklahoma State University and his MS and PhD from Oklahoma State University. He has received teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. He is an author of McGraw-Hill's *Financial Accounting* with David Spiceland and Don Herrmann.



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

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

Intermediate Accounting Tenth Edition:

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

“The textbook is readable and easy to follow since the authors present basic concepts and then cover advanced issues. Conceptually-oriented and dependable as the authors are timely in updating new accounting standards.”

—Hong Pak, California State Polytechnic University, Pomona

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

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

- ASU No. 2018-02—Income Statement—Reporting Comprehensive Income (Topic 220)—Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income
- ASU No. 2016-013, Financial Instruments—Credit Losses (Topic 326) on “Current Expected Credit Loss” (CECL) model for accounting for credit losses, as well as current GAAP requirements for recognizing impairments of investments
- Comprehensive revision of Chapter 16, Accounting for Income Taxes, improving pedagogy as well as covering effects of the Tax Cuts and Jobs Act of 2017
- FASB ASC 842-10-15-42A: Leases-Overall-Scope and Scope Exceptions-Lessor
- FASB Accounting Standards Update, Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, FASB: December, 2016. SEC Amendment to Rule 15c6-1, Ex-Dividend Date, September 2017
- FASB Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities
- ASU No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment
- ASU No. 2015-05—Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement

The Spiceland team also ensures that *Intermediate Accounting* stays current with the latest pedagogy and digital tools. The authors have incorporated new Data Analytics cases featuring Tableau at the end of each chapter. These cases are auto-gradable in Connect and help students develop in-demand skills in analyzing and interpreting data, and effectively communicating findings.

Data Analytics



The phrase *scientia est potentia* is a Latin aphorism meaning “knowledge is power!” In a business sense, this might be paraphrased as “Information is money!” Better information . . . better business decisions! This is the keystone of data analytics.

Data analytics is the process of examining data sets in order to draw conclusions about the information they contain. Data analytics is widely used in business to enable organizations to make better-informed business decisions. Increasingly, this is accomplished with the aid of specialized data visualization software such as Tableau.

The New Standard

Current events regularly focus public attention on the key role of accounting in providing information useful to financial decision makers. The CPA exam, too, has changed to emphasize the professional skills needed to critically evaluate accounting method alternatives. *Intermediate Accounting* provides a **decision makers' perspective**, highlighting the professional judgment and critical thinking skills required of accountants in today's business environment. New in the 10th edition, many of these cases have been translated to an auto-graded format in Connect.

"The use of real-world examples throughout the text helps bring accounting to life for students. For example, the use of Amazon Prime is excellent, illustrating the complexity of current business with an engaging example."

— Jennifer Winchel, University of Virginia

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

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

Clear: Reviewers, instructors, and students have all hailed *Intermediate Accounting's* ability to explain both simple and complex topics in language that is coherent and approachable. Difficult topics are structured to provide a solid conceptual foundation and unifying framework that is built upon with thorough coverage of more advanced topics. As examples, see chapters 6 (Revenue Recognition), 15 (Leases) and 16 (Income Taxes). The author team's highly acclaimed conversational writing style establishes a friendly dialogue—establishing the impression of a conversation with students, as opposed to lecturing at them.

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

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

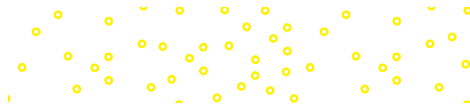
Quality assessment continues to be a focus of Connect, with over **2,500 questions** available for assignment, including more than 1,125 algorithmic questions.

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

Spiceland's Financial Accounting Series

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





What Keeps SPICELAND Users Coming Back?

Financial Reporting Cases

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

Financial Reporting Case Solution



1. What purpose do adjusting entries serve? (p. 64) Adjusting entries help ensure that all revenues are recognized in the period goods or services are transferred to customers, regardless of when cash is received. In this instance, for example, \$13,000 cash has been received for services that haven't yet been performed. Also, adjusting entries enable a company to recognize all expenses incurred during a period, regardless of when cash is paid. Without depreciation, the friends' cost of using the equipment is not taken into account. Conversely, without adjustment, the cost of rent is overstated by \$3,000 paid in advance for part of next year's rent.

With adjustments, we get an accrual income statement that provides a more complete measure of a company's operating performance and a better measure for predicting future operating cash flows. See the income statement page for a more...

Where We're Headed

These boxes describe the potential financial reporting effects of many of the FASB's proposed projects that have not yet been adopted, as well as joint proposed projects with the IASB. Where We're Headed boxes allow instructors to deal with ongoing projects to the extent they desire.

Where We're Headed

As part of its ongoing disclosure framework project, the FASB has proposed using the U.S. Supreme Court's description of materiality. Under that definition, which comes from court cases and interpretations, qualitative and quantitative disclosures are material if there is a substantial likelihood that omitting a disclosure would have been viewed by a reasonable user as having significantly altered the total mix of information made available in making a decision. This change is controversial because it could affect the amount of information that companies disclose. The FASB has committed to seek more input before moving forward with this proposal.

Additional Consideration Boxes

These are "on the spot" considerations of important, but incidental or infrequent, aspects of the primary topics to which they relate.

Additional Consideration

Solving for the unknown factor in either of these examples could just as easily be done using the future value tables. The number of years is the value of n that will provide a present value of \$10,000 when \$16,000 is the future amount and the interest rate is 10%.

$$\$16,000 \text{ (future value)} = \$10,000 \text{ (present value)} \times ?^*$$

*Future value of \$1: $n = ?$, $i = 10\%$

Rearranging algebraically, the future value table factor is 1.6.

$$\$16,000 \text{ (future value)} \div \$10,000 \text{ (present value)} = 1.6^*$$

*Future value of \$1: $n = ?$, $i = 10\%$

When you consult the future value table, Table 1, you search the 10% column ($i = 10\%$) for this value and find 1.61051 in row five. So it would take approximately five years to accumulate \$16,000 in the situation described.

Decision Makers' Perspective

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

Decision Makers' Perspective

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


A company must have cash available for the compensating balances we discussed in the previous section as well as for planned disbursements related to normal operating, investing, and financing cash flows. However, because cash inflows and outflows can vary, companies hold cash to pay for planned and unplanned transactions.

Companies hold cash to pay for planned and unplanned transactions.

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

“Our students need to think about topics critically and broadly. Spiceland is superior in terms of presenting big picture cases and scenarios that help students understand how to think beyond simple journal entries and worksheet problems.”
 —James Brushwood, Colorado State University

Decision Makers' Perspective



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

Judgment
Case 4-1
 Earnings quality
 • LO4-2, LO4-3

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


Required:

1. Define the term *earnings quality*.
2. Explain the distinction between...

Ethical Dilemma 

You recently have been employed by a large retail chain that sells sporting goods. One of your tasks is to help prepare periodic financial statements for external distribution. The chain's largest creditor, National Savings & Loan, requires quarterly financial statements, and you are currently working on the statements for the three-month period ending June 30, 2021.

During the months of May and June, the company spent \$1,200,000 on a hefty radio and TV advertising campaign. The \$1,200,000 included the costs of producing the commercials as well as the radio and TV time purchased to air the commercials. All of the costs were charged to advertising expense. The company's chief financial officer (CFO) has asked you to prepare a June 30 adjusting entry to remove the costs from advertising expense and to set up an asset called *prepaid advertising* that will be expensed in July. The CFO explained that "This advertising campaign has led to significant sales in May and June and I think it

P 15-25
 Operating lease; uneven lease payments
 • LO15-4, LO15-7 

On January 1, 2021, Harlon Consulting entered into a three-year lease for new office space agreeing to lease payments of \$5,000 in 2021, \$6,000 in 2022, and \$7,000 in 2023. Payments are due on December 31 of each year with the first payment being made on December 31, 2021. Harlon is aware that the lessor used a 5% interest rate when calculating lease payments.

Required:

1. Prepare the appropriate entries for Harlon Consulting on January 1, 2021, to record the lease.
2. Prepare all appropriate entries for Harlon Consulting on December 31, 2021, related to the lease.
3. Prepare all appropriate entries for Harlon Consulting on December 31, 2022, related to the lease.
4. Prepare all appropriate entries for Harlon Consulting on December 31, 2023, related to the lease.

Decision Makers' Perspective Cases

Designed to further develop students' decision-making abilities, each chapter includes a robust set of powerful and effective cases, asking students to analyze, evaluate, and communicate findings, further building their critical thinking skills. Many of these cases are now auto-gradable in Connect.

Ethical Dilemmas

Because ethical ramifications of business decisions impact so many individuals as well as the core of our economy, Ethical Dilemmas are incorporated within the context of accounting issues as they are discussed. These features lend themselves very well to impromptu class discussions and debates, and are complemented by Ethics Cases found in the Decision Makers' Perspective Case section at the end of each chapter.

Star Problems 

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



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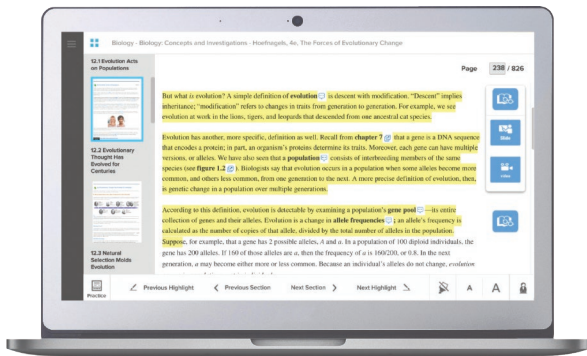
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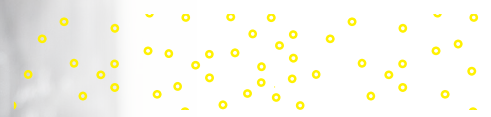


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FOR STUDENTS

Effective, efficient studying.

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“I really liked this app—it made it easy to study when you don't have your textbook in front of you.”

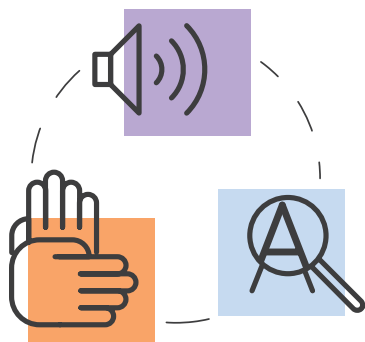
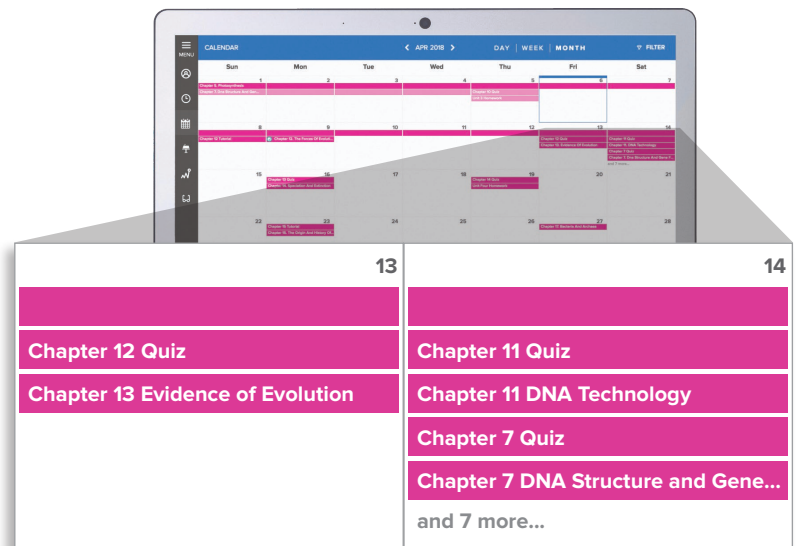
- Jordan Cunningham,
Eastern Washington University

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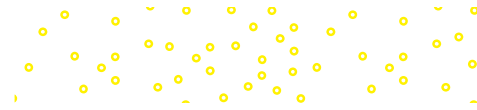
No surprises.

The Connect Calendar and Reports tools keep you on track with the work you need to get done and your assignment scores. Life gets busy; Connect tools help you keep learning through it all.



Learning for everyone.

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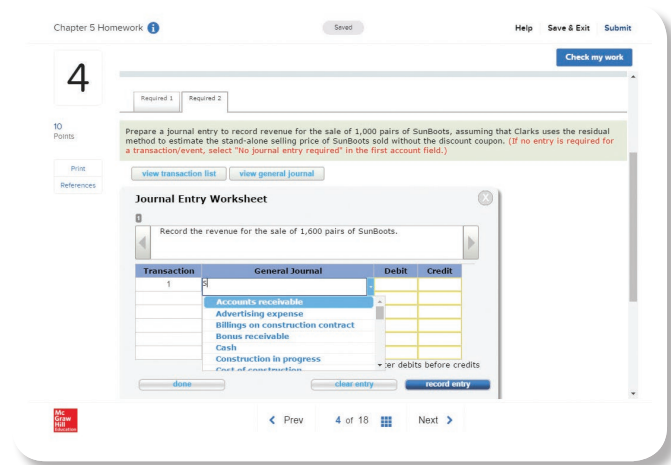
THE NEW STANDARD.

Online Assignments

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels like what one would find in a general ledger software package. For this edition, numerous questions have been redesigned to test students' knowledge more fully. New to this edition, many Decision Makers' Perspective Cases have been incorporated as auto-gradable in Connect.

End-of-chapter questions in Connect include:

- Brief Exercises
- Exercises
- Problems
- New! Select Decision Makers' Perspective Cases, Target and Air France Cases, and Data Analytics Cases



“The digital materials are an important learning resource for my students, and the constant updates between new editions are VERY useful.”

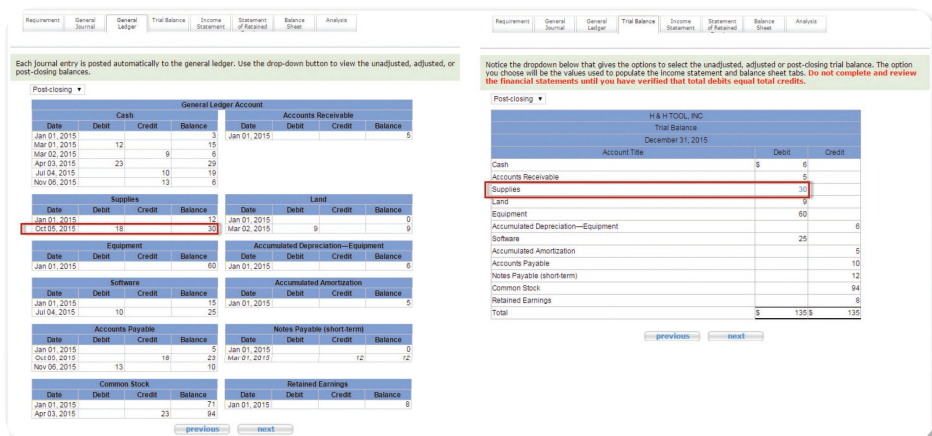
—Pamela Trafford, University of Massachusetts, Amherst

NEW! Data Analytics Cases

Data analytics is an enormously in-demand skill among employers. Students who can interpret data and effectively communicate their findings to help business makes better-informed decisions are in high-demand. New Data Analysis Cases featuring Tableau are now incorporated at the end of most chapters. These cases can easily be assigned in Connect and are auto-gradable for the instructor's convenience.

General Ledger Problems

General Ledger Problems allow students to see how transactions flow through the various financial statements. Students can audit their mistakes by easily linking back to their original journal entries. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.



POWERFUL ONLINE TOOLS & ASSESSMENTS

Concept Overview Videos

Concept Overview Videos provide engaging narratives of key topics in an assignable and interactive online format. These videos follow the structure of the text and are available with all learning objectives within each chapter of *Intermediate Accounting*. The Concept Overview Videos provide additional explanation of material in the text, allowing students to learn at their own pace – and test their knowledge with assignable questions.

Excel Simulations

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

Guided Example/Hint Videos

The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short videos are presented to students as hints and provide reinforcement when students need it most. Instructors have the option of turning them on or off.

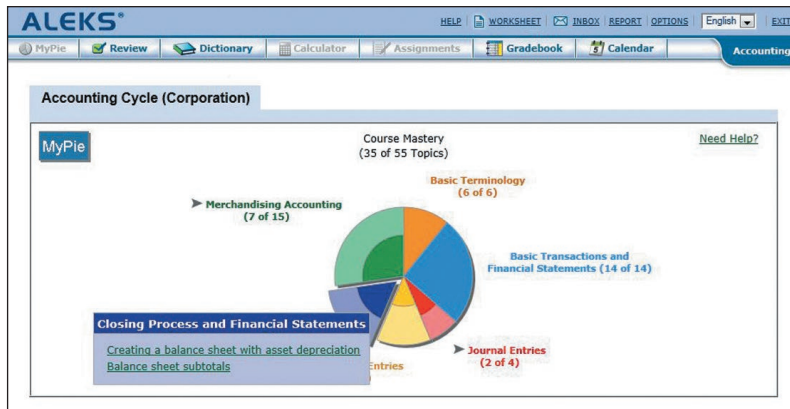
ROGER CPA SIMULATIONS
CPA Review

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

ALEKS®

ALEKS ACCOUNTING CYCLE

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



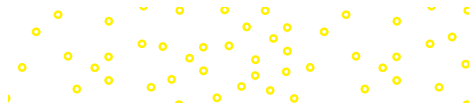
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The New Standard:

INSTRUCTOR LIBRARY

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

In-Class Presentation Tools

- PowerPoints** Three types of PowerPoint decks are available, each responding to a different instructional need:
- **Lecture PowerPoints with Concept Checks** allow instructors to intersperse short exercises that students can solve individually or do in groups before an answer is “revealed”
 - **Lecture PowerPoints without Concept Checks:** No questions included, mirror presentation from book with key illustrations and notes
 - **Accessible PowerPoints:** Allow slide content to be read by a screen reader and provide alternative text descriptions for any image files. Accessible PowerPoints are also designed with high-contrast color palettes and use texture instead of color whenever possible to denote different aspects of imagery.

Please note: All of our illustrations in the PowerPoint decks are fully editable so that you can change numbers, content, and easily customize our figures to your teaching. Teaching Tip: Use your students’ names for company names in the Illustrations or Concept Checks!

Exercise Presentations PowerPoint slides created from the Guided Example/Hint videos, these allow you to walk through a version of one of the book exercises in class without giving away the answers.

Digital Image Library High-resolution images of all illustrations from the text.

Teaching Resources

New! Instructor’s Edition We know Intermediate Accounting is a daunting course not only for students, but also for instructors! This all-new digital guide to the Spiceland Intermediate learning program contains resources to help instructors think through effective course planning, including:

- Example syllabi
- Guides to Connect setup
- Course planning materials to help identify resources that align with your course goals
- Tips from the authors on key illustrations, teaching points, and end-of-chapter content they highlight and assign
- Bloom’s rubrics for end-of-chapter content

Instructor’s Manual Specific to each chapter, contains learning outcomes, a full lecture outline, and suggestions for in-class activities including real world scenarios, group research activities, IFRS activities, and professional skills development activities. Assignment charts are also provided with topics and estimated completion times.

Solutions Manual Created by the authors, includes solutions to end-of-chapter content.

Updates Stop here for all the most recent updates from FASB. Our authors work tirelessly to keep you current — for instance, within a month of the 2017 Tax Reform bill, our authors had posted an updated PowerPoint deck, video walkthrough, and teaching tip material on how to address the new updates. We have your back!

Test Bank

Connect Test Bank Multiple-choice, true/false and worksheet questions are all available to help assess students throughout all levels from understanding to evaluation. Create an effective test in 3 easy steps:

Flexible Instructor Resources

1. **Tailor:** Use Connect's robust filters to quickly identify the content you want based on difficulty, learning objective, Bloom's, AICPA and AACSB standards, and accessibility level.
2. **Secure:** Once you've identified the questions you want, Connect's policy setting help you create a secure test through features like question pooling, time limits, scrambling, feedback constraint, and Tegrity proctoring.
3. **Report:** Connect's rich reporting features allow you to quickly compile thorough reports that will wow your assessment committees. Teaching tip: Add your department learning objectives as tags in Connect for reporting completely aligned with your institution's objectives.

TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. TestGen's random generator provides the option to display different text or calculated number values each time questions are used. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

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ASSURANCE OF LEARNING

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

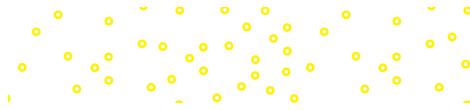
Each test bank question for *Intermediate Accounting* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of Connect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

AACSB STATEMENT

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



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



What's New in the Tenth Edition?

Spiceland is the new global standard for providing students the most accessible, comprehensive, and current Intermediate Accounting learning system. We take seriously the confidence the marketplace has accorded our text. Each revision carefully considers how the print and digital content work together to coordinate improvements in content and industry-leading technology to provide the most robust learning solution. The Spiceland team implements only those changes that constitute real improvements as identified through extensive research with users. The result is a learning system that enhances our reputation for providing the best preparation for passing the CPA exam and successful accounting careers.

Improvements in this edition include the following:

- **NEW! Updated content to reflect the latest GAAP and Accounting Standards Updates including:**
 - **Income taxes**
 - **Leases**
 - **Financial instruments**
 - **Revenue recognition**
- **NEW! Most Decision Makers' Perspective cases** are now *auto-gradable in Connect*.
- **NEW! Data Analytics Cases** providing students the opportunity to experience the power and efficacy of data analytics in the context of each chapter's topics, using Tableau as a tool, that are *auto-gradable in Connect*.
- Enhanced partnership with **Roger CPA Review**, with new CPA Exam Review multiple-choice questions that are *auto-gradable in Connect* and access to CPA Exam Review simulations.
- Updated and revised **real-world** illustrations, assignments, and discussions.
- Revised Continuing Cases featuring **Target Corporation** financial statements prepared using U.S. GAAP, now *auto-gradable in Connect*. A comprehensive version of the case is available in Appendix B.
- Revised Continuing Cases featuring **Air France–KLM** financial statements prepared using IFRS, now *auto-gradable in Connect*. A comprehensive version of the case is available in Appendix C.
- Incorporated the latest technology, including:
 - **NEW! Connect interface for students**, along with **Connect Insight for students**
 - an updated **SmartBook**
 - **General Ledger Problems** that auto-post from journal entries to T-accounts to trial balances (*auto-gradable in Connect*)
 - **Excel Simulations** that allow students to practice their Excel skills within the content of financial accounting with animated, narrated Help and Show Me tutorials (*auto-gradable in Connect*)
 - **NEW! Concept Overview Videos** that provide engaging narratives of key topics in an assignable and interactive online format (*assignable in Connect*)
 - **Guided Examples/Hint Videos** in Connect that provide a narrated, animated, step-by-step walk-through of select exercises that provide reinforcement when students need it most (can be turned on or off by instructors)
 - **NEW! Instructor's Edition** to help instructors to more easily design the course and organize chapter resources

Chapter 1

ENVIRONMENT AND THEORETICAL STRUCTURE OF FINANCIAL ACCOUNTING

- Provided more focused discussion of the convergence process.
- Revised discussion of FASB standard setting and ongoing projects (disclosure framework, materiality).
- Added or updated problems and cases relevant to The Gap.

Chapter 2

REVIEW OF THE ACCOUNTING PROCESS

- Revised and reorganized the presentation of the accounting processing cycle.
- Added the use of a Dividends account.
- Eliminated the use of Income Summary in the Closing Process.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (*auto-gradable in Connect*).

Chapter 3

THE BALANCE SHEET AND FINANCIAL DISCLOSURES

- Changed opening balance sheet to Nike.
- Clarified distinction between book value, market value, and fair value.
- Updated terminology in chapter and end-of-chapter material to reflect ASU 2016-01 for investments.
- Updated definition of long-term liability to include FASB's proposed definition.

- Discussed and provided an example of the new format for the auditor's report.
- Revised discussion of executive compensation to reflect the more prominent role of restricted stock compared to stock options.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 4

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

- Updated all illustrations and end-of-chapter assignments involving income taxes to a new overall rate of 25%.
- Revised definition and discussion of other comprehensive income.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 5

TIME VALUE OF MONEY CONCEPTS

- Revised the Financial Reporting Case
- Added **LO5–5** Explain the role of present value techniques in the valuation of notes in the Preview of Accounting Applications of Present Value Techniques—Single Cash Amount section.
- Eliminated the Expected Cash Flow section in the Preview of Accounting Applications of Present Value Techniques—Single Cash Amount section.
- Added a Valuation of Long Term Notes section in the Preview of Accounting Applications of Present Value Techniques—Single Cash Amount section.
- Added a Valuation of Long Term Notes section in the Preview of Accounting Applications of Present Value Techniques—Annuities section

Chapter 6

REVENUE RECOGNITION

- Reordered chapters 5 and 6 to have time value of money (now 5) precede coverage of revenue recognition (now 6) and have revenue recognition immediately precede coverage of receivables (7).
- Expanded coverage of time value of money considerations, including numerical examples of significant financing components for prepayments and receivables, along with new end of chapter material in brief exercises and exercises.
- Added Microsoft real-world example to illustrate materiality of new treatment of licenses.

- Added new Trueblood cases.
- Added or updated problems and cases relevant to Expedia, Priceline, and Alphabet.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 7

CASH AND RECEIVABLES

- In chapter, as well as Appendix 7B, enhanced coverage of ASU 2016–13's CECL model for accounting for credit losses.
- Modified coverage of IFRS to focus on IFRS No. 9.
- Enhanced end of chapter material with respect to credit losses and accounts receivable.
- Revised coverage on noninterest-bearing notes receivable.
- Added or updated problems and cases relevant to General Mills, Microsoft, Amdahl, Nike, Avon Products, Cisco, Sanofi-Aventis, Tyson Foods, and Pilgrim's Pride Corp.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 8

INVENTORIES: MEASUREMENT

- Clarified discussion of consignment arrangements and related costs.
- Added details about calculation of cost of goods sold and ending inventory for specific identification.
- Clarified discussion of calculating of cost of goods sold and ending inventory using perpetual average cost.
- Clarified the use of LIFO calculations under periodic versus perpetual system in practice.
- Added discussion of the impact of technology and the use of the perpetual inventory system
- Modified the Concept Review Exercise on inventory cost flow to include LIFO reserve.
- Revised Illustration 8-5 to reflect entries under a perpetual inventory system.
- Revised discussion of purchase discounts under the gross versus net method
- Added BE 8-10 for LIFO reserve.
- Modified E 8-19 and P 8-1 to include LIFO reserve adjustment from perpetual FIFO to periodic LIFO.
- Modified E 8-16 to compare FIFO and LIFO when costs are increasing and when costs are decreasing.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 9

INVENTORIES: ADDITIONAL ISSUES

- Modified Concept Review Exercise for lower of cost or net realizable value to include unit values.
- Clarified treatment of employee discounts in the conventional retail method and revised Illustration 9-13.
- Revised discussion of Dollar-Value LIFO Retail.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 10

PROPERTY, PLANT, AND EQUIPMENT AND INTANGIBLE ASSETS: ACQUISITION

- Revised discussion of nonmonetary exchanges to include four steps, and added summary Illustration 10-16.
- Revised Illustration 10-14A to clarify recording of a nonmonetary exchange.
- Moved discussion and illustration of amortization of software development costs to chapter 11.
- Added discussion of accounting for cloud computing arrangements and related implementation costs.
- Added Brief Exercise 10-18 on accounting for software development costs for internal purposes.
- Added Brief Exercise 10-19 on accounting for software development costs in cloud computing arrangements.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 11

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

- Moved discussion and illustration of amortization of software development costs from chapter 10.
- Modified Illustration 11–4B to simplify and clarify calculation of partial year depreciation.
- Added discussion of amortization of software development costs for internal purposes and in cloud computing arrangements.
- Updated discussion of impairment for goodwill based on ASU No. 2017-04.
- Added Exercise 11-13 on reporting assets held for sale.

- Updated discussion of MACRS depreciation for changes enacted by the Tax Cuts and Jobs Act.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 12

INVESTMENTS

- In chapter, as well as Appendix 12B, enhanced coverage of ASU 2016–13’s CECL model for accounting for credit losses.
- Revised wording of account titles to provide more streamlined and cohesive presentation of accounting for HTM, TS, AFS, equity, and equity method investments.
- Provided new Decision Makers’ Perspective cases for Intel, FCA and Merck.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 13

CURRENT LIABILITIES AND CONTINGENCIES

- Updated General Mills example used in Illustration 13–1 and throughout the chapter.
- Updated contingent liability examples.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 14

BONDS AND LONG-TERM NOTES

- Updated Real World Financials in Bonds section.
- Revised the journal entry in Illustration 14-A2 and added additional explanation.
- Replaced illustration of zero coupon securities in Ill. 14-7 with a newer real world example, Coca Cola.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 15

LEASES

- Added discussion to the operating leases section *related to our recording* both interest and amortization even though, for an operating lease,

the *lessee will report* a single lease expense rather than the separate interest and amortization as with a finance lease.

- Added a *Why Lease?* section to Part A and added related EOC and TB questions.
- Added an *Is it a Lease?* section to Part C and added related EOC and TB questions.
- Added a paragraph at end of Nonlease Payments section in Part C to describe new ASU on simplification option for lessors.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 16

ACCOUNTING FOR INCOME TAXES

- Reordered early coverage to provide more conceptual basis before walking through treatment of individual temporary differences.
- Revised illustrations to highlight the four-step process for calculating tax expense, using color-coded steps in all examples and solutions to end-of-chapter material.
- Revised coverage to walk through each combination of deferred tax assets and liabilities and revenue- and expense-related temporary differences.
- Modified all examples and end of chapter material to reflect new tax rates.
- Modified coverage of net operating loss carrybacks and carryforwards to reflect new tax act.
- Modified coverage of non-temporary differences to reflect new tax act, including Additional Consideration covering earning repatriation.
- Updated Real World “Shoe Carnival” case covering linkage between tax expense journal entry and changes in deferred tax assets, liabilities, and the valuation allowance.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 17

PENSIONS AND OTHER POSTRETIREMENT BENEFIT PLANS

- Added Additional Consideration box to note the trend toward the “spot rate” method of determining the interest rate.
- Added Additional Consideration box to indicate that some companies are voluntarily choosing to

recognize pension gains and losses immediately rather than amortizing them.

- Most Decision Makers’ Perspective cases are now auto-gradable in Connect.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 18

SHAREHOLDERS’ EQUITY

- Revised discussion and assignment material to reflect the SEC’s revision of the ex-dividend date from two business days before the date of record to one.
- Replaced Alcoa Case with Nike Case.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 19

SHARE-BASED COMPENSATION AND EARNINGS PER SHARE

- Modified all illustrations and end of chapter material to reflect new tax rates.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Chapter 20

ACCOUNTING CHANGES AND ERROR CORRECTIONS

- Revised discussion of approaches to account for accounting changes to include the modified retrospective approach.
- Modified all illustrations and end of chapter material to reflect new tax rates.

Chapter 21

STATEMENT OF CASH FLOWS REVISITED

- Revised a CVS Caremark Corp illustration of presenting cash flows from operating activities by the direct method.
- Added an enhanced Additional Consideration box on reporting bad debt expense in the SCF.
- Added a real world illustration of presenting cash flows from operating activities by the indirect method.

- Modified all illustrations and end of chapter material to reflect new tax rates.
- Revised a Research Case related to FedEx's investing and financing activities.
- Added a Real World Case on Staples reporting of its SCF.
- Added a Data Analytics case based on topics in the chapter, using Tableau as a tool (auto-gradable in Connect).

Appendix A

DERIVATIVES

- Extensively revised all illustrations, discussions, and assignment material to reflect changes emanating from the new FASB Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.
- Added new discussion, illustration and assignment material for a cash flow hedge, interest rate swap.
- Added new discussion, illustration and assignment material for an option contract.
- Added new discussion, illustration and assignment material for a nonfinancial forward contract
- Revised a Real World Case related to the Chicago Mercantile Exchange.
- Revised a Johnson & Johnson Real World Case on hedging transactions.

Acknowledgments

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

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

We are especially grateful for the contributions of Charlene Parnell Spiceland of Simmons University in developing the Data Analytics Case sequence that is a key enhancement to the tenth edition of this textbook. Utilizing her expertise in Tableau, she ensured that these cases provide students the opportunity to glimpse the power and efficacy of data analytics. The cases encourage students to use Tableau to analyze data sets to make business decisions in the context of chapter topics as well as to appreciate the most effective and efficient ways to communicate their findings.

In addition, we want to recognize the valuable input of all those who helped guide our developmental decisions for the tenth edition.

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David Spiceland Mark Nelson Wayne Thomas

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1

Environment and Theoretical Structure of Financial Accounting

OVERVIEW

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

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

**LEARNING
OBJECTIVES**

After studying this chapter, you should be able to:

- **LO1-1** Describe the function and primary focus of financial accounting. (p. 3)
- **LO1-2** Explain the difference between cash and accrual accounting. (p. 7)
- **LO1-3** Define generally accepted accounting principles (GAAP) and discuss the historical development of accounting standards, including convergence between U.S. and international standards. (p. 8)
- **LO1-4** Explain why establishing accounting standards is characterized as a political process. (p. 12)
- **LO1-5** Explain factors that encourage high-quality financial reporting. (p. 14)
- **LO1-6** Explain the purpose of the conceptual framework. (p. 18)
- **LO1-7** Identify the objective and qualitative characteristics of financial reporting information and the elements of financial statements. (p. 20)
- **LO1-8** Describe the four basic assumptions underlying GAAP. (p. 23)
- **LO1-9** Describe the recognition, measurement, and disclosure concepts that guide accounting practice. (p. 25)
- **LO1-10** Contrast a revenue/expense approach and an asset/liability approach to accounting standard setting. (p. 31)
- **LO1-11** Discuss the primary differences between U.S. GAAP and IFRS with respect to the development of accounting standards and the conceptual framework underlying accounting standards. (p. 11, 14 and 19)



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FINANCIAL REPORTING CASE

Misguided Marketing Major

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

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

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

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

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

1. What should you tell your friend about the presence of accounting standards in the United States and the rest of the world? Who has the authority for standard setting? Who has the responsibility? (p. 8)
2. What is the economic and political environment in which standard setting occurs? (p. 12)
3. What is the relationship among management, auditors, investors, and creditors that tends to preclude the "What would you like it to be?" attitude? (p. 14)
4. In general, what is the conceptual framework that underlies accounting principles, and how does it encourage high-quality financial reporting? (p. 18)

QUESTIONS

Financial Accounting Environment

In 1902, George Dayton took ownership of the Dayton Dry Goods Company, the fourth largest department store in Minneapolis, Minnesota. Successive generations of Daytons were innovative managers, flying in inventory to prevent shortages (1920), committing to giving 5 percent of profits back to the community (1946), and creating the nation's first enclosed shopping mall (1956). In 1962, George's grandchildren transformed Dayton's, by then a regional department store chain, into the **Target Corporation**, promising "a quality store with quality merchandise at discount prices."¹ Today Target has grown to be the second largest general merchandise retailer in America, with over 1,800 stores, almost 350,000 employees, and www.target.com reaching the online market. However, Target still stands by its "Expect More, Pay Less" motto, and still donates 5 percent of profits back to the community (giving more than \$4 million per week).

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

PART A

- LO1-1

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

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

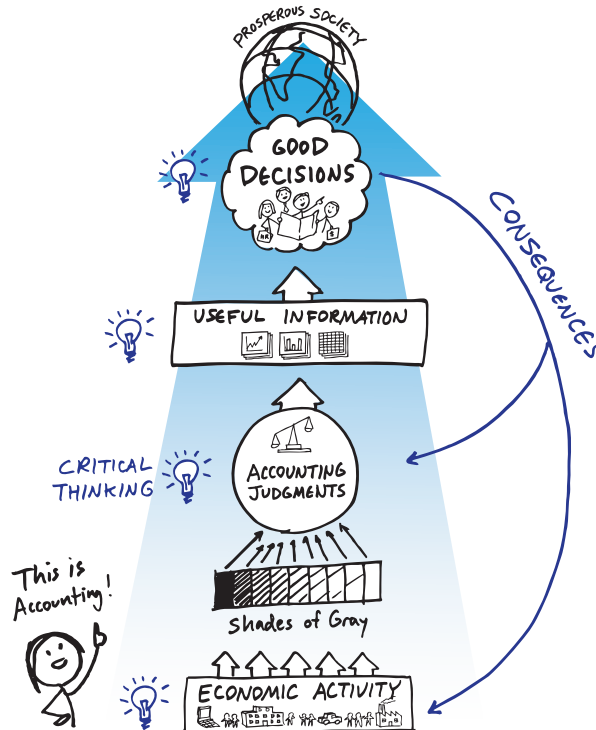
Think of accounting as a special "language" that companies like Target use to communicate financial information to help people inside and outside of the business to make decisions. The Pathways Commission of the American Accounting Association developed an illustration to help visualize this important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

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

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

Illustration 1–1

Pathways Commission visualization: "THIS is accounting!"



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²Risk refers to the variability of possible outcomes from an investment. Return is the amount received over and above the investment.

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⁴In contrast, *managerial* accounting deals with the concepts and methods used to provide information to an organization's *internal users*, that is, its managers. You study managerial accounting elsewhere in your curriculum.

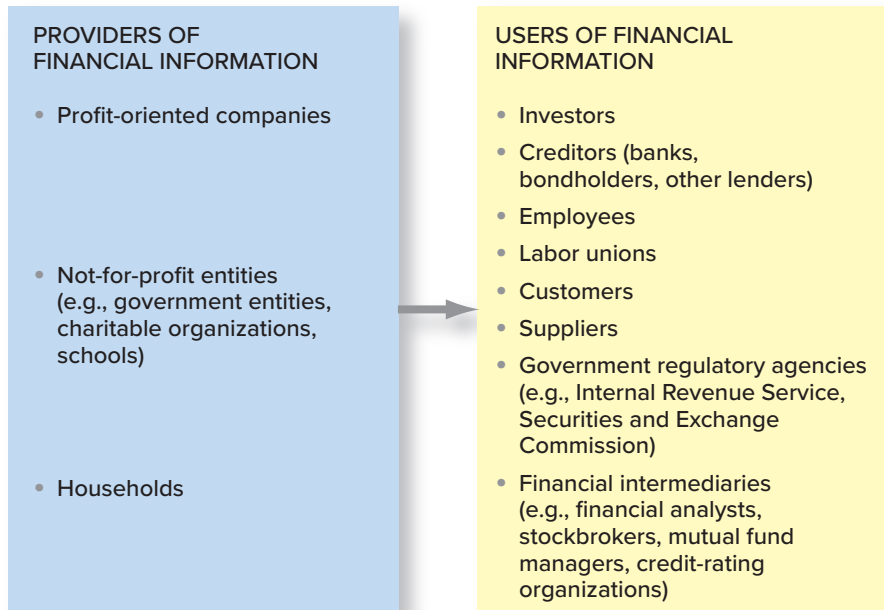


Illustration 1-2

Financial Information Providers and External User Groups

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

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

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

The Economic Environment and Financial Reporting

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

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

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

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

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

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

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

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

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

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

The Investment-Credit Decision—A Cash Flow Perspective

While the decisions made by investors and by creditors are somewhat different, they are similar in at least one important way. Investors and creditors are willing to provide capital to a corporation (buy stocks or bonds) only if they expect to receive more cash in return at some time in the future. A corporation's shareholders will receive cash from their investment through the ultimate sale of the ownership shares of stock. In addition, many corporations distribute cash to their shareholders in the form of periodic dividends. For example, if an investor provides a company with \$10,000 cash by purchasing stock at the end of 2020, receives \$400 in dividends from the company during 2021, and sells the ownership interest (shares) at the end of 2021 for \$10,600, the investment would have generated a **rate of return** of 10% for 2021, calculated as follows:

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

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

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

While the rate of return from option 1 is known with virtual certainty, the return from option 2 is uncertain. The amount and timing of the cash to be received in the future from option 2 are unknown. The company in option 2 will be able to provide investors with a return only if it can generate a profit. That is, it must be able to use the resources provided by investors and creditors to generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service. Therefore, potential investors require information about the company that will help them estimate the potential for future profits, as well as the return they can expect on their investment and the risk that is associated with it. If the potential return is high enough, investors will prefer to invest in the profit-oriented company, even if that return has more risk associated with it.

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

Cash versus Accrual Accounting

● LO1–2

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

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

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

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

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

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

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

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

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

Illustration 1–3

Cash-Basis Accounting

⁶If cash flow from operating the company is negative, the company can continue to operate by using cash obtained from investors or creditors to make up the difference.

Illustration 1-4

Accrual Accounting

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

Net income is the difference between revenues and expenses.

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

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

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

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

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

The Development of Financial Accounting and Reporting Standards

• LO1-3

FINANCIAL Reporting Case

Q1, p. 3

Accrual accounting is the financial reporting model used by the majority of profit-oriented companies and by many not-for-profit companies. The fact that companies use the same model is important to investors and creditors, allowing them to *compare* financial information among companies. To facilitate these comparisons, financial accounting employs a body of standards known as **generally accepted accounting principles**, often abbreviated as **GAAP** (and pronounced *gap*). GAAP is a dynamic set of both broad and specific guidelines that companies should follow when measuring and reporting the information in their

⁷Net income also includes gains and losses, which are discussed later in the chapter.

⁸Empirical evidence that accrual accounting provides a better measure of short-term performance than cash flows is provided by Patricia Dechow, "Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accrual Accounting," *Journal of Accounting and Economics* 18 (1994), pp. 3-42.

⁹The statement of cash flows is discussed in detail in Chapters 4 and 21.

financial statements and related notes. The more important concepts underlying GAAP are discussed in a subsequent section of this chapter and revisited throughout this book in the context of particular accounting topics.

Historical Perspective and Standards

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

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

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

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

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

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

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

The APB suffered from a variety of problems. It was never able to establish a conceptual framework for financial accounting and reporting that was broadly accepted. Also, members served on the APB on a voluntary, part-time basis, so the APB was not able to act quickly enough to keep up with financial reporting issues as they developed. Perhaps the most important flaw of the APB was a perceived lack of independence. Because the APB was composed almost entirely of certified public accountants and supported by the AICPA, critics charged that the clients of the represented public accounting firms exerted self-interested pressure on the board and inappropriately influenced decisions. A related complaint was that other interest groups lacked an ability to provide input to the standard-setting process.

THE FASB Criticism of the APB led to the creation in 1973 of the **Financial Accounting Standards Board (FASB)** and its supporting structure. There are seven full-time members of the FASB. FASB members represent various constituencies concerned with accounting standards, and have included representatives from the auditing profession, profit-oriented companies, accounting educators, financial analysts, and government. The FASB is supported by its parent organization, the **Financial Accounting Foundation (FAF)**, which is

The FASB was established to set U.S. accounting standards.

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

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