

THIRD EDITION

# INTERMEDIATE ACCOUNTING

Elizabeth A. Gordon • Jana S. Raedy • Alexander J. Sannella





This page intentionally left blank

# Intermediate Accounting

Third Edition

**Elizabeth A. Gordon**

*Fox School of Business, Temple University*

**Jana S. Raedy**

*Kenan-Flagler Business School, University of North Carolina at Chapel Hill*

**Alexander J. Sannella**

*Rutgers Business School, Rutgers University*

Please contact <https://support.pearson.com/getsupport/s/> with any queries on this content.

Cover Image by Excellent backgrounds/Shutterstock

Microsoft and/or its respective suppliers make no representations about the suitability of the information contained in the documents and related graphics published as part of the services for any purpose. All such documents and related graphics are provided “as is” without warranty of any kind. Microsoft and/or its respective suppliers hereby disclaim all warranties and conditions with regard to this information, including all warranties and conditions of merchantability, whether express, implied or statutory, fitness for a particular purpose, title and non-infringement. In no event shall Microsoft and/or its respective suppliers be liable for any special, indirect or consequential damages or any damages whatsoever resulting from loss of use, data or profits, whether in an action of contract, negligence or other tortious action, arising out of or in connection with the use or performance of information available from the services.

The documents and related graphics contained herein could include technical inaccuracies or typographical errors. Changes are periodically added to the information herein. Microsoft and/or its respective suppliers may make improvements and/or changes in the product(s) and/or the program(s) described herein at any time. Partial screen shots may be viewed in full within the software version specified.

Microsoft® and Windows® are registered trademarks of the Microsoft Corporation in the U.S.A. and other countries. This book is not sponsored or endorsed by or affiliated with the Microsoft Corporation.

---

Copyright © 2022, 2019, 2016 by Pearson Education, Inc. or its affiliates, 221 River Street, Hoboken, NJ 07030. All Rights Reserved. Manufactured in the United States of America. This publication is protected by copyright, and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise. For information regarding permissions, request forms, and the appropriate contacts within the Pearson Education Global Rights and Permissions department, please visit [www.pearsoned.com/permissions/](http://www.pearsoned.com/permissions/).

Acknowledgments of third-party content appear on the appropriate page within the text.

PEARSON, ALWAYS LEARNING, and MYLAB are exclusive trademarks owned by Pearson Education, Inc. or its affiliates in the U.S. and/or other countries.

Unless otherwise indicated herein, any third-party trademarks, logos, or icons that may appear in this work are the property of their respective owners, and any references to third-party trademarks, logos, icons, or other trade dress are for demonstrative or descriptive purposes only. Such references are not intended to imply any sponsorship, endorsement, authorization, or promotion of Pearson’s products by the owners of such marks, or any relationship between the owner and Pearson Education, Inc., or its affiliates, authors, licensees, or distributors.

**Cataloging-in-Publication Data is available on file at the Library of Congress.**

ScoutAutomatedPrintCode



ISBN 10: 0-13-694669-0  
ISBN 13: 978-0-13-694669-4

For Paul, Andrew, Mary, and my parents

*EAG*

For Nicholas, Aidan, and Kevin

*JSR*

For Ayden Alexander and Chloe Mikenzie

*AJS*

This page intentionally left blank

# About the Authors



## **Elizabeth A. Gordon, Ph.D., MBA, CPA**

ELIZABETH A. GORDON IS PROFESSOR OF ACCOUNTING at the Fox School of Business at Temple University and a Merves Senior Research Fellow. She received her doctorate from Columbia University, master's degree in business administration from Yale University, and bachelor's of science degree in accounting with highest distinction from Indiana University.

Dr. Gordon specializes in the areas of financial accounting and international financial reporting and investigates topics such as international financial reporting standards, corporate disclosure, executive compensation, related-party disclosures, and market development. Her research is published in top journals in her field including *Journal of Accounting Research*, *The Accounting Review*, *Review of Accounting Studies*, *Journal of Accounting, Auditing and Finance*, and *Journal of Accounting and Public Policy*. She serves as an editor of *Journal of International Financial Management and Accounting* and an editor of *Journal of International Accounting Research*. Dr. Gordon is a past president of the International Accounting Section of the American Accounting Association and serves as the vice president of the International Association for Accounting Education and Research. She serves as Chair of the Department of Accounting at the Fox School.

Dr. Gordon has taught courses in financial accounting and international accounting at the graduate and undergraduate levels, receiving a number of teaching awards. She has coauthored accounting readings for the CFA Institute, integrating IFRS and U.S. GAAP. She was an auditor with PricewaterhouseCoopers, LLP, and interned at the U.S. Office of Management and Budget before entering academia. Dr. Gordon is a CPA in the State of Maryland. She has been on the faculty of the Graduate School of Business at the University of Chicago, the Rutgers Business School, and a visiting professor at the University of Pennsylvania.



## **Jana S. Raedy, Ph.D., CPA**

JANA RAEDY IS ASSOCIATE PROFESSOR OF ACCOUNTING, associate dean of the Master of Accounting Program, and the Ernst & Young Scholar in Accounting at the Kenan-Flager Business School at the University of North Carolina at Chapel Hill. She received her bachelor of science and master of science degrees from the University of Kentucky and her doctorate from the Pennsylvania State University.

Dr. Raedy's research is primarily focused on issues in international financial reporting as well as areas in which financial reporting and taxation intersect. Her research is published in top journals such as *Journal of Accounting Research*, *Journal of Accounting and Economics*, *The Accounting Review*, *Contemporary Accounting Research*, *Journal of Business*, *Tax Notes*, and *Journal of the American Taxation Association*.

Dr. Raedy has taught a number of courses in financial reporting at the graduate level, including core financial reporting (both introductory and intermediate accounting), international financial reporting, financial disclosures, and forensic accounting. For over 15 years, she has taught a self-developed course in applied financial accounting research with a heavy emphasis on judgment and decision making. During her academic career, she has received a number of different teaching awards. She currently is a team member of the Ernst & Young Academic Resource Center, which provides faculty nationwide with comprehensive teaching materials related to topics such as judgment, IFRS, and fair value.



## **Alexander J. Sannella, Ph.D., CPA**

ALEXANDER J. SANNELLA IS CURRENTLY PROFESSOR of Accounting and Information Systems at the Rutgers Business School and the Director of the MBA in Professional Accounting Program, the Director of the Master of Accountancy in Professional Accounting, and the Director of the Rutgers Business School Teaching Excellence Center. He earned a BBA in Finance and an MBA in Accounting from the LaPenta School of Business at Iona College. He received his Ph.D. in Accounting and Finance from New York University and is a New York State Certified Public Accountant. He also holds a Bachelor of Arts in Music from Rutgers University.

During his years at Rutgers Business School he has taught at both the graduate and undergraduate levels and served as Associate Dean of the Business School and Vice Chair of the Department of Accounting and Information Systems. Previously, Dr. Sannella served on the faculty of New York University as an Instructor of Accounting at the Stern School of Business and as an Associate Professor of Accounting at Iona College's LaPenta School of Business.

He has public accounting experience as an auditor for PricewaterhouseCoopers, LLP and KPMG, LLP. Dr. Sannella was also an independent consultant working on many projects with other public accounting firms, bankruptcy trustees, and leasing divisions of major insurance companies. He also served as a consultant to the Line of Business Program at the Federal Trade Commission in Washington, DC. Dr. Sannella currently serves as a member of the Financial Reporting Executive Committee (FinREC) at the American Institute of Certified Public Accountants (AICPA).

Dr. Sannella has over 45 years' teaching experience at the university level and over 35 years' experience in developing and teaching commercial and investment bank training programs. His clients have included eight major investment banks and four of the world's largest commercial banks. His training programs include courses designed to train financial analysts and associates and special programs for sales and trading professionals.

He is the author of many scholarly journal articles and three books. His articles have focused on market-based accounting research and, more recently, accounting education. Dr. Sannella's books focus on the effects of accounting alternatives on the judgment of analysts and other statement users. Many of the books' topics are included on training videos and CPE courses.

He has been interviewed by several publications including the *Newark Star Ledger* and *NJ Biz*.



# Brief Contents

Preface xxiv

<b>CHAPTER 1</b>	The Financial Reporting Environment	1
<b>CHAPTER 2</b>	Financial Reporting Theory	23
<b>CHAPTER 3</b>	Judgment and Applied Financial Accounting Research	57
<b>CHAPTER 4</b>	Review of the Accounting Cycle	93
<b>CHAPTER 5</b>	Statements of Net Income and Comprehensive Income	173
<b>CHAPTER 6</b>	Statements of Financial Position and Cash Flows and the Annual Report	239
<b>CHAPTER 7</b>	Accounting and the Time Value of Money	319
<b>CHAPTER 8</b>	Revenue Recognition	377
<b>CHAPTER 9</b>	Short-Term Operating Assets: Cash and Receivables	449
<b>CHAPTER 10</b>	Short-Term Operating Assets: Inventory	513
<b>CHAPTER 11</b>	Long-Term Operating Assets: Acquisition, Cost Allocation, and Derecognition	593
<b>CHAPTER 12</b>	Long-Term Operating Assets: Departures from Historical Cost	671
<b>CHAPTER 13</b>	Operating Liabilities and Contingencies	741
<b>CHAPTER 14</b>	Financing Liabilities	793
<b>CHAPTER 15</b>	Accounting for Stockholders' Equity	863
<b>CHAPTER 16</b>	Investments in Financial Assets	919
<b>CHAPTER 17</b>	Accounting for Income Taxes	995
<b>CHAPTER 18</b>	Accounting for Leases	1073
<b>CHAPTER 19</b>	Accounting for Employee Compensation and Benefits	1163
<b>CHAPTER 20</b>	Earnings per Share	1233
<b>CHAPTER 21</b>	Accounting Changes and Error Analysis	1277
<b>CHAPTER 22</b>	The Statement of Cash Flows	1315

Glossary/Index I-1

This page intentionally left blank

# Contents

Preface xxiv

## CHAPTER 1

### The Financial Reporting Environment 1

---

#### Introduction 1

#### Overview of Financial Reporting 2

Financial Information 2

Economic Entity 3

Financial Statement User Groups 4

Other Parties Involved in the Preparation and Use of  
Financial Information 6

Legal, Economic, Political, and Social Environment 6

Data Analytics and Technology Innovation 8

#### Role of Standard Setters 8

The Importance of Understanding International  
Accounting Standards 8

#### The Standard-Setting Process 9

Standard Setting 9

#### IFRS Standard Setting 12

History of Global Standard Setting: IFRS 12

**Interview:** Daniel J. Noll, Director, AICPA 13

#### The Global Standard-Setting Structure: IFRS 14

#### Standard-Setting Process: IFRS 15

#### Standard Setting as a Political Process 15

#### Trends in Standard Setting 15

Rules- versus Principles-Based Standards 16

Asset/Liability Approach 17

Fair Value Measurements 17

#### Summary by Learning Objectives 18

#### Questions 20

Brief Exercises 20 • Exercises 21

## CHAPTER 2

### Financial Reporting Theory 23

---

#### Introduction 23

#### Overview of the Conceptual Framework 24

Conceptual Framework Components 24

**Interview:** Paul Pacter, Former Member of IASB 26

#### Conceptual Framework: IFRS 27

#### The Objective of Financial Reporting 27

#### Objective of Financial Reporting: IFRS 27

#### The Qualitative Characteristics of Financial Information 28

Fundamental Characteristics 28

Enhancing Characteristics 30

Cost Constraint 32

#### Elements of Financial Reporting 32

Elements 32

#### Elements: IFRS 35

#### Principles of Recognition and Measurement 35

General Recognition Principles 35

Revenue and Expense Recognition 36

Bases of Measurement 37

#### Recognition and Measurement: IFRS 39

Cash versus Accrual Accounting 40

#### Disclosure in the Notes to the Financial Statements 41

#### Presentation and Disclosure under IFRS 42

#### Additional Conceptual Framework Topics: IFRS 42

Financial Statements and the Reporting Entity 42

Concepts of Capital and Capital Maintenance 43

#### Assumptions in Financial Reporting 43

Going Concern Concept 43

Business or Economic Entity Concept 44

Monetary Unit Assumption 44

Periodicity Assumption 44

#### Assumptions in Financial Reporting: IFRS 44

#### Summary by Learning Objectives 45

#### Questions 49

Brief Exercises 49 • Exercises 53

## CHAPTER 3

### Judgment and Applied Financial Accounting Research 57

---

#### Introduction 57

#### The Importance and Prevalence of Judgment in Financial Reporting 58

Judgment and the Accountant	58	The Accounting Cycle	94
Judgment: Use and Abuse	58	Step 1: Analyze the Transaction	94
Judgment and Financial Statement Comparisons	58	The Accounting Equation	94
<b>The Role of Assumptions and Estimates</b>	<b>59</b>	Step 2: Journalize the Transactions	99
Assumptions and Estimates in the Financial Statements	59	Accounts	100
Judgment-Related Disclosures	59	Debits and Credits: A Review	101
Key Judgment Areas in Practice	64	Journal Entries	101
<b>Judgment Obstacles in Preparing Financial Information</b>	<b>65</b>	Step 3: Post to the General Ledger	103
Factors Influencing Management Behavior	65	The T-Account	106
Cognitive Biases	66	Step 4: Prepare the Unadjusted Trial Balance	107
Complexity of the Business Environment and Transactions	67	Step 5: Prepare Adjusting Journal Entries	108
<b>Authoritative Literature Used in Applied Financial Accounting Research</b>	<b>67</b>	Cash versus Accrual Bases of Accounting	108
Authoritative Literature	67	Deferrals	108
<b>Authoritative Literature: IFRS</b>	<b>70</b>	Accruals	112
<b>Interview:</b> Robert Herz, Chairman, FASB (Retired)	71	Step 6: Prepare the Adjusted Trial Balance	115
Basis for Conclusions	72	Step 7: Prepare Financial Statements	117
<b>Steps in the Applied Financial Accounting Research Process</b>	<b>72</b>	Step 8: Close Temporary Accounts	119
Step 1: Establish and Understand the Facts	72	Step 9: Prepare Post-Closing Trial Balance	120
Step 2: Identify the Issue: What Is the Research Question?	72	Comprehensive Example	121
Step 3: Search the Authoritative Literature	72	<b>Interview:</b> John Foristall, Executive Vice President and Chief Financial Officer, Shoebuy	137
Step 4: Evaluate the Results of the Search	73	Summary by Learning Objectives	138
Step 5: Develop Conclusions	73	Questions	142
Step 6: Communicate the Results of the Research	73	Multiple-Choice Questions <a href="#">Becker Professional Education*</a>	142
Applying the Research Process	73	• Brief Exercises	144
<b>Summary by Learning Objectives</b>	<b>78</b>	• Exercises	146
<b>Questions</b>	<b>81</b>	• Problems	152
Brief Exercises	81	<b>Appendix A: Alternative Treatment of Deferred Revenues and Expenses</b>	<b>161</b>
• Exercises	83	<b>Appendix B: Using a Worksheet</b>	<b>163</b>
<b>CASES</b>	<b>84</b>	<b>Appendix C: Reversing Entries</b>	<b>170</b>
Judgment Cases	84	<b>CHAPTER 5</b>	
• Surfing the Standards Cases	86	<b>Statements of Net Income and Comprehensive Income</b>	<b>173</b>
• Basis for Conclusions Cases	86	<b>Introduction</b>	<b>173</b>
<b>Appendix A: Structure of U.S. GAAP Codification</b>	<b>88</b>	<b>Overview of the Income Statements</b>	<b>174</b>
<b>Appendix B: IFRS Standards</b>	<b>91</b>	Income Statement Terminology	174
<b>CHAPTER 4</b>		Reporting Income	174
<b>Review of the Accounting Cycle</b>	<b>93</b>	<b>THE CONCEPTUAL FRAMEWORK CONNECTION:</b>	
<b>Introduction</b>	<b>93</b>	Usefulness and Limitations of the Income Statements	175
<small>*Multiple-Choice Questions <a href="#">Becker Professional Education</a></small>			



<b>Earnings Quality</b>	<b>175</b>	<b>CASES</b>	<b>226</b>
Permanent and Transitory Earnings	176	Judgment Cases	226 • Financial Statement
JUDGMENTS IN ACCOUNTING: Earnings Management	176	Analysis Cases	227 • Surfing the Standards
<b>Statement of Net Income Elements and Classifications</b>	<b>178</b>	Cases	229 • Basis for Conclusions Cases 229
Statement of Net Income Elements	178	<b>Appendix A: Financial Statement Analysis</b>	<b>231</b>
Statement of Net Income Classifications	179	<b>Appendix B: Profitability Analysis</b>	<b>235</b>
<b>Statement of Net Income Presentation</b>	<b>180</b>	<b>CHAPTER 6</b>	
Multiple-Step Net Income Statement	180	<b>Statements of Financial Position and Cash Flows and the Annual Report</b>	<b>239</b>
Condensed Statement of Net Income	181		
Single-Step Statement of Net Income	183	<b>Introduction</b>	<b>239</b>
<b>Statement of Net Income Presentation: IFRS</b>	<b>185</b>	<b>The Statement of Financial Position</b>	<b>240</b>
<b>Income from Continuing Operations</b>	<b>186</b>	THE CONCEPTUAL FRAMEWORK CONNECTION: Usefulness and Limitations of the Balance Sheet	240
Operating Income	188	<b>Balance Sheet Classifications</b>	<b>241</b>
Non-Operating Income	188	Assets	242
Income Tax Provision	189	Liabilities	243
<b>Discontinued Operations</b>	<b>189</b>	Stockholders' Equity	244
Characteristics of a Discontinued Operation	189	IFRS Balance Sheet Classification	245
Discontinued Operations Reporting Requirements	190	<b>Balance Sheet Presentation and Format</b>	<b>245</b>
<b>Discontinued Operations: IFRS</b>	<b>194</b>	Asset Presentation	245
<b>Net Income, Noncontrolling Interest, and Earnings per Share</b>	<b>195</b>	Liabilities Presentation	246
<b>The Statement of Comprehensive Income</b>	<b>196</b>	Balance Sheet Format	246
Statement of Comprehensive Income Elements	196	Balance Sheet Presentation: IFRS	248
<b>Statement of Comprehensive Income Elements: IFRS</b>	<b>197</b>	Judgment and the Balance Sheet	248
Statement of Comprehensive Income Format	197	<b>The Statement of Cash Flows</b>	<b>248</b>
<b>The Statement of Stockholders' Equity</b>	<b>200</b>	THE CONCEPTUAL FRAMEWORK CONNECTION: Purpose of the Statement of Cash Flows	250
Stockholders' Equity Requirements	200	Statement of Cash Flows Classifications	250
Statement of Stockholders' Equity Accounts	200	<b>Format for Cash Flows from Operating Activities</b>	<b>253</b>
<b>Interview:</b> Greg Tierney, Vice President, Finance, Planning & Analysis and Corporate Controller, Millercoors	201	<b>Financial Statement Articulation</b>	<b>256</b>
Summary by Learning Objectives	205	<b>Notes to the Financial Statements</b>	<b>259</b>
<b>Questions</b>	<b>209</b>	THE CONCEPTUAL FRAMEWORK CONNECTION: Notes to the Financial Statements	260
Multiple-Choice Questions Becker Professional Education*	210 • Brief Exercises	<b>Interview:</b> Robert Trinchetto, Partner and the Northeast Practice Leader in BDO's Accounting & Reporting Advisory Services Group	265
Exercises	216 • Problems	<b>The Annual Report</b>	<b>266</b>
<b>Data Analytics Project</b>	<b>226</b>	Management Discussion and Analysis	266
		Auditors' Report	267
		Management Report	268
		Board of Directors	269

\*Multiple-Choice Questions Becker Professional Education

**Summary by Learning Objectives 269****Questions 274**

Multiple-Choice Questions [Becker Professional Education\\*](#) 275 • Brief Exercises 276 • Exercises 284 • Problems 290

**Data Analytics Project 297****CASES 297**

Judgment Cases 297 • Financial Statement Analysis Case 299 • Surfing the Standards Cases 300 • Basis for Conclusions Cases 301

**Appendix A: Overview of the Preparation of the Statement of Cash Flows 303**

Reporting Cash Flows from Operating Activities: Indirect Method 303  
Reporting Cash Flows from Operating Activities: Direct Method 306  
Reporting Cash Flows from Investing and Financing Activities 310

**Appendix B: Liquidity and Solvency Analysis 312**

Liquidity 312  
Solvency 313  
DuPont Analysis 315

**CHAPTER 7****Accounting and the Time Value of Money 319****Introduction 319****Time Value of Money Basic Concepts 320**

Time Value of Money in Accounting 320  
Simple Interest 321  
Compound Interest 321  
Effective Interest Rates 322  
Types of Time Value of Money Problems 323

**Single-Sum Problems 323**

Future Value of a Single Sum 324  
Present Value of a Single Sum 327  
Other Single-Sum Problems 331

**Annuities 335**

Future Value of Ordinary Annuities 336  
Future Value of an Annuity Due 339  
Present Value of Ordinary Annuities 343  
Present Value of an Annuity Due 346

Other Annuity Problems 350

**Deferred Annuities 355**

Future Value of a Deferred Ordinary Annuity 355  
Present Value of a Deferred Ordinary Annuity 356

**Time Value of Money Accounting Applications 357****THE CONCEPTUAL FRAMEWORK CONNECTION:**

Present Value of Expected Cash Flows 357

**Interview:** Peter Biché, Chief Financial Officer, Monumental Sports & Entertainment, Washington, DC 358

Present Value of Future Cash Flows 359  
Computing Bond Issue Proceeds 359

**Summary by Learning Objectives 361****Questions 363**

Brief Exercises 363 • Exercises 364 • Problems 367

**Data Analytics Project 370****Appendix A: Time Value of Money Factor Tables 370****CHAPTER 8****Revenue Recognition 377****Introduction 377****Revenue Recognition Overview 378****THE CONCEPTUAL FRAMEWORK CONNECTION:**

Revenue Recognition 379

**Step 1: Identify the Contract(s) with a Customer 380**

Contract Criteria 380  
Failure to Meet Contract Criteria 381  
Multiple Contracts 382

**Identify the Contract(s) with Customers: IFRS 382****Step 2: Identify the Performance Obligations in the Contract 383****Step 3: Determine the Transaction Price 385**

Variable Consideration and Constraining Estimates of Variable Consideration 385  
Significant Financing Component 388  
Noncash Consideration 389  
Consideration Payable to a Customer 390

**Step 4: Allocate the Transaction Price to the Performance Obligations 391**

Standalone Selling Price 391  
Standalone Selling Price Estimation Methods 392  
Standalone Selling Price Exceptions 393

\*Multiple-Choice Questions [Becker Professional Education](#)

## Step 5: Recognize Revenue When or As Each Performance Obligation Is Satisfied 397

- Transfer over Time 397
- Transfer at a Point in Time 399
- Summary of the Five-Step Revenue Recognition Process 399

**JUDGMENTS IN ACCOUNTING: Revenue Recognition** 401

## Accounting for Long-Term Contracts 405

**THE CONCEPTUAL FRAMEWORK CONNECTION: Revenue Recognition for Long-Term Contracts** 406

- Percentage-of-Completion Method 406
- Completed-Contract Method 411

## Special Issues in Revenue Recognition 414

- Right-to-Return Sales 414
- Consignment Sales 415
- Other Principal-Agent Transactions 417
- Bill-and-Hold Arrangements 418
- Channel Stuffing 419

## Disclosures Related to Revenue Recognition 419

- Contracts with Customers 419

**Interview:** Michael Hall, Partner, KPMG 422

- Significant Judgments in Revenue Recognition 423

**FINANCIAL STATEMENT ANALYSIS: Comparison of the Percentage-of-Completion and Completed-Contract Methods** 423

## Summary by Learning Objectives 426

### Questions 431

- Multiple-Choice Questions **Becker Professional Education\*** 432 • Brief Exercises 434 • Exercises 437 • Problems 441

## Data Analytics Project 446

### CASES 446

- Judgment Cases 446 • Financial Statement Analysis Case 447 • Surfing the Standards Case 448 • Basis for Conclusions Case 448

## CHAPTER 9

## Short-Term Operating Assets: Cash and Receivables 449

### Introduction 449

## Accounting for Cash and Cash Equivalents 450

- Review of Cash and Cash Equivalents 450
- Restricted Cash and Compensating Balances 450
- Cash and Cash Equivalents: IFRS 451
- Required Disclosures for Restricted Cash and Cash Equivalents 451

## Accounting for Accounts Receivable: Initial Measurement 452

- Trade Discounts and Volume Discounts 452
- Sales Discounts 453

## Accounting for Accounts Receivable: Subsequent Measurement 456

- THE CONCEPTUAL FRAMEWORK CONNECTION: Accounting for Uncollectible Accounts** 456
- The Allowance Method 457

## Uncollectible Accounts Estimates 458

- Aging of Accounts Receivable 458
- Uncollectible Account Write-Off 461
- Subsequent Recoveries 462

**JUDGMENTS IN ACCOUNTING: Subsequent Measurements of Accounts Receivable** 463

## Financing with Accounts Receivable 464

- Pledging and Assigning Accounts Receivable 465
- Factoring Accounts Receivable 466
- Securitizations 469

## Accounting for Short-Term Notes Receivable 470

- Basic Features of Notes Receivable 470
- Stated Interest Rate Equal to the Market Rate 470
- No Stated Interest Rate or Stated Interest Rate Less Than the Market Rate 471

## Disclosures for Accounts Receivable and Notes Receivable 474

**FINANCIAL STATEMENT ANALYSIS: Operating Cycle Analysis** 475

**Interview:** Dalton Smart, Chief Audit Officer, Merck & Co. 480

## Summary by Learning Objectives 481

### Questions 484

- Multiple-Choice Questions **Becker Professional Education\*** 484 • Brief Exercises 485 • Exercises 489 • Problems 496

\*Multiple-Choice Questions **Becker Professional Education**

**Data Analytics Project 501****CASES 501**

- Judgment Cases 501 • Financial Statement Analysis Case 504 • Surfing the Standards Cases 504 • Basis for Conclusions Case 505

**Appendix A: Internal Controls over Cash 506**

- Cash Control Guidelines 506
- Controlling Cash by Use of a Bank Account 507
- Petty Cash 511

**CHAPTER 10****Short-Term Operating Assets: Inventory 513****Introduction 513****Types of Inventory and Inventory Systems 514**

- Types of Inventory 514
- Inventory Systems 515

**Inventory Costing: Units and Costs Included 518**

- Goods Included in Inventory 519
- Costs Included in Inventory 519
- Purchase Discounts 520

[JUDGMENTS IN ACCOUNTING: Inventory Costs](#) 522

**Inventory Cost-Flow Assumptions 522**

- Inventory Allocation Methods 524
- Specific Identification Method 524
- Moving-Average Method 525
- First-In, First-Out Method 527
- Last-In, First-Out Method 529
- Comparison of the Moving-Average, FIFO, and LIFO Methods 530

[THE CONCEPTUAL FRAMEWORK CONNECTION: Inventory Valuation Methods](#) 532

**The LIFO Cost-Flow Assumption in Detail 532**

- The LIFO Reserve and LIFO Effect 532
- LIFO Liquidations 534
- Dollar-Value LIFO 536

[JUDGMENTS IN ACCOUNTING: The LIFO Effect](#) 540

**The Lower-of-Cost-or-Market Rule 541**

[THE CONCEPTUAL FRAMEWORK CONNECTION: Lower of Cost or Market](#) 542

Lower-of-Cost-or-Market Rule Method 542

Lower-of-Cost-or-Market Rule: IFRS 548

[JUDGMENTS IN ACCOUNTING: The Lower-of-Cost-or-Market Rule](#) 549

[Interview: Barbara J. Wight, Chief Financial Officer, Taylor Guitars](#) 550

**The Retail Inventory Method 551**

- Basic Retail Method 551
- Retail Method Terminology 552
- The Conventional Retail Inventory Method 553

**Gross Profit Method of Estimating Inventory 555****Inventory Disclosures 556**

[FINANCIAL STATEMENT ANALYSIS: Conversion from LIFO to FIFO](#) 557

**Summary by Learning Objectives 560****Questions 564**

- Multiple-Choice Questions [Becker Professional Education\\*](#) 564 • Brief Exercises 566 • Exercises 570 • Problems 576

**Data Analytics Project 581****CASES 582**

- Judgment Cases 582 • Financial Statement Analysis Cases 583 • Surfing the Standards Cases 586 • Basis for Conclusions Cases 588

**Appendix A: LIFO Retail Inventory Method 589**

- Basic LIFO Retail Inventory Method 589
- Dollar-Value LIFO Retail Inventory Method 590

**CHAPTER 11****Long-Term Operating Assets: Acquisition, Cost Allocation, and Derecognition 593****Introduction 593****Initial Measurement of Property, Plant, and Equipment 594**

[THE CONCEPTUAL FRAMEWORK CONNECTION: Property, Plant, and Equipment Measurement](#) 594

**Overview of Initial Measurement 595**

- PPE Categories 595
- Initial Measurement of Basket Purchases 596
- Initial Measurement with Deferred Payment Arrangements 598
- Interest Capitalization 599

\*Multiple-Choice Questions [Becker Professional Education](#)



JUDGMENTS IN ACCOUNTING: The Initial Measurement of Property, Plant, and Equipment	609	Questions	641
Subsequent Measurement of Property, Plant, and Equipment	610	Multiple-Choice Questions <a href="#">Becker Professional Education*</a>	642 • Brief Exercises
Subsequent Expenditures	610	Exercises	645 • Problems
Depreciation of Tangible Fixed Assets	611		653
THE CONCEPTUAL FRAMEWORK CONNECTION: The Cost Allocation Process	611	Data Analytics Project	657
Derecognition of Property, Plant, and Equipment	619	CASES	657
Asset Derecognition: Sale	619	Judgment Cases	657 • Financial Statement Analysis Case
Asset Derecognition: Abandonment	620	Cases	659 • Surfing the Standards Cases
Disclosures of Property, Plant, and Equipment	620	Basis for Conclusions Cases	660
IFRS Disclosures	621	Appendix A: Nonmonetary Exchanges	661
Intangible Assets: Characteristics and Types	622	Exchanges with Commercial Substance	661
Finite-Life Intangible Assets	622	Exchanges without Commercial Substance and No Cash Received	663
Indefinite-Life Intangibles Other than Goodwill	623	Exchanges without Commercial Substance and Cash Received	663
Goodwill	623	IFRS Accounting for Nonmonetary Exchanges	665
Initial Measurement of Intangible Assets	623	Appendix B: Natural Resources	667
THE CONCEPTUAL FRAMEWORK CONNECTION: Intangible Asset Measurement	624	Costs Included in Natural Resources	667
Internally Generated Intangibles	624	Exploration Costs	667
Intangibles Acquired Individually or with a Group of Assets	624	Depletion	668
Intangibles Acquired in a Business Combination	624	IFRS Costs Included in Natural Resources	670
Goodwill	625		
Research and Development Costs	626	<b>CHAPTER 12</b>	
JUDGMENTS IN ACCOUNTING: The Measurement of Intangible Assets	630	Long-Term Operating Assets: Departures from Historical Cost	671
Subsequent Measurement and Derecognition of Intangible Assets	630	Introduction	671
THE CONCEPTUAL FRAMEWORK CONNECTION: The Cost-Allocation Process	630	Overview: Impairment of Long-Term Operating Assets	672
Amortization Method	630	THE CONCEPTUAL FRAMEWORK CONNECTION: Accounting for Impaired Long-Term Operating Assets	672
Derecognition of Intangible Assets	631	Categories and Steps Associated with the Impairment of Long-Term Operating Assets	672
<b>Interview:</b> Erin Polek, Senior Vice President, Corporate Controller, and Chief Accounting Officer, Qualcomm Incorporated	632	Accounting for Impairments: Property, Plant, and Equipment and Finite-Life Intangible Assets	673
Disclosures of Intangible Assets	633	Asset Grouping	673
IFRS Intangible Asset Disclosure	634	When to Test for Impairment	673
FINANCIAL STATEMENT ANALYSIS: Long-Term Fixed Assets	635	Two-Step Impairment Test	675
Summary by Learning Objectives	637	Measurement Subsequent to Impairment	678
		Accounting for Impairments: Indefinite-Life Intangible Assets	679
		Asset Grouping	679
		When to Test for Impairment	679

\*Multiple-Choice Questions [Becker Professional Education](#)

One-Step Impairment Test	679
Measurement Subsequent to Impairment	680
<b>Accounting for Impairments: Goodwill</b>	<b>681</b>
Asset Grouping	681
When to Test for Impairment	682
One-Step Impairment Test	682
Measurement Subsequent to Impairment	684
JUDGMENTS IN ACCOUNTING: For Impaired Long-Term Operating Assets	684
<b>Accounting for Impairments: Property, Plant, and Equipment, Finite-Life Intangible Assets and Indefinite-Life Intangible Assets: IFRS</b>	<b>686</b>
Asset Grouping	686
When to Test for Impairment	686
Impairment Test	686
<b>Accounting for Impairments: Goodwill under IFRS</b>	<b>694</b>
Asset Grouping	694
When to Test for Impairment	694
Impairment Test	694
<b>Required Disclosures for Asset Impairments</b>	<b>698</b>
Impaired Asset Disclosure Requirements	698
Impaired Asset Disclosure Requirements: IFRS	700
<b>Long-Term Operating Assets Held for Sale or Disposal</b>	<b>701</b>
Recording Long-Term Operating Assets Held for Sale or Disposal	701
<b>Interview:</b> Jack Markey, Assistant Controller, Eisai US, New York, New York	704
Required Disclosures of Long-Term Operating Assets Held for Disposal	705
FINANCIAL STATEMENT ANALYSIS: Long-Term Operating Assets with Departures from Historical Cost	705
<b>Summary by Learning Objectives</b>	<b>707</b>
<b>Questions</b>	<b>710</b>
Multiple-Choice Questions <a href="#">Becker Professional Education*</a>	710 •
Brief Exercises	711 •
Exercises	714 •
Problems	718
<b>Data Analytics Project</b>	<b>722</b>

<b>CASES</b>	<b>723</b>
Judgment Cases	723 •
Financial Statement Analysis Case	726 •
Surfing the Standards Cases	728 •
Basis for Conclusions Cases	730

## **Appendix A: Revaluation Model in IFRS Accounting for Certain Long-Term Operating Assets 731**

### THE CONCEPTUAL FRAMEWORK CONNECTION: Revaluation 731

The Revaluation Model 731

### JUDGMENTS IN ACCOUNTING: Revaluation under IFRS 739

Required Disclosures for Revaluation of Long-Term Operating Assets 740

## **CHAPTER 13**

## **Operating Liabilities and Contingencies 741**

### **Introduction 741**

### **Operating Liabilities 742**

Accounts Payable and Trade Notes Payable 742

Unearned Revenues 743

Gift Cards 744

Deposits 747

Sales Taxes Payable 748

Income Taxes Payable 748

Compensated Absences 748

Footnote Disclosures: Operating Liabilities 751

### **Asset Retirement Obligations 752**

Accounting for Asset Retirement Obligations 752

Footnote Disclosures: Asset Retirement Obligations 753

Asset Retirement Obligations: IFRS 755

### **Gain and Loss Contingencies 755**

Gain Contingency 755

Loss Contingency 755

### THE CONCEPTUAL FRAMEWORK CONNECTION: Loss Contingencies 756

Recognition and Measurement of Loss Contingencies 757

Accounting for Loss Contingencies 757

Accounting for Contingencies: IFRS 758

### **Loss Contingencies: Litigation, Warranties, and Premiums 758**

Accounting for Litigation 759

\*Multiple-Choice Questions [Becker Professional Education](#)

Accounting for Litigation: IFRS	760	Bonds Issued at Par	806
Accounting for Warranty Costs	760	Overview of Bonds Payable Issued at a Discount or Premium	807
Accounting for Premiums	763	The Effective Interest Rate Method of Amortization	808
JUDGMENTS IN ACCOUNTING: For Contingencies	766	Accounting for Bonds Payable Issued at a Premium	808
<b>Interview:</b> Cathy Engelbert, Chairman and CEO, Deloitte & Touche LLP	767	Accounting for Bonds Payable Issued at a Discount	810
Required Disclosures for Contingencies	768	Recording Bonds Payable: IFRS	815
Required Disclosures for Contingencies: IFRS	768	<b>Bonds Issued between Interest Dates</b>	<b>815</b>
FINANCIAL STATEMENT ANALYSIS: More on Liquidity	769	<b>Bond Issue Costs</b>	<b>818</b>
<b>Summary by Learning Objectives</b>	<b>771</b>	<b>Early Retirement of Bonds Payable</b>	<b>819</b>
<b>Questions</b>	<b>774</b>	<b>Convertible Bonds</b>	<b>820</b>
Multiple-Choice Questions <a href="#">Becker Professional Education*</a>	775	THE CONCEPTUAL FRAMEWORK CONNECTION: Convertible Bonds	821
Brief Exercises	776	Accounting for Convertible Bonds	821
Exercises	778	Accounting for Convertible Bonds: IFRS	823
Problems	780	JUDGMENTS IN ACCOUNTING: Convertible Bonds	824
<b>Data Analytics Project</b>	<b>783</b>	<b>Bonds with Stock Warrants</b>	<b>825</b>
<b>CASES</b>	<b>783</b>	Accounting for Stock Warrants	825
Judgment Cases	783	Accounting for Stock Warrant: IFRS	827
Financial Statement Analysis Case	784	<b>Reclassifications of Financing Liabilities</b>	<b>828</b>
Surfing the Standards Cases	785	Current Maturities of Long-Term Debt	828
Basis for Conclusions Cases	786	Short-Term Debt Expected to Be Refinanced	828
<b>Appendix A: Payroll Taxes Payable</b>	<b>788</b>	Obligations Callable by Creditor	831
Social Security Taxes	788	<b>The Fair Value Option to Value Liabilities</b>	<b>832</b>
Unemployment Taxes	788	Fair Value Option Accounting at Initial Recognition	832
Income Taxes Withheld	789	Fair Value Option: IFRS	833
<b>CHAPTER 14</b>		<b>Disclosures for Financing Liabilities</b>	<b>833</b>
<b>Financing Liabilities</b>	<b>793</b>	Short-Term Debt Expected to Be Refinanced	834
<b>Introduction</b>	<b>793</b>	Long-Term Debt	834
<b>Notes Payable</b>	<b>794</b>	Convertible Debt	834
Short-Term Notes Payable	794	Fair Value Disclosures	834
Long-Term Notes Payable: Term Loans	795	FINANCIAL STATEMENT ANALYSIS: Credit Risk	835
Long-Term Notes Payable: Installment Loans	796	<b>Interview:</b> Carolyn Slaski, Managing Partner, Northeast Region Assurance, Ernst & Young LLP	838
Long-Term Notes Payable: Stated Rate Less Than Market Rate	799	<b>Summary by Learning Objectives</b>	<b>839</b>
<b>Overview of Bonds Payable</b>	<b>801</b>	<b>Questions</b>	<b>843</b>
Credit Ratings	801	Multiple-Choice Questions <a href="#">Becker Professional Education</a>	
Bond Indenture	802		
Bond Pricing	803		
<b>Accounting for the Initial and Subsequent Measurement of Bonds Payable</b>	<b>806</b>		

\*Multiple-Choice Questions [Becker Professional Education](#)

Education*	843	•	Brief Exercises	845	•	Exercises	849	•	Problems	852
<b>Data Analytics Project</b>	<b>855</b>									
<b>CASES</b>	<b>856</b>									
Judgment Cases	856	•	Financial Statement Analysis Case	857	•	Surfing the Standards Cases	857	•	Basis for Conclusions Cases	858
<b>Appendix A: The Straight-Line Method of Amortization</b>	<b>859</b>									
Straight-Line Amortization: IFRS	862									
<b>CHAPTER 15</b>										
<b>Accounting for Stockholders' Equity</b>	<b>863</b>									
<b>Introduction</b>	<b>863</b>									
<b>Overview of Stockholders' Equity</b>	<b>864</b>									
Components of Stockholders' Equity	864									
<b>Accounting for Common Stock</b>	<b>865</b>									
Overview of Common Stock	865									
Legal Issues: Par and Stated Values	866									
Accounting for Common Stock Issuances	866									
Stock Splits	868									
<b>Accounting for Share Repurchase Transactions</b>	<b>870</b>									
THE CONCEPTUAL FRAMEWORK CONNECTION: Share Repurchase Transactions	870									
Purpose of Share Repurchases	870									
Accounting for Treasury Stock Transactions	871									
Accounting for Share Retirements	874									
<b>Accounting for Preferred Stock</b>	<b>876</b>									
THE CONCEPTUAL FRAMEWORK CONNECTION: Preferred Stock	876									
Overview of Preferred Stock	876									
Features of Preferred Shares	878									
<b>Accounting for Retained Earnings</b>	<b>883</b>									
Types of Dividends	883									
Accounting for Cash Dividends	884									
Accounting for Stock Dividends	885									
JUDGMENTS IN ACCOUNTING: Stock Dividends	888									
Prior-Period Adjustments	889									
<b>Accounting for Other Comprehensive Income</b>	<b>890</b>									
Components of Comprehensive Income	890									

THE CONCEPTUAL FRAMEWORK CONNECTION: Other Comprehensive Income 891

Reporting Other Comprehensive Income 891

Accumulated Other Comprehensive Income 892

## Stockholders' Equity Disclosures 892

Rights and Privileges of Classes of Stock 893

**Interview:** Robert Laux, North American Lead, International Integrated Reporting Council 894

Preferred Shares and Liquidation Preferences 895

Convertible Equity Securities 895

Redeemable Preferred Shares 895

Changes in Stockholders' Equity Accounts 895

Disclosures: IFRS 895

FINANCIAL STATEMENT ANALYSIS: Valuation Ratios 896

## Summary by Learning Objectives 899

## Questions 901

Multiple-Choice Questions Becker Professional Education\* 901 • Brief Exercises 902 • Exercises 904 • Problems 909

## Data Analytics Project 913

## CASES 913

Judgment Cases 913 • Financial Statement Analysis Case 916 • Surfing the Standards Cases 917 • Basis for Conclusions Cases 917

## CHAPTER 16

## Investments in Financial Assets 919

### Introduction 919

### Overview of Investments in Debt and Equity 920

Investments in Debt Securities 920

Investments in Equity Securities 920

THE CONCEPTUAL FRAMEWORK CONNECTION: Fair Value versus Cost 921

Key Questions for Investments in Debt and Equity Securities 921

### Investments in Debt Securities 922

Classification of Debt Securities 922

Held-to-Maturity Debt Securities 922

Trading Debt Securities 926

Available-for-Sale Debt Securities 928

Presentation of Other Comprehensive Income: Reclassification Adjustments for Available-for-Sale Debt Investments 933

\*Multiple-Choice Questions Becker Professional Education



JUDGMENTS IN ACCOUNTING: For Debt Investments	935	CASES	980
Transfers between Classifications	935	Judgment Cases	980 • Financial Statement Analysis Case
Accounting for Debt Investments under IFRS	936	Selected Excerpts of Cisco Systems, Inc. Financial Statements and Annual Report	981 • Surfing the Standards Case
<b>Investments in Equity Securities: No Significant Influence</b>	<b>937</b>	Basis for Conclusions Cases	983
Equity Investments with No Significant Influence: Readily Determinable Fair Value	938	<b>Appendix A: Impairments of Investment Securities</b>	<b>984</b>
Equity Investments with No Significant Influence: No Readily Determinable Fair Values	941	Accounting for Impairments of Debt Investments Measured at Amortized Cost	984
JUDGMENTS IN ACCOUNTING: Equity Investments with No Significant Influence and No Readily Determinable Fair Values	942	Accounting for Impairments of Available-for-Sale Debt Investments	986
Accounting for Equity Investments with No Significant Influence under IFRS	943	Accounting for Impairments of Equity Securities with No Readily Determinable Fair Value	988
<b>Investments in Equity Securities: Significant Influence</b>	<b>944</b>	Accounting for Impairments: IFRS	990
The Equity Method	944	Accounting for Impairments under IFRS: Debt Securities Reported at Amortized Cost or Fair Value through Other Comprehensive Income	990
JUDGMENTS IN ACCOUNTING: For Equity Investments	949	JUDGMENTS IN ACCOUNTING: Impairments of Investments in Financial Assets	992
<b>Long-Term Notes Receivable</b>	<b>949</b>	<b>CHAPTER 17</b>	
Stated Interest Rate Equal to the Market Rate	950	<b>Accounting for Income Taxes</b>	<b>995</b>
Stated Interest Rate Less Than the Market Rate	952	<b>Introduction</b>	<b>995</b>
<b>IFRS Accounting for Note Receivable</b>	<b>955</b>	<b>No Differences between Book and Tax Reporting</b>	<b>996</b>
<b>The Fair Value Option for Reporting Investments</b>	<b>956</b>	<b>Permanent Differences between Book and Tax Reporting</b>	<b>997</b>
Fair Value Option: IFRS	957	Accounting for Permanent Differences	998
<b>Disclosures for Investments in Financial Assets</b>	<b>957</b>	Permanent Differences and Effective Tax Rates	998
Debt Securities	957	<b>Temporary Differences between Book and Tax Reporting</b>	<b>999</b>
Equity Securities with No Significant Influence	959	Accounting for Temporary Differences	1001
Equity Method Investments	959	Deferred Tax Assets and Liabilities	1001
Notes Receivable	959	Temporary Difference Reversal	1005
Fair Value Measurement Disclosures	959	Temporary Differences and Tax Rates	1009
Fair Value Disclosures	960	THE CONCEPTUAL FRAMEWORK CONNECTION: Temporary Differences	1009
<b>Interview:</b> Thomas Angell, Partner, Withumsmith + Brown	961	<b>Realizability of Deferred Tax Assets: Assessing and Reporting</b>	<b>1010</b>
FINANCIAL STATEMENT ANALYSIS: Investments in Debt Securities and Equity Securities with No Significant Influence	962	Treatment of Deferred Tax Assets	1010
<b>Summary by Learning Objectives</b>	<b>964</b>	<b>Treatment of Deferred Tax Assets: IFRS</b>	<b>1013</b>
<b>Questions</b>	<b>967</b>	JUDGMENTS IN ACCOUNTING: Temporary Book-Tax Differences	1015
Multiple-Choice Questions Becker Professional Education*	967 • Brief Exercises	<b>Change in Tax Rates</b>	<b>1016</b>
Exercises	971 • Problems	Accounting for Changes in Tax Rates	1016
<b>Data Analytics Project</b>	<b>979</b>		

\*Multiple-Choice Questions Becker Professional Education

Effect of Tax Rate Changes on Deferred Tax  
Accounts 1017

## Accounting for Tax Rate Changes: IFRS 1018

JUDGMENTS IN ACCOUNTING: Changing Tax  
Rates 1019

## Accounting for Net Operating Losses 1019

Carrybacks and Carryforwards under U.S. Tax Law 1019  
Accounting for an NOL Carryback 1020  
Accounting for an NOL Carryforward 1021  
Assessing NOL Carryforward Realizability 1026  
Assessing NOL Carryforward Realizability: IFRS 1027

## Uncertain Tax Positions 1027

Accounting for Uncertain Tax Positions 1028

## Accounting for Uncertain Tax Positions: IFRS 1030

JUDGMENTS IN ACCOUNTING: Uncertain Tax  
Positions 1032

## Financial Statement Presentation 1034

Balance Sheet Presentation 1034  
Income Statement Presentation 1034

## Income Tax Financial Statement Disclosures 1036

Income Tax Expense and Income Taxes Paid 1036  
Tax Rate Reconciliation 1036  
Deferred Tax Liabilities and Deferred Tax Assets 1037  
Uncertain Tax Positions 1037

## Income Statement Disclosures: IFRS 1037

**Interview:** Laurie Wax, Tax Partner, RSM US LLP, New  
York, NY 1038

FINANCIAL STATEMENT ANALYSIS: Accounting for  
Income Taxes 1039

## Summary by Learning Objectives 1041

## Questions 1044

Multiple-Choice Questions [Becker Professional  
Education\\*](#) 1044 • Brief Exercises 1047 •  
Exercises 1050 • Problems 1056

## Data Analytics Project 1063

## CASES 1064

Judgment Cases 1064 • Financial Statement  
Analysis Case 1064 • Surfing the Standards  
Cases 1065 • Basis for Conclusions Cases 1066

## Appendix A: Comprehensive Book-Tax Difference Problem 1068

\*Multiple-Choice Questions [Becker Professional Education](#)

**Becker**+

## CHAPTER 18

## Accounting for Leases 1073

### Introduction 1073

### Leases: Overview 1074

Advantages of Leasing for the Lessee 1074  
Disadvantages of Leasing for the Lessee 1074  
Understanding the Basics of Lease Accounting 1075

### Lease Contracts, Lease Components, and Contract Consideration 1075

Separating Components in a Lease Contract 1076  
Allocating Consideration in a Lease Contract 1077

### Lease Classifications 1078

Criteria for Classification 1078  
Lease Payments and Discount Rates 1081

### IFRS Lease Classification 1083

CONCEPTUAL FRAMEWORK CONNECTION: Lease  
Classification 1085

### Accounting for Operating Leases: Lessee and Lessor 1086

Initial Measurement of an Operating Lease:  
Lessee 1086  
Subsequent Measurement of an Operating Lease:  
Lessee 1088  
Operating Lease with Residual Values: Lessee Guarantees  
Residual Value 1091  
Short-Term Policy Election: Lessee 1092  
Operating Lease: Lessor Accounting 1093

### Accounting for Finance Leases: Lessee 1095

Initial and Subsequent Measurement of Finance Leases:  
Lessee 1095  
Finance Lease with Residual Values: Lessee 1099

### IFRS Accounting for Operating and Finance Leases: Lessee 1101

### Accounting for Sales-Type Leases: Lessor 1101

Initial Measurement of a Sales-Type Lease 1101  
Subsequent Measurement of a Sales-Type Lease 1105  
Residual Values in a Sales-Type Lease 1106

### Accounting for Direct Financing Leases: Lessor 1108

Initial Measurement of a Direct Financing Lease 1108  
Subsequent Measurement of a Direct Financing  
Lease 1110

### IFRS Accounting for Leases: Lessor 1112

JUDGMENTS IN ACCOUNTING: For Leases 1113

**Interview:** Chad Soares, Partner, Transaction Services,  
PricewaterhouseCoopers LLP 1114

## Lease Disclosures 1115

Lessee-Disclosure Requirements 1115

Lessor-Disclosure Requirements 1117

**FINANCIAL STATEMENT ANALYSIS: Operating Leases  
versus Finance Leases for the Lessee** 1119

## Summary by Learning Objectives 1122

## Questions 1127

Multiple-Choice Questions **Becker Professional  
Education\*** 1128 • Brief Exercises 1129 •  
Exercises 1131 • Problems 1136

## Data Analytics Project 1140

## CASES 1141

Judgment Cases 1141 • Financial Statement  
Analysis Case 1141 • Surfing the Standards  
Cases 1143 • Basis for Conclusions Cases 1145

## Appendix A: Complexities in Accounting for Lease Transactions (with a Comprehensive Problem) 1146

Accruing Interest on Leases 1146

Leasehold Improvements 1147

Executory Costs 1148

Purchase Options 1151

Deferred Profit in Direct Financing Leases 1152

## CHAPTER 19

## Accounting for Employee Compensation and Benefits 1163

### Introduction 1163

### Overview of Stock-Based Compensation 1164

Stock Option Terminology 1164

**THE CONCEPTUAL FRAMEWORK CONNECTION:**  
**Stock-Based Compensation** 1165

Estimates in Accounting for Stock-Based  
Compensation 1166

### Equity-Classified Stock-Based Compensation 1167

Issuance of Equity-Classified Awards 1167

Change in the Fair Value of Equity-Classified  
Awards 1169

Change in the Estimated Forfeiture Rate 1169

Exercise of Equity-Classified Awards 1170

Expiration of Equity-Classified Awards 1171

Equity-Classified Awards: IFRS 1171

### Liability-Classified Stock-Based Compensation 1172

Issuance of Liability-Classified Awards 1172

Fair Value Adjustments 1173

Exercise of Liability-Classified Awards 1174

Expiration of Liability-Classified Awards 1175

Liability-Classified Awards: IFRS 1175

### Other Types of Stock-Based Compensation 1175

Stock Appreciation Rights 1175

Restricted Stock Plans 1177

Employee Stock Purchase Plans 1179

### Stock-Based Compensation Disclosures 1180

**THE CONCEPTUAL FRAMEWORK CONNECTION:**  
**Stock-Based Compensation** 1182

### Overview of Pensions 1183

Pension Plan Administration 1183

Types of Pension Plans 1183

Measures of the Actuarially Determined Defined-Benefit  
Pension Obligation 1184

### Defined-Benefit Pension Plan Accounting 1186

**THE CONCEPTUAL FRAMEWORK CONNECTION:**  
**Defined-Benefit Pension Plans** 1186

Factor 1: Service Cost 1186

Factor 2: Prior Service Costs 1187

Factor 3: Interest on the PBO 1188

Factor 4: Expected Return on Pension Plan Assets 1189

Factor 5: Current-Year Net Gains and Losses 1190

Factor 6: Funding the Plan 1192

Factor 7: Payments to Retirees 1193

Summary: Accounting Effects of Defined-Benefit  
Pension Plans 1193

Accounting for Defined-Benefit Pension Plans:  
IFRS 1193

**JUDGMENTS IN ACCOUNTING: Defined-Benefit  
Pension Plans** 1198

### Defined-Benefit Pension Plan Disclosure Requirements 1199

**FINANCIAL STATEMENT ANALYSIS: Defined-Benefit  
Pension Plan** 1201

**Interview:** Ryan Kaufman, Vice President, Assistant  
Corporate Controller, WESCO International, Inc. 1205

### Summary by Learning Objectives 1206

\*Multiple-Choice Questions **Becker Professional Education**

**Becker**<sup>+</sup>

**Questions 1209**

Multiple-Choice Questions [Becker Professional Education\\*](#) 1209 • Brief Exercises 1211 • Exercises 1214 • Problems 1219

**Data Analytics Project 1224****CASES 1224**

Judgment Cases 1224 • Financial Statement Analysis Cases 1224 • Surfing the Standards Cases 1226 • Basis for Conclusions Cases 1226

**Appendix A: Comprehensive Illustration of Accounting for Defined-Benefit Pension Plans 1227****CHAPTER 20****Earnings per Share 1233****Introduction 1233****Basic Earnings per Share 1234****THE CONCEPTUAL FRAMEWORK CONNECTION:**

Earnings per Share 1234

Basic EPS Numerator 1234

Basic EPS Denominator 1235

**JUDGMENTS IN ACCOUNTING:** Presentation of EPS 1237

**Diluted Earnings per Share 1238**

If-Converted Assumption 1239

Convertible Debt 1239

Convertible Preferred Stock 1244

Options and Warrants 1245

Diluted Earnings per Share: IFRS 1247

**Antidilutive Securities 1247**

Antidilutive Convertible Securities 1247

Antidilutive Options and Warrants 1249

Antidilution Sequencing 1249

Antidilution with a Net Loss from Continuing Operations 1250

**Earnings per Share Presentation and Disclosures 1251**

Comprehensive Example: EPS Calculation, Antidilution Sequencing, and Disclosures 1253

**FINANCIAL STATEMENT ANALYSIS:** EPS 1257

**Interview** Michael H. Dolan, Managing Director, Duff & Phelps, LLC 1260

**Summary by Learning Objectives 1261**

\*Multiple-Choice Questions [Becker Professional Education](#)

**Questions 1263**

Multiple-Choice Questions [Becker Professional Education\\*](#) 1263 • Brief Exercises 1264 • Exercises 1266 • Problems 1268

**Data Analytics Project 1271****CASES 1272**

Judgment Case 1272 • Financial Statement Analysis Case 1274 • Surfing the Standards Case 1276 • Basis for Conclusions Cases 1276

**CHAPTER 21****Accounting Changes and Error Analysis 1277****Introduction 1277****Overview of Accounting Changes 1278**

Types of Accounting Changes 1278

**THE CONCEPTUAL FRAMEWORK CONNECTION:**

Changes in Accounting Principles and Estimates 1278

Methods for Reporting Accounting Changes 1279

**Changes in Accounting Principle 1279**

Reporting a Change in Accounting Principle 1279

Direct and Indirect Effects 1280

Retrospective Method Illustration 1280

Prospective Method Illustration 1284

Required Disclosures for a Change in Accounting Principle 1287

**Changes in Accounting Estimates 1287**

Prospective Method Illustration 1287

Change in Accounting Estimate Effected by a Change in Accounting Principle 1288

**JUDGMENTS IN ACCOUNTING:** Changes in Accounting Estimates 1288

Disclosure of a Change in Accounting Estimate 1289

**Change in the Reporting Entity 1289**

Disclosure of a Change in the Reporting Entity 1289

**Errors and Error Analysis 1290****THE CONCEPTUAL FRAMEWORK CONNECTION:**

Errors 1291

Balance Sheet Errors 1291

Income Statement Errors 1291

Errors Affecting the Income Statement and the Balance Sheet 1292

**JUDGMENTS IN ACCOUNTING:** Error

Corrections 1296

FINANCIAL STATEMENT ANALYSIS: Accounting Changes 1297

**Interview:** Lawrence Steenvoorden, Vice President & Global Controller, Siemens Healthcare Diagnostics, Tarrytown, NY 1300

**Summary by Learning Objectives** 1301

**Questions** 1303

Multiple-Choice Questions [Becker Professional Education\\*](#) 1303 • Brief Exercises 1304 • Exercises 1305 • Problems 1308

**Data Analytics Project** 1312

**CASES** 1312

Judgment Case 1312 • Financial Statement Analysis Case 1312 • Surfing the Standards Case 1313 • Basis for Conclusions Case 1313

## CHAPTER 22

### The Statement of Cash Flows 1315

**Introduction** 1315

**Overview of the Statement of Cash Flows** 1316

**THE CONCEPTUAL FRAMEWORK CONNECTION:** Statement of Cash Flows 1316

Purposes of the Cash Flow Statement 1316

Cash and Cash Equivalents 1316

Cash Equivalents under IFRS 1317

**Format of the Cash Flow Statement** 1317

Sections in the Statement of Cash Flows 1317

Statement of Cash Flows Classifications 1318

Classification of Dividends, Interest, and Taxes 1318

Reconciliation of Cash and Cash Equivalents 1320

Significant Noncash Investing and Financing Transactions 1321

**Conceptual Model for the Statement of Cash Flows** 1321

**Operating Cash Flows** 1322

The Indirect Method 1322

The Direct Method 1328

**Investing Cash Flows** 1333

**Financing Cash Flows** 1334

Illustration of the Statement of Cash Flows 1335

**JUDGMENTS IN ACCOUNTING:** Impacts on the Statement of Cash Flows 1339

**Complexities in Determining Cash Flows** 1340

Acquisition and Disposition of Long-Term Assets 1340

Deferred Income Taxes 1343

Net Accounts Receivable and Bad Debt Expense 1344

Unrealized Gains and Losses on Fair Value Adjustments 1345

Equity Method Investments 1346

Share-Based Compensation 1346

Pension Adjustments 1347

Amortization of Bond Premiums and Discounts 1347

Overview of Indirect Method Adjustments 1348

**Cash Flow Statement Disclosures** 1349

Cash Equivalents Policy: Direct and Indirect Methods 1349

Noncash Investing and Financing Activities: Direct and Indirect Methods 1349

Interest and Income Taxes Paid: Indirect Method Only 1349

Reconciliation of Net Income to Net Cash Provided by Operating Activities: Direct Method Only 1349

Restrictions on Cash and Cash Equivalents: Direct and Indirect Methods 1349

Cash Flow Statement Disclosures under IFRS 1349

Comprehensive Cash Flow Problem 1349

**Interview** Christina Loebach, Senior Vice President, Global Financial Planning & Analysis, Cushman and Wakefield, Chicago, Illinois 1359

FINANCIAL STATEMENT ANALYSIS: Operating Cash Flow 1360

**Summary by Learning Objectives** 1364

**Questions** 1368

Multiple-Choice Questions [Becker Professional Education\\*](#) 1368 • Brief Exercises 1370 • Exercises 1378 • Problems 1387

**Data Analytics Project** 1398

**CASES** 1398

Judgment Case 1398 • Financial Statement

Analysis Case 1398 • Surfing the Standards

Cases 1400 • Basis for Conclusions Cases 1400

**Glossary/Index** I-1

\*Multiple-Choice Questions [Becker Professional Education](#)



# Preface

## New to This Edition

### Coverage of the Latest Standards

- Chapter 2 incorporates Statement of Financial Accounting Concepts No. 8, Chapter 8, which discusses the information that should be included in the notes to the financial statements. Chapter 2 also incorporates the new IASB Conceptual Framework.
- Chapter 8 incorporates ASU 2017-14, which made minor changes based on two SEC releases.
- Chapter 15 incorporates ASU2020-06, which changes the accounting for convertible debt. Under U.S. GAAP convertible debt is no longer bifurcated between debt and equity, even when a beneficial conversion option exists.
- Chapter 15 incorporates ASU 2018-07, which specifies the measurement of stock exchanged for noncash consideration. The new rules disallow the alternative measurement of the fair value of the consideration received; only the fair value of the stock issued is allowed.
- Chapter 17 incorporates the Tax Cuts and Jobs Act (TCJA) and IFRIC 23. TCJA eliminates the domestic production activities deduction (a permanent book-tax difference). The tax act also eliminates net operating loss carrybacks and limits the use of the net operating loss carryforwards to 80% of taxable income. IFRIC 23 provides guidance for companies reporting IFRS on reporting uncertain tax positions.
- Chapter 18 incorporates ASU 2018-11, which adds an election for the lessor not to allocate lease and non-lease components separately.

### New Data Analytics Projects!

Found in most chapters within the end of chapter exercises, students will be provided with opportunities for practice in reading and analyzing company financial statements in the context of key concepts covered in each chapter. They'll then be asked to support their findings by creating data visualizations and to answer the multiple choice questions in MyLab for assessment purposes and contextualized feedback.

## 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.

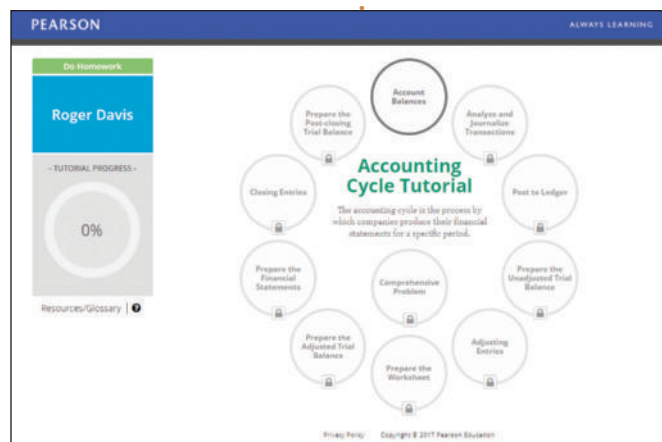
We have chosen to reassess coverage of topics based primarily on five criteria: (1) The topic is repeated elsewhere in the normal accounting curriculum, (2) the topic is industry specific, (3) the topic covers transactions/events that rarely occur, (4) the particular accounting method is not typically 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 . . .

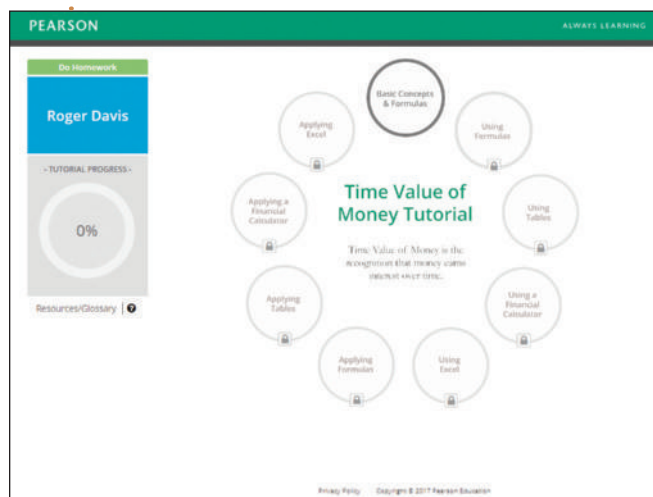
### Accounting Cycle Tutorial

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 . . .

## Data Analytics Projects

Accessed via the MyLab, Data Analytics problems provide students the opportunity to practice reading and analyzing company financial statements, and then using data visualizations to support their findings.

### DATA ANALYTICS

#### Data Analytics Project

##### Data Analytics Project: Accounts Receivable Collection

Prompt collection of accounts receivable is critical to a company's cash flow and enhances its ability to pay off short-term obligations when due. Specifically, managers need to be diligent regarding accounts receivable collection and ensure timely completion of the cash operating cycle. In order to monitor accounts receivable balances and collections, managers will determine the accounts receivable turnover rate and the number of days sales in accounts receivable. The greater the turnover, the fewer the number of days it takes to collect outstanding receivables. Managers may also provide incentives for customers to pay early in order to improve cash flow. These incentives typically include discounts for early cash payment. Sales can be increased by offering volume discounts. Generally, the volume discount is increased with the level of products purchased.

The Chapter 9 Data Analytics Project included in MyLab Accounting provides you practice in using a large data set of information related to a company's sales transactions and accounts receivable in order to understand how careful analysis of the trends in accounts receivable collection and the use of volume and cash discounts can improve revenue and cash flows.

## 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, February 2, 2019

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 a basis for domestic inventories and on the first-in, first-out ("FIFO") basis for Merchandise inventories of the Direct-to-Customers business are valued at using weighted-average cost, which approximates FIFO.

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

##### NOTE 5: Merchandise Inventories

	2018	2017
	(in millions)	
LIFO inventories	\$ 838	\$ 869
FIFO inventories	431	469
Total merchandise inventories	<u>\$1,269</u>	<u>\$1,278</u>

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

Source: Foot Locker, Inc. February 2, 2019, Financial Statement. [http://www.annualreports/PDF/NYSE\\_FL\\_2018.pdf](http://www.annualreports/PDF/NYSE_FL_2018.pdf), pages 44 and 51.

#### 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

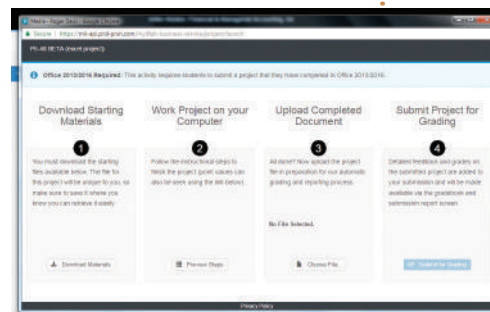
## Auto-Graded Excel Projects

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+

## 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.



**Becker+** 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.

**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, 2023, 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 2023. Given an interest rate of 8%, what value should FA give to the machinery?

c. FA purchased a new machine and wants to pay for payments start in one year. Given an interest rate of 8%, what amount should FA pay each year for the next six years?

**P7-2. Present Value, Present Value of an Ordinary Annuity.** The owner of a truck needs to purchase a new truck. The owner is considering two alternatives. The owner is currently driving a 2015 Ford F-150. The owner is considering purchasing a 2020 Ford F-150. The owner is considering purchasing a 2020 Ford F-150. The owner is considering purchasing a 2020 Ford F-150.

## 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	\$ 6,000
Trading Securities at Fair Value	700
Accounts Receivable—net	11,000
Merchandise Inventory	24,000
Office Supplies	600
Prepaid Rent	200
Total Current Assets	\$ 41,500
<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
<b>Instructor's Manual</b>	<b>Course Content</b>
Created in collaboration with Regan Garey from Lock Haven University	<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>
	<b>Chapter Content</b>
	<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>
<b>Solutions Manual</b>	
Created by the textbook authors	Contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems

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>Connie Belden, Butler 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 Instructor PowerPoint Presentations 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>

# CPA EXAM REVIEW DESIGNED FOR YOU.



We work harder (and smarter) to help you master the exam content and prepare the way that works best for you. Because you're not just prepping for an exam - you're preparing for your future.



## Expert instructors

Every Becker instructor is an experienced CPA in accounting, law or business. Few come more respected or qualified than Peter Olinto, Tim Gearty and Mike Brown - each with their own unique teaching methodology and mnemonic devices.



## Relevant content

Our course follows the AICPA blueprint with reports showing how each module maps back to the topics on the exam as well as a user-interface that mirrors the exam. We also collaborate with the AICPA to ensure our content is up-to-date and you're informed about any exam changes.



## Personalized learning

Our proprietary Adapt2U Technology, powered by Sana Labs' award-winning AI, makes learning personal and dynamic. The course includes proficiency badges to help you determine your areas of opportunity allowing for an efficient use of study time. The course also tailors your personalized review sessions and practice tests to areas you need the most help.

The prep you do right before exam day is critical for exam day readiness. Our study materials and practice tools help you apply your knowledge in the same way you will be asked to apply your knowledge so there are no surprises on exam day.

## Simulated exams

New questions never seen before - not computer-generated mashups of past modules - written by knowledgeable instructors. Everything from timing to structure is based on the actual exam to help you plan for the real thing.



## Final Review

A condensed review that focuses on the most commonly tested concepts. It includes completely new lectures, multiple-choice questions and simulations to help you get the most out of your study time. Perfect for last minute cramming!



Visit **becker.com** for more information

**Becker**<sup>™</sup>+



## Acknowledgments

We are indebted to our colleagues for the time and expertise invested as manuscript reviewers, class testers, and focus group participants. We list all these contributors here but want to single out one group, our editorial board, for special notice. Their invaluable insights across the Intermediate I and Intermediate II chapters greatly improved the clarity, consistency, and accuracy of the textbook.

Nandini Chandar, Rider University  
 Nancy Fan, Cal Poly Pomona  
 Mitchell Franklin, Le Moyne College  
 Dr. William Jefferson, Metropolitan  
 Community College  
 Ming Lu, Santa Monica College  
 Angel Luper, Tri-County Technical College  
 Josh Neil, CU Boulder

Cecile Roberti, Community College of Rhode  
 Island  
 Greg Sommers, Southern Methodist  
 University  
 Jan Williams, University of Baltimore  
 Wendy Wilson, Southern Methodist  
 University

We are grateful for our colleagues' insights as well; we extend our sincere thanks to Steve Balsam, Brad Hendricks, Marco Malandra, Jonathon Reiter, Tanja Snively, and C. Daniel Stubbs. We also extend our sincere thanks to Ruanjia (Katerina) Liu and Hongmin (William) Du for their work on our data analytics projects. In addition, the following instructors gave their time to peer review and contribute to chapters:

Rebecca Adams, University of Virginia  
 Asher Albaz, Housatonic Community College  
 Daniel Ames, Illinois State University  
 Bridget Anakwe, Delaware State University  
 Matt Anderson, Michigan State University  
 Paul Ashcroft, Missouri State University  
 Eric Ball, Wake Tech Community College  
 Steven Balsam, Temple University  
 James Bannister, University of Hartford  
 Cheryl Bartlett, Central New Mexico  
 Community College  
 Okera Bishop, Lone Star College, Kingwood  
 Kathleen Brenan, Ashland University  
 Anne Brooks, University of New Mexico  
 Kevin Brown, Wright State University  
 Stephen Brown, University of Maryland  
 Timothy Bryan, University of Southern  
 Indiana  
 Jill Buchmann, Gateway Technical College  
 Charles Carslaw, University of Nevada, Reno  
 Deborah Carter, Coahoma Community  
 College  
 Mary Ellen Carter, Boston College  
 Richard Cazier, The University of Texas at El  
 Paso  
 Anna Ciani, Wake Forest University  
 Cheryl Clark, Point Park University  
 Dina Clark, Bloomsburg University of  
 Pennsylvania  
 Mary Cline, Rock Valley College  
 Constance Crawford, Ramapo College of New  
 Jersey  
 Cynthia Cuccia, University of Oklahoma  
 Marc Cussatt, Washington State University

Brent Daulton  
 Angela Davis, University of Oregon  
 David Dearman, University of Arkansas at  
 Little Rock  
 Araya Debessay, University of Delaware  
 Kate Demarest, University of Baltimore  
 Michael Deschamps, Mira Costa College  
 David T. Doran, Pennsylvania State  
 University  
 Nina Dorata, St. John's University  
 Tom Downen, Southern Illinois University  
 Joseph Dulin, University of Oklahoma  
 Dennis Elam, Texas A&M University–San  
 Antonio  
 Desiree Elias, Florida International University  
 Gene Elrod, University of North Texas  
 Darlene Ely, Carroll Community College  
 James Emig, Villanova University  
 Ryan Enlow, University of Nevada, Las Vegas  
 Nancy Fan, California Polytechnic State  
 University, Pomona  
 Patrick Fan, Virginia Tech  
 Magdy Farag, California Polytechnic State  
 University, Pomona  
 Damon Fleming, San Diego State University  
 Marianne Fortuna, University of Georgia  
 Dan Fox, Boise State University  
 Micah Frankel, CSU East Bay  
 Mitchell Franklin, Syracuse University  
 Diane Franz, University of Toledo  
 Virginia Fullwood, Texas A&M  
 University–Commerce  
 Regan Garey, Lock Haven University  
 Gregory Gaynor, University of Baltimore

- Robin Gibson, Tri-County Community College  
Lisa Gillespie, Loyola University Chicago  
Hubert Glover, Drexel University  
Giorgio Gotti, The University of Texas at El Paso  
Pamela Graybeal, University of Central Florida  
Amy Haas, Kingsborough Community College  
Jan Hardesty, Pima Community College  
Syed Hasan, George Mason University  
Shanelle Hopkins, Carroll Community College  
Susan Hughes, University of Vermont  
Dave Hurtt, Baylor University  
Mark Jackson, University of Nevada, Reno  
Jeffrey Jones, College of Southern Nevada  
Celina Jozsi, University of South Florida  
John Karbens, Hawaii Pacific University  
Mary Keener, The University of Tampa  
Jerry Kreuze, Western Michigan University  
Gaurav Kumar, University of Arkansas  
Lisa Kutcher, Colorado State University  
Jolene Lampton, Park University at Austin  
Gerald Lander, University of South Florida  
Ellen L. Landgraf, Loyola University Chicago  
Nammy Lee, University of Virginia  
Christy Lefevers, Catawba Valley Community College  
Hui Lin, DePaul University  
Ellen Lippman, University of Portland  
Mary Loyland, University of North Dakota  
Bismarck  
Ming Lu, Santa Monica College  
James Lukawitz, University of Memphis  
Marco Malandra, Temple University  
Katie Maxwell, University of Arizona  
Casey McNellis, University of Montana  
Michelle Meckfessel, Case Western Reserve University  
Linda Miller, Northeast Community College  
Jose Miranda-Lopez, University of Tulsa  
Joe Moran, College of DuPage  
Laura Morgan, NHTI, Concord's Community College  
Donald Minyard, University of Alabama  
Volkan Muslu, University of Houston  
Cory Ng, Temple University  
Derek Oler, Texas Tech University  
Kingsley Olibe, Kansas State University  
Susan Pallas, Southeast Community College  
Janet Papiernik, Indiana University–Purdue University Fort Wayne  
Nancy Pasternack, University of Washington  
Nori Pearson, Washington State University Pullman  
Bonita Peterson Kramer, Montana State University  
Marc Picconi, College of William and Mary  
Catherine Plante, University of New Hampshire  
Kristin Portz, St. Cloud State University  
Richard Price, University of Oklahoma  
Damian R. Prince, New Jersey City University  
Lauren Psomostitis, North Seattle College  
James Racic, Lakeland Community College  
Raymond Reisig, Pace University  
Cecile Roberti, Community College of Rhode Island  
L. H. Rogero, University of Dayton  
Eric Rothenburg, Kingsborough Community College  
Brian Routh, University of Southern Indiana  
Chris Ruderman, Linn-Benton Community College  
Anwar Salimi, California Polytechnic State University, Pomona  
Paul Schloemer, Ashland University  
Kathleen Sevigny, Bridgewater State College  
Marsha Shapiro, Park University  
Praveen Sinha, California State University, Long Beach  
Leonard Soffer, University of Chicago  
Gregory Sommers, Southern Methodist University  
Jalal Soroosh, Loyola University Maryland  
Derinda Stiene, Caldwell Community College and Technical Institute  
Stephen Strand, Southern Maine Community College  
Joel Strong, St. Cloud State University  
C. Daniel Stubbs, Rutgers University  
Alan Styles, California State University San Marcos  
Zane Swanson, University of Central Oklahoma  
Robert Terrell, University of Central Oklahoma  
Geoffrey Tickell, Indiana University of Pennsylvania  
Paula Thomas, Middle Tennessee State University  
Arindam Tripathy, University of Washington Tacoma  
Norbert Tschakert, Salem State University  
Frank Urbancic, University of South Alabama  
Marcia Veit, University of Central Florida  
Edward Walker, University of Central Oklahoma  
Ping Wang, Pace University  
Janis Weber, University of Louisiana at Monroe  
Yan Xiong, California State University, Sacramento  
Michael Yampuler, University of Houston  
Shaokun Yu, Northern Illinois University

Instructors (and their students) who participated in our multiple class testing of select chapters and the corresponding key supplements follow.

Asher Albaz, Housatonic Community College  
Bridget Anakwe, Delaware State University  
Ira Bates, Florida Agricultural and Mechanical University  
Alisa Brink, Virginia Commonwealth University  
Steven Burris, Daley College  
Cassandra Catlett, Carson–Newman University  
Martha Cranford, Rowan Cabarrus Community College  
Cynthia Cuccia, University of Oklahoma  
Nina Dorata, St. John’s University  
Richard Ellison, Middlesex Community College  
Anna Froman, Metro State University of Denver  
Gregory Gaynor, University of Baltimore  
Drew Goodson, Central Carolina Community College  
Rita Grant, Grand Valley State University  
Ying Huang, University of Louisville  
Susan Hughes, University of Vermont  
Christopher Jankiewicz, Howard Community College  
Bill Jefferson, Metropolitan Community College

Christine Kuglin, Metropolitan State University of Denver  
Jolene Lampton, Park University  
Christa Land, Catawba Valley Community College  
Hui Lin, DePaul University  
Ellen Lippman, University of Portland  
Stephani Mason, DePaul University  
Tammy Metzke, Milwaukee Area Technical College  
Linda Miller, Northeast Community College  
Laura Morgan, New Hampshire Technical Institute  
JT Norris, University of the Incarnate Word  
Derek Oler, Texas Tech University  
Kristen Reilly, Colorado State University  
Jennifer Jones Rivers, University of Georgia  
Melloney Simerly, Virginia Commonwealth University  
Michelle Sotka, Howard Community College  
Pamela Stuerke, University of Missouri–St. Louis  
Robin Thomas, North Carolina State University  
Michael Trendell, Governors State University  
Joe Welker, Western Idaho Community College  
Jan Williams, University of Baltimore

# 1

# The Financial Reporting Environment

## LEARNING OBJECTIVES

- 1 Define financial accounting and describe the demand for financial information, including the role of general-purpose financial statements, the information needs of financial statement users and other parties, and the factors that influence financial reporting.
- 2 Discuss the role of financial accounting standard setters in the United States and internationally.
- 3 Detail the standard-setting process.
- 4 Explain three recent trends in standard setting: principles-based, rules-based, and objectives-oriented standards; the asset/liability approach; and fair value measurements.

## Introduction

WELL-DEVELOPED ACCOUNTING STANDARDS ENABLE WORLDWIDE capital markets to function effectively by providing credibility to published financial information used by investors, creditors, and others. Transparent financial information included in the financial statements

allows these parties to make rational investment and credit decisions that direct capital to corporations that develop new products and technology, create employment, and encourage growth and development.

Consider *Pinterest, Inc.*, the social media company, which raised capital of over \$1.368 billion by issuing 85 million shares of stock in its initial public offering. Investors subsequently traded over 367 million shares of *Pinterest's* stock valued at \$10.3 billion during the first month after the initial public offering.<sup>1</sup> These investors based their decisions on the financial information provided by *Pinterest*. The capital provided by such investments fuels the overall economy and directs capital to its most productive uses.

Multiple factors in the overall accounting environment influence economic decisions at the firm level. For example, user groups such as investors and creditors impact the demand for accounting information and influence the standard-setting bodies. Financial reporting encompasses much more than the financial statements: Other key elements include the footnotes to the financial statements, the letter to the owners, management's discussion and analysis, the auditors' report, the management report, and press releases. Financial statement users rely on all categories of financial information to make rational economic decisions.

In this chapter, we first define *financial accounting* and discuss the demand and supply of financial information. We identify the economic entities that prepare financial information as well as the users of financial information. We then explore factors that shape accounting information. We also overview the historical development of the U.S. and international standard-setting bodies and discuss the standard-setting processes. We conclude the chapter with a review of recent trends in standard setting. «



Allmy/Shutterstock

<sup>1</sup> Pinterest, Inc. is traded on the New York Stock Exchange. It made its initial public offering April 18, 2019.

- 1 Define financial accounting and describe the demand for financial information, including the role of general-purpose financial statements, the information needs of financial statement users and other parties, and the factors that influence financial reporting.

## Overview of Financial Reporting

**Financial accounting** is the process of identifying, measuring, and communicating financial information about an economic entity to various user groups within the legal, economic, political, and social environment. This definition contains four major elements:

1. Financial information
2. Economic entity
3. User groups
4. Legal, economic, political, and social environment

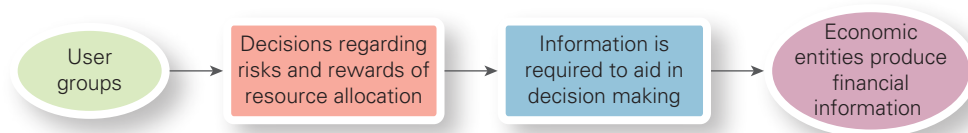
We will examine these elements in the following sections of the chapter. We also discuss how *data analytics* and technology are changing business and affecting the amount of and ability to analyze financial information.

### Financial Information

Financial information falls into two categories: information that is or that is not governed by rules set forth by the accounting standard-setting bodies. Firms prepare the financial statements and the footnotes to the financial statements (also referred to as footnote disclosures) based on accounting standard setters' rules. In contrast, the letter to the owners, management's discussion and analysis, the auditors' report, the management report, and press releases are not governed by the accounting standard-setting bodies, although they are regulated to some degree by other authoritative bodies.<sup>2</sup>

**Demand for Financial Information.** The form, content, and extent that firms provide financial information are based on market participant demand. Financial accounting provides information that enables users to evaluate economic entities and make efficient resource allocation decisions based on the risks and returns of a particular investment. This process directs capital flows to their most productive uses. In this way, the demand for financial information is linked to the allocation of scarce resources, as illustrated in Exhibit 1.1.

#### EXHIBIT 1.1 Demand for Financial Information



Capital is a scarce resource. How do investors and creditors make decisions regarding the amount of capital to invest in a given entity? Accountants report the economic performance and financial position of the firm so that potential debt and equity investors can adequately assess the risks and returns of investing in the entity. Similarly, lenders can use the financial statements to assess the potential for payment. For example, a bank limited in the number of loans that it can make would clearly prefer to lend to a business that has been profitable over the past five years rather than one that has not.

Transparent and complete financial statements aid investors in assessing the amounts and timing of future cash flows as well as the uncertainty of cash flow realization. However, financial statement users should be aware that performance-based compensation can create an incentive for managers to strategically manage—or to misreport—financial statements. Compensating managers based upon reported net income provides a financial incentive to inflate net income. For example, when the management at *Well Fargo & Company's (WFC)* committed accounting

<sup>2</sup>For a discussion of the financial statements and many of these other items, see Chapters 5 and 6.



fraud that increased sales, the Wells Fargo board of directors required two senior executives to pay back to the company \$136 million of compensation received based on the fraudulent accounts.<sup>3</sup> Financial accounting standards seek to limit this type of management behavior. Most managers faithfully report their financial statements, but it is important for standard setters and auditors to be aware of incentives to alter net income.

**Sources of Financial Information.** The financial reporting process generates a significant amount of financial information that yields the four basic financial statements as well as the footnote disclosures. In the chapters that follow, we examine the theory, rationale, and principles underlying the four basic financial statements:

- The balance sheet (also referred to as the statement of financial position)
- The statement of comprehensive income<sup>4</sup>
- The statement of cash flows
- The statement of shareholders' equity

Published financial statements are called **general-purpose financial statements** because they provide information to a wide spectrum of user groups: investors, creditors, financial analysts, customers, employees, competitors, suppliers, unions, and government agencies. Although considered general purpose, most financial information is provided to satisfy users with limited ability or authority to obtain additional information, which includes investors and creditors. The **Financial Accounting Standards Board (FASB)**, which is the body responsible for promulgating U.S. Generally Accepted Accounting Principles (U.S. GAAP), identifies investors, lenders, and other creditors as the primary users of the financial statements.

Financial statements are the culmination of the financial reporting process. These financial statements, along with the accompanying footnote disclosures, are the primary source of publicly available financial information for investors and creditors. None of the other sources of financial information—such as management forecasts, press releases, and regulatory reports—provide as much information as the financial statements.

The term financial information includes more information than the financial statements. The financial statements include the four basic financial statements and the related footnotes. However, financial information also includes items such as:

- A letter to the shareholders
- A formal discussion and analysis of the firm by the management of the firm
- Management report
- Auditors' report
- Financial summary

Therefore, the general-purpose financial statements and the related footnotes are subsets of financial information. The financial statements and the footnotes are governed by U.S. GAAP, which may not always be the case for all components of financial information.<sup>5</sup>

## Economic Entity

The second element in the definition of financial accounting involves the *economic entity* for which the financial statements and other financial information are presented. An **economic entity** is an organization or unit with activities that are separate from those of its owners and other entities. Financial information always relates to a particular economic entity. Economic entities can be corporations, partnerships, sole proprietorships, or governmental organizations. Also, economic

<sup>3</sup>New York Times article, "Wells Fargo to Claw Back \$75 Million From 2 Former Executives," at <https://www.nytimes.com/2017/04/10/business/wells-fargo-pay-executives-accounts-scandal.html>.

<sup>4</sup>Entities may report comprehensive income either in one combined statement or in two statements—the statement of net income and the statement of comprehensive income.

<sup>5</sup>We discuss these other types of financial information more extensively in Chapter 6.

entities may be privately held or publicly held.<sup>6</sup> If the entity is publicly held, then its equity can be bought and sold by external parties on stock exchanges.

The management of a particular economic entity prepares its financial information, including the financial statements. While the management of the entity may also use the financial information to some extent, they are better classified as preparers than users of financial information.<sup>7</sup>

### Financial Statement User Groups

The third element in the financial accounting definition involves identifying the primary user groups that demand financial information. Some users employ accounting information to make economic decisions for their own benefit while other users employ accounting information to make economic decisions for the benefit of others or to assist others in making investment or credit decisions. Exhibit 1.2 lists the user groups.

#### EXHIBIT 1.2 User Groups

Users	Description
Equity Investors	Shareholders of the company
Creditors and Other Debt Investors	Entities including banks and other financial institutions that lend money to the company either through a private agreement or through a public debt offering
Competitors	Companies that produce the same service or product
Financial Analysts	Individuals employed at investment banks, commercial banks, and brokerage houses that use financial information to provide guidance to individuals and other entities in making investment and credit decisions
Employees and Labor Unions	Individuals that work for the company and the organizations that represent the employees' interests
Suppliers and Customers	Organizations that provide the necessary inputs for the products or services produced by the entity and companies or individuals that purchase the goods or services from the entity
Government Agencies	Agencies representing the government that are in charge of reviewing and/or regulating the company

**Equity Investors.** Equity investors are the shareholders of the company. That is, an equity investor purchases a percentage ownership of the company. Equity investors include individuals, other corporations, partnerships, mutual funds, pension plans, and other financial institutions that expect to receive a return on their investment either through dividends (i.e., distributions of cash or other assets to owners) or in the form of an increase in the price of their equity shares.

Equity investors use financial information to determine a company's ability to generate earnings and cash flow as well as to make an assessment of the potential risks and returns of their investments. Equity investors also use financial information to assess the ability of the entity to pay dividends and to grow over time. Firm growth in earnings and cash flow are important for the investor to sell his or her investment at a gain.

<sup>6</sup>In this textbook, we focus primarily on publicly traded entities. We use examples from the financial statements issued by manufacturing, retail, and service entities. We will not focus on financial statements from specialized industries such as insurance, banking, and other regulated industries.

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

**Creditors and Other Debt Investors.** Creditors and other debt investors are entities, including banks and other financial institutions, that lend money to the company. Debt can be either public or privately held. In the case of publicly traded debt, market participants invest in the entity's debt—specifically, the entity's bonds. In the case of privately held debt, companies obtain capital directly from lenders, such as commercial banks. Creditors typically receive a return on their investment in the form of interest income. However, in the case of public debt, they may also receive a return in the form of an increase in the price of the bonds.

Creditors use financial information to determine whether the principal and interest on their loans will likely be paid by debtors when due. Creditors are also concerned with the priority of claims against the assets of the debtor company. Some lenders have priority over others when determining the order of repayment. Finally, creditors can use financial information to assess the entity's current and future profitability and growth prospects.

**Competitors.** Competitors use financial information to determine their market position relative to the reporting entity. Companies analyze a competitor's financial information to identify its strategy and determine if it is possible to successfully compete with the company. An analysis of a competitor's financial information enables a financial statement user to identify that entity's objectives, assumptions, overall business strategy, and capabilities. For example, a pharmaceutical company would be interested in any increases in a rival's research and development expenses that could indicate new and competing products in the future.

**Financial Analysts.** Financial analysts employed at investment banks, commercial banks, and brokerage houses use financial information to provide guidance to individuals and other entities in making investment and credit decisions. Analysts use various techniques to estimate the value of an entity based on information obtained from the annual report and other publicly available information as well as from interviews with company officers and outside industry or economic experts. Some financial analysts are equity analysts who follow an industry or certain companies and provide their opinions or recommendations on a regular basis. These reports result in a recommendation as to whether investors should buy or sell the stock of that company. For example, in the first quarter of 2020, there were 24 analyst recommendations issued for *Pinterest*—11 were buys and outperforms, 13 were holds, and 0 were sells or underperforms.<sup>8</sup> Financial analysts act as market intermediaries in that they are trained to examine an extensive volume of financial data and reduce it to a manageable amount of information for use by investors.

**Employees and Labor Unions.** Employees and labor unions use financial statements to assess the economic performance and liquidity of entities employing members of the union. For example, the United Auto Workers represents employees in the automobile industry. Financial statement information can be useful during the negotiation of new labor agreements and compensation contracts.

**Suppliers and Customers.** Suppliers and customers use financial statements to determine a company's financial position. For suppliers, it is critically important to assess the company's ability to pay for goods and services provided. A company's financial condition indicates the quality of its products and its ability to honor warranties to potential customers. *General Motors (GM)* lost many prospective customers when it was in bankruptcy during the economic crisis of 2008. In this case, auto buyers were concerned that *GM* would not be in business long enough to fulfill its warranty obligation to its customers.

**Government Agencies.** Government agencies review the financial statements of publicly traded companies for a variety of reasons. For example, the U.S. Federal Trade Commission may review publicly available financial information to identify a potential monopoly or an entity in violation of antitrust laws.

<sup>8</sup>See <https://money.cnn.com/quote/forecast/forecast.html?symb=pins>.

## Other Parties Involved in the Preparation and Use of Financial Information

Another important group involved in the financial reporting process is the *preparers* themselves. **Financial statement preparers** are the companies that issue the financial statements.

In addition to preparers and users of the financial statements, other parties involved in the financial reporting process include:

- Auditors
- Accounting standard setters such as the Financial Accounting Standards Board and the *International Accounting Standards Board*
- Regulatory bodies such as the Securities and Exchange Commission and the Public Company Accounting Oversight Board
- Professional organizations such as the American Institute of Certified Public Accountants

Auditors can be *external* or *internal*. **External auditors** are independent of the company and are responsible for ensuring that management prepares and issues financial statements that comply with accounting standards and fairly present the financial position and economic performance of the company. Because external auditors are independent parties, they lend a significant amount of credibility to the financial statements. **Internal auditors** are employees of the company serving in an advisory role to management and providing information regarding the company's operations and proper functioning of its internal controls.

**Accounting standard setters** develop and promulgate accounting concepts, rules, and guidelines that provide information that is relevant and faithfully represents the economic performance and the financial position of the reporting entity. The Financial Accounting Standards Board (FASB), the primary standard setter in the United States, promulgates U.S. GAAP. The **International Accounting Standards Board (IASB)** sets International Financial Reporting Standards (IFRS). We discuss the standard setters' role and the standard-setting process in more depth later in the chapter.

**Regulatory bodies** protect investors and oversee the accounting standard-setting process. In the United States, the U.S. Securities and Exchange Commission (SEC) regulates publicly traded companies.<sup>9</sup> Privately held companies are not required to comply with the SEC's regulations. The SEC gives the FASB the authority to issue U.S. GAAP. In addition, the SEC reviews the filings of public companies in the United States. The Public Company Accounting Oversight Board (PCAOB) sets auditing standards and oversees the audits of public companies in the United States.

Professional organizations such as the *American Institute of Certified Public Accountants (AICPA)* are also involved in the financial reporting process. The **AICPA** is the national professional association for Certified Public Accountants (CPAs) in the United States. The AICPA prepares and grades the Uniform CPA Examination. This organization also supports accounting professionals throughout their careers by providing training, professional skills development, and other resources.

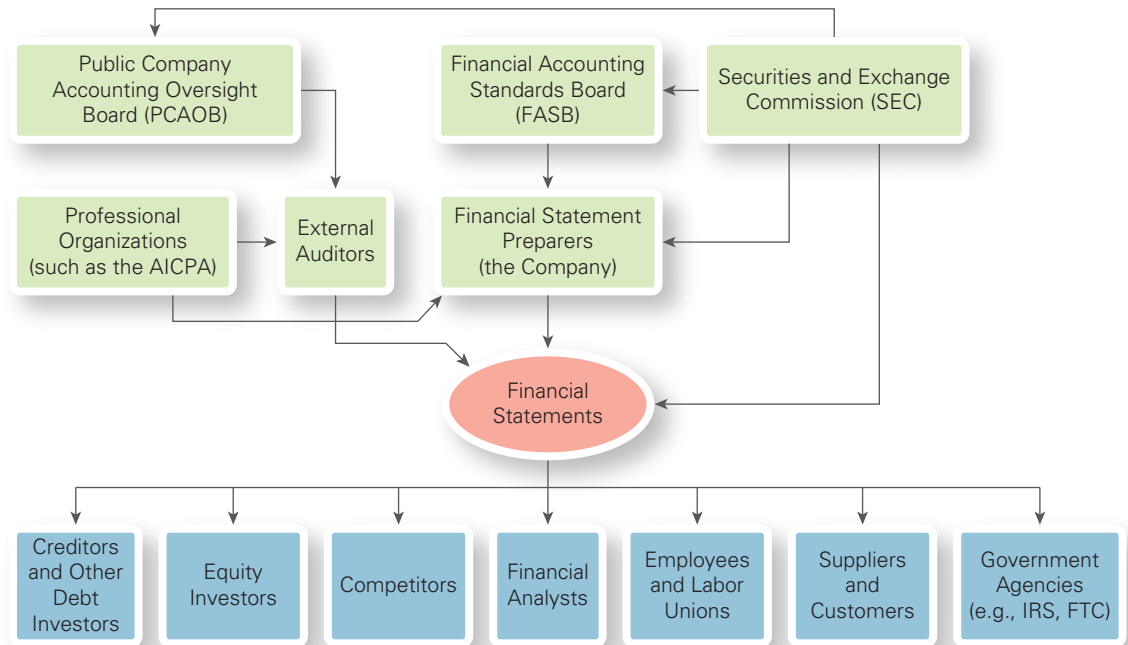
Exhibit 1.3 summarizes the various groups involved in the financial reporting process.

## Legal, Economic, Political, and Social Environment

Financial reporting takes place in a complex and dynamic world: Financial statement users' information needs change as business evolves. So it is natural that environmental factors—legal, economic, political, and social—shape and influence the financial reporting process. The environment is the fourth element of the financial accounting definition. Financial accounting interacts with its environment in both a reactive and a proactive fashion.

**Reactive Factors.** Financial accounting reacts to pressure (lobbying) from various groups and changes in its environment. Accounting theories and procedures evolve to meet the dynamic changes and demands from the environment. For example, FASB made changes in the accounting

<sup>9</sup>A company is regulated by the SEC if it has either debt or equity that is publicly traded.

**EXHIBIT 1.3** Parties Involved in the Financial Reporting Process in the United States

for off-balance sheet subsidiaries following the discovery of the massive fraud scheme at *Enron* in the early 2000s.

In addition, accounting conforms to economic conditions, legal standards, and social values. Today, accounting disclosures highlight a company's policies regarding pollution control, community service, and diversity in business. For example, in *Johnson & Johnson's* 2018 annual report, the company highlighted its responsibility not only to its shareholders but also to the "communities in which we live and work," as shown in Exhibit 1.4.

**EXHIBIT 1.4** *Johnson & Johnson Company's* 2018 Excerpt from "Our Credo"

We are responsible to the communities in which we live and work and to the world community as well. We must help people be healthier by supporting better access and care in more places around the world. We must be good citizens—support good works and charities, better health and education, and bear our fair share of taxes. We must maintain in good order the property we are privileged to use, protecting the environment and natural resources.

**Source:** Annual Report, 2018 Johnson & Johnson.

The development of accounting standards is also a political process that is heavily influenced by the various groups within the reporting environment. Lobby groups include investors, creditors, financial analysts, the financial community, academics, accounting organizations, and industry associations.

**Proactive Factors.** Financial accounting is proactive in that it can change or influence its environment by providing feedback information that is used by organizations and individuals to reshape the economy. Accounting information is used to efficiently allocate resources throughout the economy by directing capital flows to their most productive uses. For example, start-up capital is needed to develop new technology such as solar power and electric vehicles.

Accounting standards can also influence managerial behavior. For example, expensing research and development costs may slow investment in research during economic downturns because this accounting treatment results in lower earnings figures.



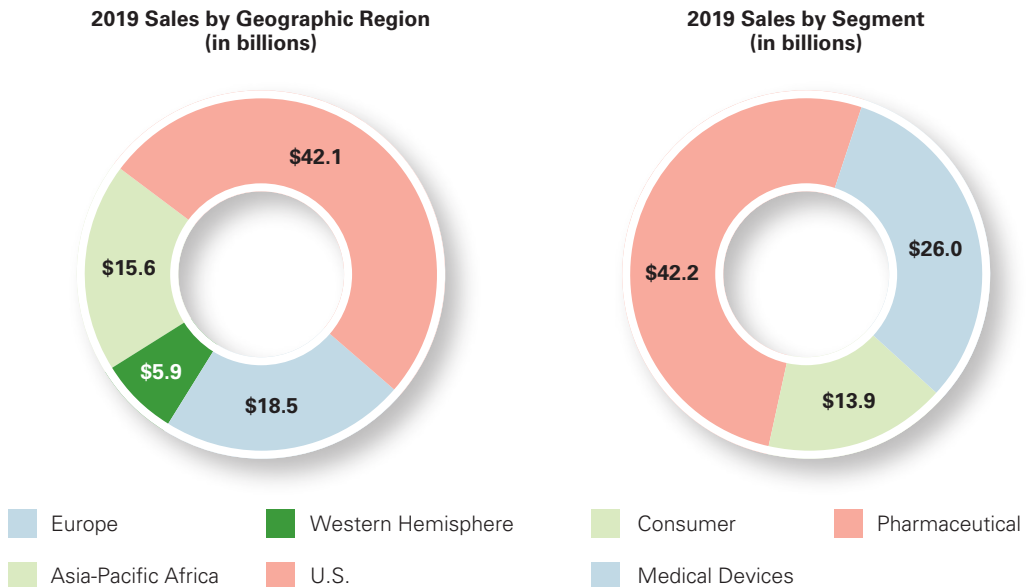
## Data Analytics and Technology Innovation

*Data analytics* and technology innovation are changing the business world. We are producing an extensive amount of data every day. Now, due to technological improvements, we have the ability to capture that data and use it to make business decisions. Analysis of this data, especially accounting data, can provide powerful business insights to increase the efficiency and effectiveness of our business world.

**Data analytics** is the process of analyzing large data sets in order to draw useful conclusions. It involves converting raw data into useful knowledge. Data analytics is playing an increasingly important role in the accounting profession. In financial reporting, we can use data analytics to improve the quality of our estimates and valuations. Auditors are using it to increase the quality and accuracy of the audit. Tax professionals are using it to provide more sophisticated tax planning advice.

Because of the importance of data analytics in the accounting profession, we include assignments in certain chapters to help you become more proficient in this skill. These assignments emphasize addressing relevant accounting questions, analyzing data using appropriate techniques, and interpreting and communicating results. For example, *Johnson & Johnson* presents graphs of its 2019 sales by both region and operating segment in its annual 10-K report, which assists readers in visualizing the extent of its sales by region and segment, as shown in Exhibit 1.5.

**EXHIBIT 1.5** *Johnson & Johnson Company* 2019 Sales by Geographic Region and Segment



**Source:** Johnson & Johnson's 2019 10-K at <https://www.sec.gov/ix?doc=/Archives/edgar/data/200406/000020040620000010/form10-k20191229.htm>.

- ② Discuss the role of financial accounting standard setters in the United States and internationally.

## Role of Standard Setters

Standard setters work diligently to develop concepts, rules, and guidelines for financial reporting that will satisfy the requirement to accurately present the economic performance and financial position of the firm. These standards are designed to encourage transparent and truthful reporting. Publicly traded entities must follow the rules and guidelines set forth by the standard setters to maintain public trust and to ensure the efficient functioning of capital markets. The FASB promulgates accounting standards in the United States, and the IASB issues global accounting standards, called International Financial Reporting Standards (IFRS).

## The Importance of Understanding International Accounting Standards

Although U.S. GAAP and IFRS are converged in many areas, some differences still remain. Throughout the text, we present the U.S. GAAP standards in detail and highlight pertinent differences

with IFRS. Why is it important for an accountant in the United States to learn international accounting standards? There are several reasons:

- U.S. companies operate subsidiaries outside of the United States. Many of these subsidiaries report under IFRS in their home countries. Accountants must convert the subsidiaries' financial statements to U.S. GAAP when preparing consolidated financial statements. For example, *Johnson & Johnson* operates in over 60 countries throughout the world.
- Non-U.S. companies operate in the United States and prepare their financial statements using IFRS. Consequently, if you are working at or auditing an international firm, you will likely see IFRS. For example, *GlaxoSmithKline* is a worldwide pharmaceutical company based in the United Kingdom with 15% of its employees in the United States and a U.S. headquarters in Philadelphia.
- The SEC permits the use of IFRS-based financial statements by international companies with shares trading on U.S. stock exchanges.<sup>10</sup> U.S. accountants and auditors often assist these non-U.S. companies in preparing U.S. regulatory reports. As of September 2016, these companies represented a worldwide market capitalization in excess of \$7 trillion across more than 500 companies.<sup>11</sup>
- The SEC promotes high-quality, globally accepted accounting standards. U.S. accountants and auditors need a working knowledge of IFRS to implement global standards in companies and perform audits.
- Many U.S. accountants now spend time working outside of the United States. IFRS is required or permitted in 144 countries worldwide.
- The accounting profession has determined that a working knowledge of IFRS is important for today's accountant. For example, the American Institute of Certified Public Accountants tests IFRS on the CPA exam.

To ensure that you are prepared to meet these challenges, we address both U.S. GAAP and IFRS in this text. We introduce accounting practices in the United States first. We then compare U.S. GAAP to IFRS in sections with green headings, focusing on similarities and differences. Where there are differences, we cover IFRS at the same level of detail as used for U.S. GAAP.

### 3 Detail the standard-setting process.

## The Standard-Setting Process

We previously established that the FASB sets accounting standards in the United States and the IASB sets global accounting standards. The standard-setting processes are similar for the two Boards but there are some important differences that we will highlight.

### Standard Setting

We begin with the history of U.S. standard setting, the structure of the standard-setting body, and the process of standard setting.

**History of Standard Setting.** U.S. financial reporting standard setting began with the 1934 Securities Exchange Act, which gave the SEC the power to promulgate accounting standards for all publicly traded firms. The SEC delegated its standard-setting power to the private sector, prompting the accounting profession to establish the first U.S. standard-setting board. The Committee on Accounting Procedures (CAP) was formed in 1939 as a subcommittee of the American Institute of Certified Public Accountants (AICPA) to reduce the number of accounting methods used in practice. Prior to the formation of the CAP, there were significant inconsistencies in the form and content of financial statements. For example, some companies would provide only a balance sheet while others would report only an income statement. During its tenure, the CAP produced 51 standards, referred to as Accounting Research Bulletins (ARBs or Bulletins).

<sup>10</sup>The SEC eliminated the requirement that foreign issuers reconcile their financial statements from IFRS (or other accounting standards) to U.S. GAAP in 2007. To be clear, U.S. companies may not use IFRS in their financial statements. U.S. GAAP is required for U.S. companies.

<sup>11</sup>See <https://www.sec.gov/news/statement/white-2016-01-05.html>.

The CAP accomplished its goal of reducing accounting alternatives and was replaced in 1959 by the Accounting Principles Board (APB). The APB, another subcommittee of the AICPA, issued pronouncements known as Opinions and Statements. The APB's primary objective was to respond to existing and emerging problems in financial reporting. The APB issued 31 APB Opinions and four APB Statements.

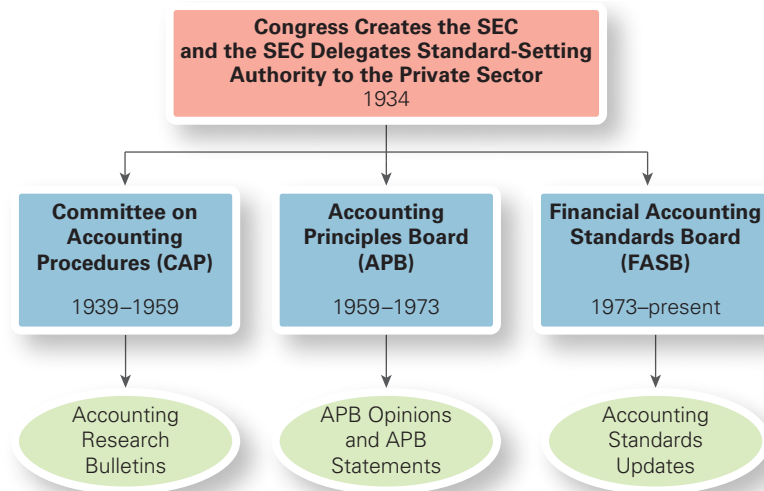
The APB was criticized for being slow to develop accounting standards and inactive on several controversial issues. The part-time board members were all CPAs still affiliated with their employers. As a result, board members were not viewed as independent. Further, the APB did not develop standards in anticipation of changes in the accounting environment. Rather, the Board simply responded to long-existing, controversial accounting issues. Due to these criticisms, the Financial Accounting Standards Board (FASB) replaced the APB in 1973.

The FASB is a more independent board than the APB. The seven members employed as full-time board members must sever all relationships with outside entities. In addition, board members of the FASB do not have to be accountants or CPAs—the members can join the board from industry, education, and public service. Members on the board have represented a broad range of constituencies, including members from the corporate world, the accounting profession, the investment community, government, and academia. The FASB is not a subcommittee of the AICPA and is not affiliated with any professional organization.

The FASB currently issues Accounting Standards Updates (ASUs) as part of the *Accounting Standards Codification* (ASC).<sup>12</sup> The **Accounting Standards Codification** (often referred to as the Codification) is the single source of GAAP in the United States and includes all pronouncements issued by any of the standard-setting bodies that have not been superseded.<sup>13</sup>

Exhibit 1.6 presents the history of U.S. standard setting as well as pronouncements issued by each group.

**EXHIBIT 1.6** History of Accounting Standard Setting in the United States

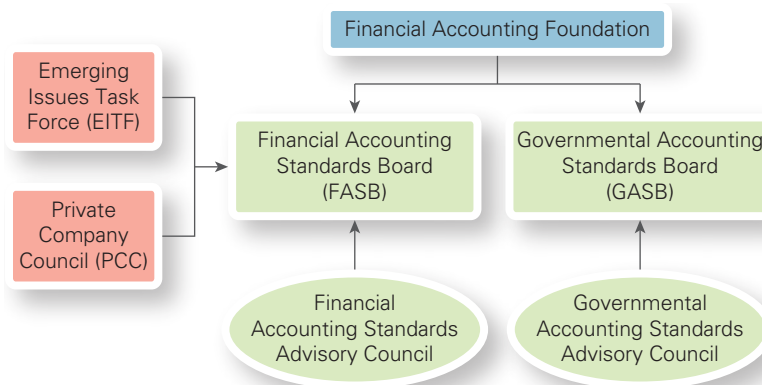


**The Standard-Setting Structure.** As illustrated by Exhibit 1.7, the FASB is part of a larger organizational structure that also includes the

- Financial Accounting Foundation (FAF)
- Governmental Accounting Standards Board (GASB)
- Financial Accounting Standards Advisory Council (FASAC)
- Governmental Accounting Standards Advisory Council (GASAC)
- Emerging Issues Task Force (EITF)
- Private Company Council (PCC)

<sup>12</sup>The primary pronouncements of the FASB were originally called Statements of Financial Accounting Standards (SFAS).

<sup>13</sup>We discuss the Codification in depth in Chapter 3.

**EXHIBIT 1.7** Standard-Setting Organizational Structure in the United States

The FAF is responsible for the oversight, administration, and finances of the FASB. The FAF obtains funds primarily through the Public Company Accounting Oversight Board (PCAOB), which assesses charges known as accounting support fees against issuers of equity securities based on their market capitalization.<sup>14</sup> Other sources of funds include publications, subscriptions, and contributions from state and local governments for the GASB.

The GASB sets standards for state and local governmental units. The FASAC exists to advise FASB on technical issues and the GASAC serves as an advisory board to the GASB.

The EITF was formed in 1984 to assist the FASB by addressing issues that are not as broad in scope as those found on the FASB's agenda. For example, EITF agenda items often include industry-specific issues. The EITF is made up of 13 representatives, including preparers, auditors, and financial statement users. The group reaches an EITF Consensus when three or fewer members object to a proposed position that has been exposed for public comment. Although the FASB members do not vote on the consensus at the EITF meetings, all consensus decisions must be approved by a majority of the FASB members before they become a part of U.S. GAAP.

In 2012, the PCC was established to set accounting standards for U.S. private companies. Before this time, if a private company was required to present financial information according to U.S. GAAP, it followed the same rules as public companies with minor exceptions. Now the PCC is responsible for determining whether modifications to existing U.S. GAAP standards are warranted for private companies, and, if so, it has the responsibility of developing, deliberating, and voting on these modifications. However, the FASB retains the authority to make the final decision as to incorporating these changes into U.S. GAAP for private companies.

**Standard-Setting Process.** FASB follows a seven-step process to issue a final standard.<sup>15</sup>

**Step 1: Identification of an issue.** FASB identifies a financial reporting issue based on recommendations from analysts, government agencies, or other market participants.

**Step 2: Decision to pursue.** After consultation with FASB members and others as appropriate, the FASB chairperson decides whether to add the issue to the technical agenda.

**Step 3: Public meetings.** Once added to the technical agenda, the Board holds public meetings where it deliberates the various issues identified by the FASB staff.

**Step 4: Exposure Draft.** The Board issues an Exposure Draft (ED), which is intended to solicit input from financial statement preparers, auditors, and users of the financial statements.<sup>16</sup>

<sup>14</sup> Market capitalization is the total value of a company's equity shares. It is equal to the market price per share multiplied by the total number of equity shares outstanding.

<sup>15</sup> See <http://www.fasb.org/cs/ContentServer?site=FASB&c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176157307939>.

<sup>16</sup> The Board may also issue a Discussion Paper to obtain input earlier in the project.

**Step 5: Public roundtables.** The Board may hold public roundtables to discuss the ED, if needed.

**Step 6: Redeliberation.** The FASB staff analyzes the comment letters received from preparers, financial statement users and auditors, public roundtable discussions, and any other information. The Board then redeliberates the issue.

**Step 7: Publication of the final standard.** The Board issues an Accounting Standards Update (ASU), which is the final standard. It requires a majority vote of the Board to issue a new standard. The ASU will then be incorporated into the body of the Accounting Standards Codification that makes up U.S. GAAP.

## IFRS Standard Setting

We will now discuss the history of global standard setting, the structure of the standard-setting body, and the process for global standard setting.

### History of Global Standard Setting: IFRS

Until recently, most countries established their own accounting standards. For instance, France, Germany, and Australia each had its own GAAP. The GAAP of each nation varied due to the country's specific needs for accounting information. Factors such as the country's sources of capital, its culture, its tax laws, or other regulations influenced the development of its accounting standards. Given almost 200 countries in the world and almost as many sets of different GAAP standards, global investors and creditors struggled to compare accounting standards when analyzing companies and making investment and credit decisions.

Recognizing the need for comparable accounting information internationally, the professional accounting organizations from 10 countries formed the International Accounting Standards Committee (IASC) in 1973.<sup>17</sup> At that time, the IASC consisted of up to 16 part-time volunteer members setting International Accounting Standards (IAS). Companies in each country could adopt IAS on a voluntary basis. However, the IASC was criticized for allowing highly flexible accounting standards. As a result, most major developed countries continued to require the use of their own standards.

As global business relationships continued to grow, the need for a comparable and rigorous international set of accounting standards became apparent. In the 1990s, the IASC initiated an improvement project to develop a cohesive and uniform set of "core accounting standards" to meet the needs of investors in cross-border offerings and exchange listings. Shortly after this improvement project was completed, the International Organization of Securities Commissions (IOSCO) endorsed IAS for use in cross-border stock offerings and listings, allowing companies to report under IAS within their jurisdictions and on their exchanges.

Around the same time, the IASC began to recognize the limitations in its existing organizational structure. As a result, the International Accounting Standards Board (IASB) replaced the IASC in 2001. The IASB now promulgates standards called International Financial Reporting Standards (IFRS).

The IASB also developed a set of accounting standards to address the needs of private companies, called IFRS for small- and medium-sized entities (IFRS for SMEs). IFRS for SMEs is based on IFRS but eliminates certain costly reporting requirements that are designed to provide information to external financial statement users. IFRS for SMEs was developed because some countries require all public and private companies to prepare financial statements under IFRS. These countries can then allow private companies the option to use the less costly IFRS for SMEs.

---

<sup>17</sup> The original 10 countries were Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland, and the United States. Other countries subsequently joined the committee.



## Interview

**DANIEL J. NOLL,**  
**DIRECTOR, AICPA »**



Daniel J. Noll

*Daniel J. Noll, director of Accounting Standards at the American Institute of Certified Public Accountants, works with the Financial Reporting Executive Committee to develop AICPA positions on financial reporting matters. He also provides external financial reporting guidance and leads the AICPA's private company financial reporting efforts.*

- 1** What is the role of effective financial reporting in enabling financial statement users to make rational economic decisions?

For users—the ultimate customers of financial reporting—financial statements are a critical information source for investing and lending decisions. Imagine you are the sole owner of the Bank of Your Town and are considering whether to loan money to a local business. Before parting with your cash, you would ask questions such as: How does the business's profit and cash flow look? Are the numbers the business provided trustworthy and developed using accounting practices consistent with how other businesses in the same industry report?

Useful and reliable financial statements allow investors and lenders to make smart capital allocation decisions. The notion of “efficient and effective” allocation of capital helps drive capitalist economies and societies to greater standards of living. An inefficient and wasteful allocation would reward poorly run entities until they ultimately flounder or go bust. Consequently, funding would not be available for well-run businesses that could grow, employ people, and improve their communities.

- 2** What is AICPA's general role in the accounting environment and the standard-setting process?

The AICPA is the world's largest member association representing the CPA profession, with more than 418,000 members in 143 countries, and a history of serving the public interest since 1887. AICPA members represent many areas of practice, including business and industry, public practice, government,

education, and consulting. Student membership is free. The AICPA sets ethical standards for the profession and U.S. auditing standards for private companies; nonprofit organizations; and federal, state, and local governments. It develops and grades the Uniform CPA Examination, offers specialized credentials, builds the pipeline of future talent, and drives professional competency development to advance the vitality, relevance, and quality of the profession. The AICPA's Financial Reporting Executive Committee (FinREC) serves as the official voice on all GAAP matters, advocating for sound external financial reporting practices related to private and public companies, not-for-profit entities, and employee benefit plans.

- 3** What is AICPA's role in improving the effectiveness of financial reporting?

The AICPA routinely interacts with regulators, standard setters, and all participants in the financial reporting process to identify and solve issues and contribute to policy development. AICPA is not an accounting standard setter; rather, it identifies issues needing authoritative FASB resolution or weighs in publicly on what good accounting practices might be under various circumstances.

- 4** What are the key areas in which accounting professionals and financial statement users look to the AICPA for guidance?

The key areas related to GAAP as set by FASB are:

- 1.** The AICPA's industry accounting and audit guides, although not GAAP, are often viewed as a bible for their particular industry. We help professionals understand and apply accounting standards to unique or significant transactions within their industries.
- 2.** The AICPA's accounting and valuation guides, also not GAAP, help bridge any language barriers between accounting/auditing staff and valuation specialists when tackling complex fair value measurements.
- 3.** The AICPA issued revenue recognition accounting guidance based on FASB's newly effective standard that replaced the prior industry-specific GAAP. Our new accounting guide helps upwards of 16 industries understand and apply the newly effective standard to their particular circumstances. Because every entity has revenue, and professionals have been challenged for many years to determine when to recognize it, companies, auditors, and regulators will give this standard front and center attention for many years to come.

### Discussion Questions

- 1.** Discuss the role that the AICPA will play in your accounting career as a student and when you join the profession.
- 2.** How would you characterize the current relationship between the FASB and the AICPA?

Exhibit 1.8 presents the history of international accounting standard setting.

**EXHIBIT 1.8** History of International Accounting Standard Setting



**The Global Standard-Setting Structure: IFRS**

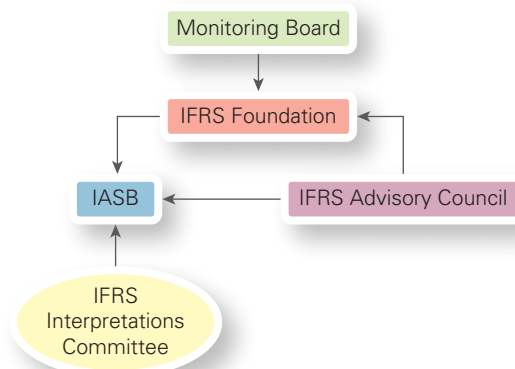
As illustrated by Exhibit 1.9, the IASB is part of a larger organizational structure that also includes:

- The IFRS Foundation
- The Monitoring Board
- The IFRS Advisory Council
- The IFRS Interpretations Committee

The IFRS Foundation oversees the IASB and is responsible for financing the IASB's operations. Unlike funding for the FASB, the IASB relies on contributions from companies and other parties that have an interest in promoting international accounting standards. The Monitoring Board was formed in 2009 to enhance the public accountability of the IFRS Foundation while still allowing for independence in the standard-setting process.

The Monitoring Board oversees the IFRS Foundation, participates in nominating individuals to serve as foundation trustees, and approves appointments. The IFRS Advisory Council advises the IASB and the IFRS Foundation on many issues, including the IASB's agenda and the

**EXHIBIT 1.9** International Accounting Organizational Structure



implementation of standards. The IFRS Interpretations Committee is the interpretative body of the IASB, similar to the EITF in the United States.

The IASB is composed of 14 members who are appointed by the IFRS Foundation's board of trustees. At least 11 members serve full time, and no more than 3 can be part-time members. To ensure broad and diverse international representation, the IASB is composed of:

- Four members from the Asia/Oceania region
- Four members from Europe
- Four members from the Americas
- One member from Africa
- One member appointed from any area, subject to maintaining overall geographical balance

The IFRS Interpretations Committee (IFRSIC) develops interpretations of standards that must be approved by the IASB. Whenever the need arises, the IFRS Interpretations Committee forms working groups, which are task forces for individual agenda projects. The IASB will also normally form working groups or other types of specialized advisory groups to advise on major projects; an example is the Emerging Economies Group.

## Standard-Setting Process: IFRS

The IASB follows a similar process to the FASB's standard-setting process, so we discuss it only briefly here.

When a topic is identified, the Board considers the nature of the issues, seeks input from its constituents, and prepares an exposure draft. After receiving comments on the exposure draft, the IASB may modify the proposed standard before approving a final standard.

Unlike the FASB, the IASB is required to carry out a post-implementation review of each new standard or significant change to an existing standard. The review focuses on controversial issues identified during the development stage, unexpected costs, and implementation problems. This review is normally carried out up to two years after the new standard has been in effect.

## Standard Setting as a Political Process

The issuance of new standards and changes in existing standards can have significant effects on an entity's reported net income. In turn, these income effects impact the flow of capital throughout the economy.

At the company level, managers have incentives to oppose changes in standards or new standards that reduce their company's reported net earnings. On the financial statement user level, a new standard or a change in existing standards should provide better and more transparent financial information that will assist users in making more effective investment and credit decisions.

Standard setters address the concerns of both the managers and financial statement users by employing the standard-setting processes we described in the previous section. These processes rely on the information gathered and opinions of users, managers, and auditors along with comments obtained from responses to exposure drafts and public roundtables. The standard-setting bodies analyze this information to gauge the economic consequences of the proposed standard and to assess the improvements in the quality of the financial information disseminated to the market. Standard setters address this trade-off between the income effects and the value of financial information, reaching a balance before issuing the final standard.

- 4** Explain three recent trends in standard setting: principles-based, rules-based, and objectives-oriented standards; the asset/liability approach; and fair value measurements.

## Trends in Standard Setting

We now turn to an introduction of three current trends in standard setting that we will explore further in later chapters:

- A move toward a less *rules-based* (or a more *principles-based*) system as found in International Financial Reporting Standards
- A move toward standards that are focused on the *asset/liability approach*
- A move toward measuring balance sheet items at *fair value* rather than historical cost

## Rules- versus Principles-Based Standards

Both the U.S. GAAP and IFRS systems of accounting standards are based on principles and rules. A **principles-based standard** relies on theories, concepts, and principles of accounting that are linked to a well-developed theoretical framework. A **rules-based standard** contains specific, prescriptive procedures rather than relying on a consistent theoretical framework. For example, assume your parents tell you that you must maintain a GPA of at least 3.0 to receive a car at graduation. This is a rules-based standard. Now assume your parents tell you they will buy you a new car at graduation if you do well in school. This is an example of a principles-based standard. The SEC uses the term **objectives-oriented standard** to refer to a standard that is somewhere between a pure principles-based standard and a pure rules-based standard.<sup>18</sup>

**Principles-Based Standards.** Pure principles-based standards exhibit the following characteristics:

- Provide a clear discussion of the accounting objective related to the standard.
- Involve few, if any, exceptions.
- Involve no tests (referred to as **bright-line tests**) that require meeting a pre-established numerical threshold.<sup>19</sup>
- Provide insufficient guidance to implement the standard.
- Involve a significant amount of interpretation in application.

With pure principles-based standards, comparability across entities is often lost due to the extensive amount of preparer judgment required. In addition, preparers and auditors worry that regulators will not support the judgment used when reporting under a principles-based system, even judgments made honestly without intent to bias. Finally, the lack of application guidance can make it difficult to enforce principles-based reporting requirements in practice.

**Rules-Based Standards.** Unlike principles-based standards, rules-based standards may not relate to a consistent theoretical framework. In addition, pure rules-based standards:

- Contain numerous exceptions to the types of firms and industries that are covered by the standard.
- Contain numerous bright-line tests.
- Result in inconsistencies between standards.
- Contain detailed application guidance.
- Do not rely on extensive use of professional judgment.

As is the case with pure principles-based standards, pure rules-based standards also result in implementation problems. At times, reporting entities may circumvent rules and are therefore able to override the intent of the standard. A system of rules-based standards is difficult to interpret from a user perspective. Rules-based standards tend to result in an environment where financial reporting is viewed as an act of compliance rather than a process of disseminating transparent financial information to investors and creditors.

**Objectives-Oriented Standards.** An SEC report studying rules-based and principles-based standard setting indicated that an objectives-oriented standard is optimal.<sup>20</sup> Similar to principles-based standards, objectives-oriented standards are derived from and are consistent with a

<sup>18</sup> See Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, U.S. Securities and Exchange Commission, July 2003 for a thorough discussion of principles and rules-based standards. The full text of the study is available at <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

<sup>19</sup> For example, a rule specifying that a material item is 10% or more of net income is a bright-line test.

<sup>20</sup> Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, U.S. Securities and Exchange Commission, July 2003.

high-quality theoretical framework and clearly stated accounting objectives. However, objectives-oriented standards include a sufficient level of rules to provide detail and structure, resulting in the consistent application of accounting standards across entities and across time. An objectives-oriented standard would minimize exceptions to a particular standard and reduce the number of bright-line tests used in its implementation. Many of the existing standards in both U.S. GAAP and IFRS qualify as objectives-oriented standards.

**U.S. GAAP and IFRS: Rules versus Principles.** Neither U.S. GAAP nor IFRS fits perfectly into a rules- or principles-based approach. The greatest difference between the two standards is that U.S. GAAP contains many more rules than does IFRS.<sup>21</sup> Although U.S. GAAP includes more rules than IFRS, it is not purely rules based. Similarly, IFRS is not purely principles based. Both U.S. GAAP and IFRS base standards on their respective *conceptual frameworks*, which we discuss in more detail in Chapter 2. Exhibit 1.10 shows the placement of U.S. GAAP and IFRS standards on the rules-based and principles-based continuum.

**EXHIBIT 1.10** Rules versus Principles



### Asset/Liability Approach

The next trend relates to the interrelationship between the balance sheet and income statement. When a firm reports an event on the income statement, the transaction typically also changes a balance sheet account. For example, if a firm reports revenue, it also increases the balance in accounts receivable or cash.

Although the two financial statements are interrelated, which set of accounts is dominant—the revenues and expenses on the income statement or assets and liabilities on the balance sheet? For example, in a typical sales transaction, an accountant will increase accounts receivable and revenue. But how does the accountant decide whether to record the transaction?

1. Recording based on revenue recognition criteria involves an **income statement approach**.
2. Basing the decision on whether an economic resource is received and it meets the definition of an asset, such as accounts receivable, is an **asset/liability (balance sheet) approach**.

In FASB's early years, it tended to focus on an income statement approach. However, in recent years, it has shifted to the asset/liability approach.<sup>22</sup>

### Fair Value Measurements

Another trend in standard setting is the movement toward the use of *fair value* measurements as a viable alternative to historical cost. **Fair value** is the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties.<sup>23</sup> Twenty years ago, firms reported very few items on the balance sheet at fair value. Today, firms use fair values to measure some balance sheet accounts. For example, firms must report some investments in equity securities that have a readily determinable fair value and some investments in debt at fair value, as opposed to historical cost. We discuss fair value measurements more extensively in Chapter 2.

<sup>21</sup> It is likely that the considerable number of rules in U.S. GAAP were written in an attempt to protect preparers and auditors from potential, excessive litigation in the U.S. reporting environment.

<sup>22</sup> FASB ASC 740, *Income Taxes*, provides an example of the trend toward the use of the asset/liability approach. Prior to this standard, the profession employed an income statement approach when accounting for income taxes but now uses a balance sheet approach.

<sup>23</sup> See FASB ASC—Master Glossary.