

# Intermediate Accounting

Second Edition

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For Paul, Andrew, Mary, and my parents

*EAG*

For Nicholas, Aidan, and Kevin

*JSR*

For Ayden Alexander and Chloe Mikenzie

*AJS*



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# Preface

## New to This Edition

### Coverage of the Latest Standards

Students need to begin understanding and applying standard changes to critical topics such as revenue recognition and leasing as early as possible in their college curriculum to be prepared for the CPA exam and practice when they graduate. With this in mind, key second edition updates include:

- Chapter 10 incorporates ASU 2015-11, which changes the measurement of the market value for lower-of-cost-or-market computations to net realizable value for all firms except those using LIFO or RIM.
- Chapter 14 incorporates ASU 2015-03, which changes the accounting method for debt issue costs under U.S. GAAP and converges U.S. GAAP with IFRS. Debt issue costs are now netted with the debt, thus changing the effective interest rate.
- Chapter 16 is significantly altered to incorporate ASU 2016-01, ASU 2016-13, and changes to IFRS 9. The principal impact of these standards is to the subsequent measurement of equity investments and the impairment of debt investments.
- Chapter 17 incorporates ASU 2015-17, which simplifies the presentation of deferred tax assets and liabilities on the balance sheet. The deferred tax accounts are now reported only as noncurrent assets and liabilities.
- Chapter 18 is a new chapter that incorporates the entirely new lease standards, ASU 2016-02, and IFRS 16.
- Chapter 19 incorporates ASU 2016-09, which allows companies the option of reporting actual forfeitures in addition to the current method of estimated forfeitures.

## Solving Teaching and Learning Challenges

Our textbook is based on the belief that success in today's business environment requires an intuitive understanding of financial reporting and the ability to interpret and apply changing standards. In a world where there are simply too many rules to memorize, a traditional rules-based teaching approach has become inefficient and inadequate. Our goals for this textbook are aligned with the American Accounting Association's Pathways Commission, which seeks to correct misperceptions about the mechanical nature of accounting and to shift focus to the importance of critical thinking by accounting decision makers, particularly when the business context and related accounting rules require judgment.

We seek to develop the judgment and decision-making skills that accountants require to critically evaluate financial accounting methods and the financial statements. Using the conceptual framework fundamentals as a guide throughout, we emphasize solving accounting problems by applying standards, understanding how business activities are reflected in the financial statements, and critically evaluating the trade-offs and assumptions of accounting methods.

## Coverage Grounded in the Conceptual Principles

To apply what they learn in the classroom to their professional lives, students need a solid grounding in the conceptual principles of financial reporting and the economic concepts underlying accounting. Thus, we open the textbook with coverage of these foundational topics, including the conceptual framework. In each chapter, sections called "The Conceptual Framework Connection" guide discussions and analyses by explicitly laying out the relevant conceptual underpinnings. For example, in the chapter on long-term operating assets, we discuss the capitalization decision.

## Focus on Judgment, Decision Making, and Critical-Thinking Skills

Increasingly, the accounting profession and business world are looking for well-trained professionals with strong problem-solving and critical-thinking skills.

## Judgment

To prepare students for future careers, we highlight the various *judgments* involved in all major topics in the context of real-business situations. For example, in Chapter 3, we discuss the factors that Activision Blizzard, a leading provider of interactive game services, considered when applying revenue recognition rules to its new technology and virtual goods. Our goal is to develop students' critical-thinking skills in assessing the assumptions, choices, and judgments that managers make when analyzing and reporting the business activities of a company. For example, many rules govern impairments, but ultimately, reporting comes down to judgment related to issues such as the expectation of future cash flows. Future career success depends on students' understanding the importance and prominence of the many judgments that inform a final set of financial statements.

## Real-World Business

We pair our focus on real business situations with meaningful *real-company examples*. We examine financial statements from several high-profile firms—such as Johnson & Johnson, Netflix, Tesla, Amazon, Snap, Facebook, General Electric, Ericsson, Target, Adidas, Nike, Novartis, Coca-Cola, Pepsi Bottling Group, Starbucks, Walmart, and Ford Motor Company—in examples throughout the book.

In addition, our *Practitioner Interviews* feature question-and-answer-style exchanges with leaders in the field that provide insights into topics from a practitioner perspective and timely viewpoints on the business impact of rapidly evolving standards. Interviews profile executives at major firms—the Big Four accounting firms and name-brand companies such as Microsoft—as well as members of standard-setting boards.

## Problem-Solving Skills

We emphasize problem solving within the chapters with *worked examples* accompanying every important concept. The consistent problem-solving methodology utilizes a problem/solution format and highlights the logic guiding the process, fostering students' ability to tackle problems on their own.

A variety of *end-of-chapter exercises* revolves around judgment and decision making. We include short problems and time-intensive cases that emphasize building students' ability to read and interpret authoritative accounting literature.

## Highlighting Key Differences between U.S. GAAP and IFRS Standards

The book's central focus and grounding for each topic is U.S. GAAP. When IFRS diverges, we address the key conceptual differences in separate sections, often working through examples that parallel the GAAP coverage and providing tables with side-by-side comparisons of the GAAP and IFRS standards. With the aim of preparing students to apply the latest standards, we highlight key differences between IFRS and U.S. GAAP as pertinent. Our approach allows the instructor flexibility in IFRS topics covered and the depth of coverage. End-of-chapter summaries recap the main points for each section and contrast the U.S. GAAP and IFRS standards.

Presenting both sets of standards is important because the business world now operates in a global setting. Given the large number of multinational firms and foreign subsidiaries in the United States and the mobility of the workforce across international borders, students need to understand both IFRS and U.S. GAAP.

## Reassessment of Coverage

We give fresh consideration to the necessary and proper content of an intermediate textbook. Due to changes in the business world and in the authoritative accounting literature, some topics may warrant less coverage while others have gained importance. This focused reconsideration of topical coverage will set students on a trajectory for success in their accounting careers and on the CPA exam.

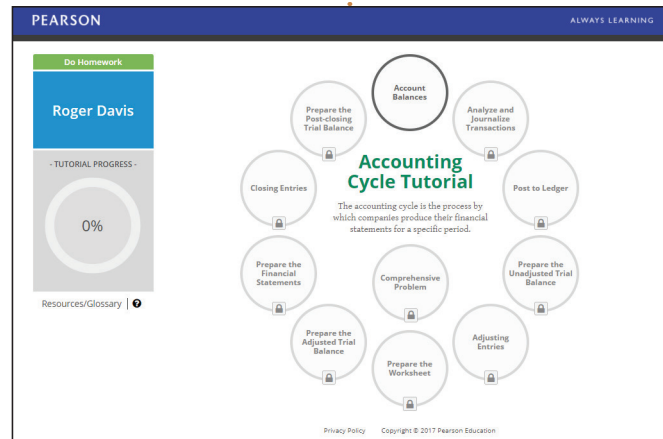
We have chosen to reassess coverage of topics based primarily on five criteria: (1) The topic is repeated elsewhere in the normal accounting curriculum, (2) the topic is industry specific, (3) the topic covers transactions/events that rarely occur, (4) the particular accounting method is not typically allowed under U.S. GAAP or IFRS, and (5) the topic covers transactions/events that do not commonly occur and the accounting treatment of the transaction is rule intensive.

By reassessing the coverage, we have made room for a number of topics not typically included in texts that have gained importance in the field (for example, tax contingencies, and revaluations of long-term operating assets under IFRS).

## Get Students Ready . . .

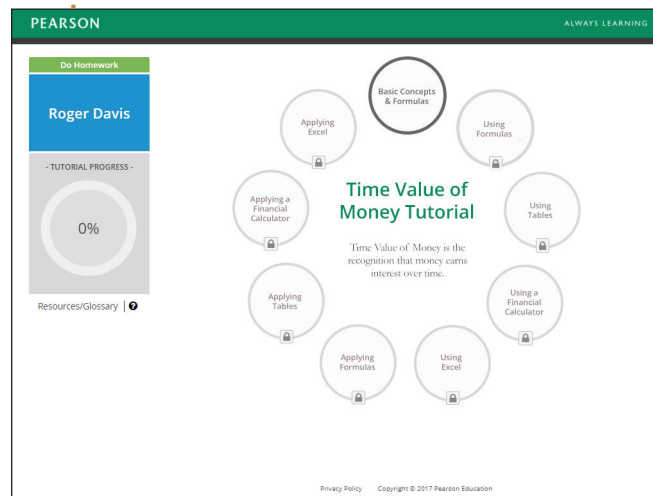
### Accounting Cycle Tutorial

Accessed through MyLab Accounting by computer, smartphone, or tablet, the Accounting Cycle Tutorial provides a refresher on the basics so students are ready for intermediate-level work. This updated version includes a new comprehensive problem.



### Time Value of Money Tutorial

The Time Value of Money Tutorial in MyLab ensures that students understand the basic theory and formulas of the TVM while helping test their ability to *apply* the TVM in the measurement of financial statement items. Students work through two sections. The first is to help them understand the theory using whichever method the instructor chooses (manually, through Excel, with tables, or via a calculator), and the second is to give students the opportunity to apply the theory by giving them a number of scenarios regarding each financial statement.



### Worked Problem Videos

Worked Problem Videos provide step-by-step explanations of problems similar to those students will encounter in the text, helping them to understand how to arrive at the correct answers themselves.

### Concept Overview Videos

Concept Overview Videos are short videos focusing on key concepts available in MyLab Accounting to further emphasize major concepts. These videos can be assigned as homework or used as part of a flipped classroom strategy.

## To Be Decision Makers . . .

### Conceptual Framework Connections

Each chapter guides students through discussions and analysis with a solid grounding in the conceptual framework fundamentals of reporting relevant, useful, timely, and understandable financial information.

### Emphasis on Judgment and Decision Making

Sections in each chapter identify key management decision points, and a unique full chapter dedicated to judgment and research identifies the assumptions, choices, and financial statement impacts from reporting business activities.

#### THE CONCEPTUAL FRAMEWORK CONNECTION: Usefulness and Limitations of the Income Statements

The income statements provide useful information to financial statement users in three ways:

1. **Evaluate past performance.** Income statements enable financial statement users to evaluate the entity's past performance. By disclosing separate components of revenues and expenses, income statements provide useful information about the entity's overall past performance (i.e., the earnings) and identify the main factors that influence performance. Income statements provide confirmatory value, which is an aspect of relevant information. For example, investors are interested in whether companies meet or beat analysts' forecasts of net income as indicated by the statement of net income.
2. **Predict future performance.** Income statements have predictive value because they provide a basis for estimating future performance. Predictive value is an aspect of relevance. For example, a firm with a trend of earnings growth over the last 10 years may continue that growth in the future.
3. **Assess risks or uncertainties of achieving future cash flows.** Income statements provide information that is useful in assessing the risks or uncertainties of achieving future cash flows. Some items of income are more persistent in nature than others, making them strong indicators of future cash flows. For example, revenue from normal sales tends to persist from year to year. However, a gain from the sale of a specialized piece of equipment is

#### JUDGMENTS IN ACCOUNTING Inventory Costs

Judgment is crucial in determining the initial measurement of inventory. Deciding what costs to include in inventory is often subjective, as indicated by the Codification's statement that "although principles for the determination of inventory costs may be easily stated, their application . . . is difficult because of the variety of considerations in the allocation of costs and charges."<sup>6</sup> As a simple example, consider the requirement that companies capitalize freight-in costs into the inventory account whereas abnormal freight must be expensed. Deciding what freight cost is normal versus what is abnormal requires subjective judgment. For example, if an auto dealer pays freight for a shipment of vehicles delivered from the factory, it is a normal part of the dealer's business operations. In this case, the freight is considered part of the cost of inventory because it was reasonable and necessary to have the inventory in place and ready for sale. However, if sales begin to slow down and the dealer holds too much inventory, this inventory may have to be shipped to alternate locations. This additional freight may be considered abnormal and expensed because it is not a reasonable and necessary cost and does not represent a part of inventory value.

The decision to use the gross or net method of recording purchase discounts also affects the balance in the inventory account. In Example 10.4, the final balance in the inventory account is \$4,960 using the gross method and \$4,900 using the net method for the same three transactions. Thus, the inventory balance is impacted by management's choice of the method to account for the discount.

### Worked Examples

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

#### EXAMPLE 15.4 Common Stock Issue Costs

**PROBLEM:** Piper Products decided to raise additional financing by issuing common stock. The company received \$4,000 in exchange for 1,000 shares of \$1 par value common stock. Piper paid an underwriter \$200 in stock issue costs. What is the necessary journal entry to record this transaction?

**SOLUTION:** The \$200 of issue costs reduces Piper's cash received from the sale of the stock. Thus, it records the cash received at the net amount of \$3,800, which is the \$4,000 total proceeds less the \$200 stock issue costs. The issue costs also reduce the additional paid-in capital in excess of par—common by \$200. The journal entry follows.

Account	Current Year	
Cash	3,800	
Common Stock – \$1 par		1,000
Additional Paid-in Capital in Excess of Par – Common		2,800

# To Think Like Accountants . . .

## Focus on Real-Company Financials

Disclosures and statements from well-known companies provide a connection to the application of accounting concepts and financial statement analysis.

**EXHIBIT 10.11** Inventory Disclosures, *Foot Locker, Inc.*, Financial Statements, January 28, 2017

From Financial Statement Notes:  
 NOTE 1: Summary of Significant Accounting Policies  
**Merchandise Inventories and Cost of Sales**

Merchandise inventories for the Company's Athletic Stores are valued at the lower of cost or market using the retail inventory method. Cost for retail stores is determined on the last-in, first-out ("LIFO") basis for domestic inventories and on the first-in, first-out ("FIFO") basis for international inventories. Merchandise inventories of the Direct-to-Customers business are valued at the lower of cost or market using weighted-average cost, which approximates FIFO.

The retail inventory method is commonly used by retail companies to calculate gross margins due to its practicality. Under the retail inventory method, a cost-to-retail percentage across groupings of similar items to-retail percentage is applied to ending inventory at its current owned cost of ending inventory on a department basis. The Company providing prices when the inventory has not been marked down to market.

NOTE 5: Merchandise Inventories

	2016	2015
	(in millions)	
LIFO inventories	\$ 861	\$ 847
FIFO inventories	446	438
Total merchandise inventories	<u>\$1,307</u>	<u>\$1,285</u>

The value of the Company's LIFO inventories, as calculated on a LIFO calculated on a FIFO basis.

Source: Foot Locker, Inc. January 28, 2017 Financial Statement. <https://www.data/850209/000085020917000003/01-20170128x10k.htm>, pages 44 and 52.

**Inventory Disclosures: IFRS.** IFRS inventory disclosures under U.S. GAAP. Additionally, IFRS requires firms to report

**Classification of Dividends, Interest, and Taxes: IFRS**  
 IFRS differs from U.S. GAAP in the classification of the following items:

1. Cash receipts from interest and dividends
2. Cash payments for taxes
3. Cash payments for interest
4. Cash payments for dividends

As shown in Exhibit 6.8, U.S. GAAP requires companies to report the preceding items in operating cash flows except for the payment of dividends. IFRS grants companies discretion in classifying these items as operating, investing, or financing activities as Exhibit 6.8 illustrates.

**EXHIBIT 6.8** Classification of Dividends, Interest, and Taxes

Activities	Standard	
	U.S. GAAP	IFRS
Cash receipts from interest and dividends	Operating	Operating or Investing
Cash payments for taxes	Operating	Operating activities, unless they can be specifically identified with Financing or Investing activities.
Cash payments for interest	Operating	Operating or Financing
Cash payments for dividends to owners	Financing	Operating or Financing

## Key IFRS Differences

To prepare students for the global business world, IFRS material is highlighted in separate chapter sections. Side-by-side comparisons of GAAP and IFRS standards focus students on the key differences.

## Interviews

Question-and-answer style exchanges with leaders in the field provide insight on topics from both standard-setter and practitioner perspectives and timely viewpoints on changing standards. Assign the new discussion questions to challenge students' understanding and critical-thinking skills.

**Interview**

**BARBARA J. WIGHT**  
 CHIEF FINANCIAL OFFICER  
 TAYLOR GUITARS »



Barbara J. Wight

*Barbara Wight is Chief Financial Officer at Taylor Guitars, an industry-leading guitar manufacturer whose instruments are played by leading musicians worldwide. She directs all financial, information technology, and legal affairs on behalf of the company and oversees various aspects of operations management, multinational manufacturing, acquisitions, and international compliance.*

material market deliveries, it might want to use LIFO for materials subject to inflation and FIFO for materials whose pricing is stable or even in decline.

3 Describe the most common components included in the unit cost of inventory at Taylor.

Taylor states inventories at standard cost based on the expected raw material costs, labor, and overhead. Our primary raw material is wood.

At the beginning of each year, Taylor determines how many total labor hours it will need to build the forecasted number of guitars and allocates overhead (and labor) to each guitar based on the calculated overhead and labor rate. The overhead rate times the number of labor hours per guitar equals overhead applied to each guitar unit. Taylor drives production based on a hybrid model; we build to order and to a sales forecast of specific models to ensure that high-turnover models are in stock at all times.

4 What are the most significant judgments employed in the decision to write inventory down to market when applying the lower-of-cost-or-market rule?

# From the First Day of Class and into Their Careers

## Auto-Graded Excel Projects

Using proven, field-tested technology, MyLab Accounting's new auto-graded Excel Projects allow instructors to seamlessly integrate Excel content into their course without having to manually grade spreadsheets. Students have the opportunity to practice important accounting skills in Microsoft Excel, helping them to master key concepts and gain proficiency with Excel. Students simply download a spreadsheet, work live on an accounting problem in Excel, and then upload that file back into MyLab Accounting where they receive reports on their work that provide personalized, detailed feedback to pinpoint where they went wrong on any step of the problem.



## Becker

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

In partnership with **BECKER** PROFESSIONAL EDUCATION

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

**MC9-1.** The following are held by YRT Corporation at December 31, Year 1:

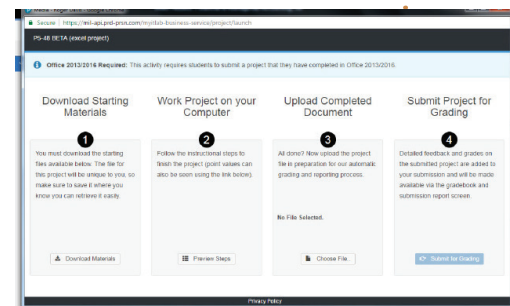
Cash in checking account	\$15,000
Petty cash	250
Check from customer dated 01/31/Year 2	350
3-month certificate of deposit, due 01/15/Year 2	40,000
12-month certificate of deposit, due 02/28/Year 2	36,000
Cash in bond sinking fund account	60,000

YRT Corporation classifies investments with original maturities of three months or less as cash equivalents. In its December 31, Year 1, balance sheet, what amount should YRT Corporation report as cash and cash equivalents?

a. \$ 15,250    b. \$ 55,250    c. \$ 55,600    d. \$ 151,250

**MC9-2.** Fernandez Company had an accounts receivable balance of \$150,000 on December 31, Year 2, and \$175,000 on December 31, Year 3. The company wrote off \$40,000 of accounts receivable during Year 3. Sales for Year 3 totaled \$600,000, and all sales were on account. The amount collected from customers on accounts receivable during Year 3 was:

a. \$575,000    b. \$531,000    c. \$600,000    d. \$535,000



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

Keyed to learning objectives, the items here progress in difficulty to test student understanding from the conceptual to multi-concept applied level.

Case exercises build students' ability to apply judgment-based analysis, read and interpret accounting literature, and analyze financial statements.

**Problems**

**P7-1.** **Present Value of an Ordinary Annuity, Future Value of an Ordinary Annuity.** FA Manufacturers must make several investment decisions related to its business operations. Interest is compounded annually. Analyze the following independent situations to help FA make a profitable investment.

a. FA Manufacturers reported a \$150,000 debt that matures in eight years. In order to accumulate sufficient funds to pay for the debt, the company decided to make eight equal annual payments into a fund paying 5% interest. What amount must FA Manufacturers deposit into the fund at the *end* of each year so that the company will be able to liquidate its debt?

b. On January 1, 2019, FA Manufacturers decided to purchase a piece of heavy machinery. FA agreed to pay \$50,000 on the date of purchase and would like to pay the remaining balance with six annual installments of \$20,000 commencing at the *end* of each year. How much should FA Manufacturers give to the machinery?

c. FA purchased a new machine and will make six equal annual payments of \$10,000 starting on January 1, 2019. How much should FA Manufacturers pay for the machine?

**P7-2.** **Present Value, Present Value of an Ordinary Annuity.** On January 1, 2019, Boyne's two alternative trucks were available on the market. Boyne's two alternative

## CASES

### Judgment Cases

#### Judgment Case 1: Balance Sheet Management

The CFO of First Things Computing, Inc. (FTC) prepared the following balance sheet as of December 31, 2019.

First Things Computing, Inc. Balance Sheet As of December 31, 2019	
<b>Assets</b>	
<b>Current Assets:</b>	
Cash	\$ 5,000
Trading Securities at Fair Value	700
Accounts Receivable – net	11,000
Merchandise Inventory	24,000
Office Supplies	600
Prepaid Rent	200
Total Current Assets	<u>\$ 41,500</u>
<b>Noncurrent Assets:</b>	
Investments	\$ 15,000
Property, Plant, and Equipment	
Land	20,000

## Instructor Teaching Resources

This program comes with the following teaching resources.

Supplements Available to Instructors at <a href="http://www.pearsonhighered.com/gordon">www.pearsonhighered.com/gordon</a>	Supplement Features
<p><b>Instructor's Manual</b></p> <p>Created in collaboration with Mary Cline from Rock Valley College Regan Garey from Lock Haven University</p>	<p><b>Course Content</b></p> <ul style="list-style-type: none"> <li>• Tips for Taking Your Course from Traditional to Hybrid, Blended, or Online</li> <li>• Standard Syllabi for Intermediate Accounting–2-semester course</li> <li>• Standard Syllabi for Intermediate Accounting–3-semester course</li> <li>• “First Day of Class” student handouts include               <ul style="list-style-type: none"> <li>• Student Walk-Through to Set Up MAL</li> <li>• Tips on How to Get an A in This Class</li> </ul> </li> </ul>
	<p><b>Chapter Content</b></p> <ul style="list-style-type: none"> <li>• Chapter Overview contains a brief synopsis and overview of each chapter.</li> <li>• Learning Objectives</li> <li>• Teaching Outline with Lecture Notes walks instructors through what material to cover and what examples to use when addressing certain items within the chapter.</li> <li>• IFRS Breakaways outline when IFRS diverges and addresses the key conceptual differences in these separate sections.</li> <li>• Student Supplement to Teaching Outline can be printed for (or emailed to) students. This outline will aid students in following the class and taking notes.</li> <li>• Assignment Grid indicates for each question, exercise, and problem the corresponding learning objective, the estimated completion time, and availability of Final Answer Questions and Worked Solutions in MyLab Accounting.</li> <li>• Suggestions for Class Activities are organized by learning objectives, allowing instructors to choose activities that fit with each day's discussions.</li> <li>• Model answers to Interview Discussion Questions</li> <li>• Guidance on Incorporating IFRS Material offers instructors direction on how to discuss the IFRS with their students.</li> </ul>
<p><b>Solutions Manual</b></p>	
<p>Created by the textbook authors</p>	<p>Contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems</p>



Supplements Available to Instructors at <a href="http://www.pearsonhighered.com/gordon">www.pearsonhighered.com/gordon</a>	Supplement Features
<b>Test Bank</b>	<b>Question Types</b>
<p>Created in collaboration with</p> <p>Michael P. Griffin from University of Massachusetts Dartmouth</p> <p>Kate Demarest from Carroll Community College</p>	<p>True/False and multiple-choice questions, essays, and problems make up more than 2,500 questions in this test bank. Most question types consist of both conceptual and computational problems, to ensure that students understand both the theory and the application. The Algorithmic test bank is available in MyLab Accounting. Most computational questions are formulated with an algorithm so that the same question is available with unique values. This offers instructors a greater pool of questions to select from and will help ensure that each student has a different test.</p> <p>All questions include the following annotations:</p> <ul style="list-style-type: none"> <li>• Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis)</li> <li>• Type (multiple-choice and true/false questions, short-answer, essays, and problems)</li> <li>• IFRS/GAAP indicator</li> <li>• Learning Objective reference</li> <li>• AACSB learning standard (Ethical Understanding and Reasoning; Analytical Thinking Skills; Information Technology; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)</li> </ul>
<b>Computerized TestGen</b>	
	<p><b>TestGen allows instructors to:</b></p> <ul style="list-style-type: none"> <li>• Customize, save, and generate classroom tests.</li> <li>• Edit, add, or delete questions from the Test Item Files.</li> <li>• Analyze test results.</li> <li>• Organize a database of tests and student results.</li> </ul>
<b>PowerPoints</b>	
<p>Created in collaboration with</p> <p>Alisa Brink from Virginia Commonwealth University</p>	<p><i>Instructor PowerPoint Presentations</i> mirror the organization of the text and include key exhibits, worked examples, and lecture notes. Instructors can download PowerPoint presentations that best match their teaching style.</p> <ul style="list-style-type: none"> <li>• <i>Lecture Support Only</i> presentations consist of the chapter outline mirroring the text and include all main headings, key terms, key figures, and key tables.</li> <li>• <i>Worked Examples Only</i> presentations consist of selected worked examples from the text for use as in-class demonstration problems.</li> <li>• <i>Combined</i> presentations consist of both the lecture support and the examples organized to correspond to the text.</li> </ul> <p>Modifying supplied PowerPoint presentations to correspond with classes can be a time-consuming task. To aid in this task, instructors can download a table of contents of the PowerPoint presentations. These documents will list the slide numbers for chapter content for quick removal of content that will not be covered in class.</p> <p><i>Student PowerPoint Presentations</i> are abridged versions of the <i>Instructor PowerPoint Presentations</i> and can be used as a study tool or note-taking tool for students.</p> <p>The <i>Image Library</i> contains all image files from the text to assist instructors in modifying our supplied PowerPoint presentations or in creating their own PowerPoint presentations.</p>

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