

MOSICH

INTERMEDIATE ACCOUNTING

REVISED
SIXTH
EDITION

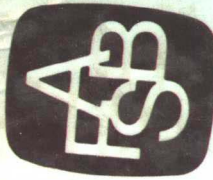


ACCOUNTING STANDARDS

Statements of Financial Accounting Concepts 1-5



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ACCOUNTING STANDARDS **Current**
GENERAL

REVISED SIXTH EDITION

Intermediate Accounting

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Intermediate Accounting

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Preface

The revised sixth edition of *Intermediate Accounting* is designed for use in an intermediate-level financial accounting course following the introductory course in financial accounting. The book may be used in a two-semester or a three-semester course, or in a single course at the graduate level. The emphasis throughout is on underlying concepts and on analysis of the problems that arise in the application of the concepts to financial accounting. Appropriate attention is given to the use of accounting information as a basis for decisions by management, stockholders, creditors, and other users of financial statements.

The revised sixth edition reflects the dramatic changes that have been occurring in the development and application of accounting principles, with special attention to the pronouncements and exposure drafts of the Financial Accounting Standards Board and the Securities and Exchange Commission. In particular, the new FASB requirements in the areas of accounting for income taxes, statement of cash flows, and accounting for the effects of price change have been incorporated.

Features of This Edition

Four chapters have been significantly updated to include relevant pronouncements by accounting rule-making bodies. These pronouncements have been incorporated in this new edition in a manner that we consider pedagogically sound. Discussion of the economic consequences of new accounting principles has been expanded, and many illustrations have been added or strengthened.

For the sixth edition we prepared a new chapter, "Revenue and Expense Rec-

ognition; Income Measurement and Reporting,” following the introductory chapters on accounting principles and information processing. We consider the concepts involved in the recognition of revenue and expenses (including gains and losses) as providing a useful foundation for much of the discussion in subsequent chapters dealing with the measurement of assets and liabilities. Because we place this new chapter early in the text (Chapter 3), our illustrations of revenue recognition situations are designed to cover the important concepts without unnecessary complexities. In this new chapter we cover revenue and expense recognition issues for service industries as well as for trading and manufacturing enterprises. Because revenue and expenses are the primary determinants of net income, we conclude with a discussion of income measurement concepts and special problems accountants face in the reporting of income.

The subject matter in Chapter 3 made it possible for us to present the discussion of financial statements in a single chapter (Chapter 4), thus maintaining this edition at 25 chapters. Chapter 4 also includes a section on “Additional Disclosures,” with special emphasis on reports filed with the Securities and Exchange Commission and annual reports issued to shareholders by publicly owned corporations.

Many additional topics have been incorporated in this edition. These include, for example, a discussion of standards overload, “Big GAAP,” and “Little GAAP”; double-extension and link-chain techniques for estimating inventories under dollar-value LIFO; depreciation for income tax purposes under the Accelerated Cost Recovery System (ACRS); unrealized intercompany profits in the application of the equity method of accounting for investments in equity securities; zero-coupon and deep-discount bonds; extinguishment of bonds through debt-equity swaps and in-substance defeasance; induced conversion of convertible debt (*FASB Statement No. 84*); contingent stock warrants issued to customers and junior stock issued to employees; effective yield test for determining common stock equivalency of convertible securities (*FASB Statement No. 85*); reporting a change in the reporting entity as a result of pooling-type business combinations; and the statement of changes in financial position on the cash concept that highlights operating, investing, and financing activities.

The financial section of the annual report of Walt Disney Productions is included in an Appendix at the end of Chapter 4, and reference is made to it in many of the subsequent chapters. The tables of present values and future amounts are included in an Appendix at the end of Chapter 5.

This edition also features innovative use of color to facilitate the learning process. The number of exercises and problems has been expanded significantly in many of the chapters. We have made a strong effort to cover all new topics added in the revised sixth edition in the questions, exercises, cases, and problems. The first exercise in each chapter consists of a series of multiple-choice questions, many adapted from recent Uniform CPA Examinations.

Organization of Subject Matter

We have organized the book in six parts to give focus to the subject matter and to provide a psychological benefit to students by making the contents more digestible. This arrangement should facilitate for instructors the planning and presentation of

the subject matter and make it easier for students to learn and retain the concepts and procedures presented. A description of the contents of the six parts follows.

Part 1: Basic Concepts and Financial Statements (Chapters 1–5). The first part includes an overview of accounting principles and professional practice, a concise summary of the accounting process, recognition of revenue and expenses, financial statements and additional disclosures, and the application of present and future value concepts to financial accounting measurements. Chapter 1 places in perspective the development and application of accounting principles. The student is introduced to the issue of “standards overload” and to the debate between supporters of a single body of accounting standards and the advocates of “Little GAAP” and “Big GAAP.” Increased emphasis is given to the objectives of financial statements, to the conceptual framework project of the FASB, to the economic consequences of accounting principles, and to the role of the SEC in stressing timely and relevant disclosure and in protecting investors. The review of basic data-collecting processes in Chapter 2 reinforces the student’s understanding of fundamental recording, classifying, and summarizing procedures. This chapter includes a new section on the type of analysis required for the preparation of correcting entries. The background developed in the first two chapters leads to a consideration in Chapter 3 of the revenue and expense recognition principles on which income measurement is based. Special problems in income reporting also are included in this chapter; financial statements and additional disclosures are covered in Chapter 4.

The discussion in these early chapters (and throughout the book) is not limited to a description of acceptable practices. We believe it is important at this stage in accounting education to encourage students to evaluate accounting principles critically and to make them aware of the conflicts and shortcomings that exist in the traditional structure of accounting theory. At the same time, it is important to provide students with an analytical foundation for making this evaluation and to stress that many controversial areas in financial accounting frequently revolve around the economic consequences of accounting principles. To this end, the critical evaluation of accounting concepts is correlated with the *Statements* of the Financial Accounting Standards Board, the *Opinions* and *Statements* of the Accounting Principles Board, and the *Financial Reporting Releases* and *Staff Accounting Bulletins* of the Securities and Exchange Commission.

The first four chapters of the book constitute an overview of the accounting process and financial statements and are designed to provide a gradual transition from the introductory course in financial accounting to the more rigorous level of analysis in subsequent chapters of this book.

The final chapter in Part 1 addresses the concepts of present and future values of cash flows. The early introduction of this material enables us to make appropriate use of present and future value concepts for receivables and liabilities, for the acquisition of plant assets, for investments in bonds and promissory notes, for amortization of bond discount and premium, and for pension plans and leases.

Part 2: Working Capital (Chapters 6–10). The second part of the book addresses the accounting for cash and short-term investments, receivables, inventories, current liabilities, and contingencies. The discussion and illustrations of accounting for investments in short-term securities have been expanded and made

more efficient. The components of electronic banking are described with the purpose of introducing students to computer-induced changes in handling cash transactions.

The section on the use of receivables to accelerate cash inflows has been expanded and updated to conform to the requirements of *FASB Statement No. 77*, "Reporting by Transferors for Transfers of Receivables with Recourse." The discussion and illustrations of accounting for notes receivable have been extensively revised.

The two chapters on inventories have been expanded and updated. For example, the double-extension and link-chain techniques of applying the dollar-value LIFO method have been added, and the section on accounting for construction-type contracts has been rewritten. Included is a discussion of input and output measures of degree of performance on contracts and an evaluation of accounting practices for construction-type contracts. Accounting for contingencies, notes payable, and other current liabilities has been reorganized and improved, and a new tabular summary of different types of contingencies has been provided.

Part 3: Long-Term Assets and Liabilities (Chapters 11–15). This part includes chapters on plant assets and depreciation, intangible assets, long-term investments, and long-term liabilities. New material is included relative to accelerated depreciation computations and the use of ACRS for income tax purposes. Coverage of natural resources and depletion has been expanded to include a discussion of the successful efforts and full cost methods of accounting by oil and gas enterprises.

The chapter on long-term investments includes an expanded treatment of the equity method of accounting for equity securities. Among new topics are: unrealized intercompany profits, retroactive application of the equity method of accounting, market value method of accounting for the conversion by investors of bonds to common stock, and long-term receivables.

We have attempted to sharpen the relationship of long-term investments to long-term debt. Accounting for zero-coupon bonds, debt-equity swaps, in-substance defeasance of debt, and restructured debt has either been added or significantly expanded. The illustration of the type of analysis required for a refunding decision (a financial management topic) has been deleted from the current edition.

Part 4: Stockholders' Equity (Chapters 16–18). The coverage of accounting topics unique to corporations is again presented in three chapters. The first chapter includes the accounting for the traditional issues relating to paid-in capital, retained earnings, and dividends. In the second chapter, we have significantly revised the discussion of stock warrants, convertible securities, and employee capital accumulation plans. New sections have been added on contingent stock warrants to customers, market value method of accounting by the issuer for the conversion of bonds to common stock, induced conversion of convertible bonds, accounting for terminated stock options, and accounting for junior stock. The accounting for employee stock ownership plans (ESOP) is now illustrated with journal entries and the coverage of stock option plans has been updated and made more cohesive.

Part 4 concludes with consideration of accounting for treasury stock and earnings per share. These two subjects are combined in this chapter for two reasons—to achieve a better balance of learning modules in this part of the textbook and to emphasize the importance of treasury stock transactions and the "treasury stock

method” for outstanding stock options and stock warrants in the computation of primary and fully diluted earnings per share. Developments in the areas of “hostile corporate takeovers,” “greenmail” payments to corporate “raiders,” “tender offers” for large amounts of outstanding capital stock, and the “effective yield” method to test the common stock equivalency of convertible securities are incorporated in this chapter.

Part 5: More Complex Accounting Topics (Chapters 19–22). The chapters in this part are grouped together because they address some of the more specialized and challenging financial accounting topics. Separate chapters are devoted to the accounting for employee pension plans, leases, and income taxes. Chapter 19 fully incorporates *FASB Statement No. 87*, “Employers’ Accounting for Pension Plans.” The final chapter includes three topics—changes in accounting principles and estimates, correction of accounting errors, and the preparation of financial statements from fragmentary accounting records.

Among the improvements we have made in this part are the following: (1) substantial rewrite and expansion of discussion of defined benefit pension plans; (2) presentation of differing views on nature of pension liabilities; (3) expanded amortization and funding tables to illustrate more typical measurement of pension expense; (4) new illustration of accounting for a legal obligation for unfunded past service cost; (5) expanded coverage of accounting for sales-type leases and addition of discussion of the effect of investment tax credits retained by lessors; (6) more complete discussion of income taxes for interim periods and the new *FASB Statement No. 96*; and (7) a new section illustrating a change in the reporting entity.

Part 6: Analytical Procedures and Statements (Chapters 23–25). The final part consists of three chapters on special financial statements (statements of cash flow, constant-purchasing power and current-cost financial statements), the new *FASB Statement No. 89*, and the analysis and interpretation of financial statements. Special emphasis is given to the impact of inflation on financial statements and on business decisions. The chapter on the statement of cash flow has been thoroughly revised. Emphasis is given to the new reporting requirements of *FASB Statement No. 95* and to a new statement format that highlights operating, investing, and financing activities of business enterprises.

Features Carried Forward from Prior Edition

A continuing feature of this edition is the accompanying *Test Bank* (formerly called *Examination Questions*) with test material arranged on a chapter-by-chapter basis. This booklet contains true or false and multiple-choice questions and numerous short problems for each chapter. It should be a most useful source for instructors who prepare their own examinations and emphasize specific chapters or topics. Answers for the questions and short problems are provided in the booklet.

An especially useful supplement carried forward from the prior edition is a *Study Guide* prepared by the authors and designed to help students measure their progress by immediate feedback. The Guide contains an outline of the most important points for each chapter, plus a variety of objective questions and short exercises. Answers to the questions and short exercises appear at the end of each chapter of the Guide to help students evaluate their understanding of the topics covered in

the text. The Appendix of the *Study Guide* includes check figures for selected exercises in the text.

The *Instructor's Manual*, written by Prof. Talmadge C. Tillman, Jr., of California State University, Long Beach, again has been prepared for use with the revised sixth edition of *Intermediate Accounting*. It is available at no cost to instructors. The *Manual* includes for each chapter a description of all available assignment materials (problems, cases, exercises, and review questions), suggested assignments, objectives of the chapter and suggested teaching approach, review of the subject matter of the chapter, selected multiple-choice questions from recent CPA Examinations, and a suggested list of supplementary readings.

Also continued from the prior edition is a two-volume set of partially filled-in working papers, a comprehensive package of transparencies for problem solutions, and (inside the text covers) a list of check figures for problems.

Questions, Exercises, Cases, and Problems

An expanded amount of learning and assignment material is provided at the end of each chapter. This material is divided into four groups—questions, exercises, cases, and problems.

The questions are intended for use by students as a self-testing and review device to measure their comprehension of key points in each chapter. Many of the questions are provocative, which makes them suitable for written assignments and class discussion.

Exercises generally cover a specific point or topic and do not require extensive computations. Instructors may use the exercises for homework assignments, for class discussion, and for examination purposes. We have class-tested all exercises included in this edition.

Cases generally require analytical reasoning but involve little or no quantitative data. In these cases, students are required to analyze business situations, to apply accounting principles, and to propose a course of action. However, they are not required to prepare lengthy working papers or otherwise to manipulate accounting data on an extensive scale. The cases also have been class-tested and are an effective means of encouraging students to take positions in the evaluation of controversial accounting issues. A number of the cases have been adapted from Uniform CPA Examinations. The cases and questions are especially recommended as a means of sharpening students' skills in communicating accounting concepts and in weighing the merits of opposing arguments.

Many of the problems are new, and most of the problems carried over from the preceding edition have been updated and revised. Special attention has been given to the inclusion of an adequate number of short problems in each chapter. The problems range in difficulty from easy to strong. Most of the problems in the Accounting Theory and Accounting Practice sections of recent Uniform CPA Examinations that are appropriate to intermediate accounting are included, although many have been considerably modified. In addition, several problems in each chapter are designed especially to demonstrate the concepts presented in the theoretical discussion included in the chapter. (Problems adapted from the Uniform CPA Examination are not identified in the text because we have selected such problems solely for their "learning value" and because many of them have been altered to

conform to the contents of the chapter and to subsequent changes in accounting principles. However, we identify the problems adapted from the Uniform CPA Examination in the *Instructor's Manual*.)

Helping Students to Achieve Proficiency in Solving Professional Level Problems

A feature of this edition is the inclusion of a large number of short problems closely correlated with the text material. The gradation in difficulty is carefully tailored to aid the student in a smooth progression from introductory accounting to a professional level of achievement.

A List of Key Figures is provided for problems. The purpose of the list is to aid students in verifying problem solutions and in discovering errors. The list appears on the inside covers of the book.

Two sets of partially filled-in working papers are available. One set is designed for problems in Chapters 1 through 13, and one set for problems in Chapters 14 through 25. On these working papers, the company names, problem numbers, numerous headings, and some preliminary data (such as trial balances) have been entered to save student time and to facilitate rapid review by the instructor. Use of partially filled-in working papers permits assignment of a larger variety of problems and reduces student frustration in deciding on appropriate solution format.

Transparencies of Problem Solutions

Transparencies are available for most problems, to be used by instructors who wish to display in a classroom complete solutions to problems. For longer, more complex problems, the transparencies are an effective means of showing desired organization and format of solutions. Transparencies have not been prepared for some short or easy problems.

Computer-Assisted Practice Set

Accompanying the revised sixth edition of *Intermediate Accounting* is *American Aircraft Sales Corporation*, a computer-assisted practice set that includes computer instructions, computer controls, and a solution. It is essentially a comprehensive problem incorporating many of the concepts in the first half of the text and requires the recording of transactions and the preparation of financial statements.

Contributions by Others

The material for the revised sixth edition was prepared by Charles J. Davis of California State University—Sacramento. Without his help, this edition would not have come out as timely, up-to-date, and as comprehensive as it is. His assistance was invaluable and much appreciated. A special thanks goes to Bruce Bublitz, University of Kansas, and Walter A. Parker, Central Connecticut State, for their additional contribution in reviewing the revised material for this edition.

The many instructors and students who have used previous editions of this book have contributed to the improvements in this edition. Their suggestions for modification of certain problems and alterations of certain sections of the text material have been most valuable. We would like to again acknowledge the advice

received in the revision for the sixth edition from Profs. Wayne Bremser, Villanova University; Jane E. Campbell, Ohio State University; Myrtle Clark, University of Kentucky; Darrel Davis, University of Northern Iowa; Susan Harrison, Webster University, Leiden, The Netherlands; Richard Kochanek, University of Connecticut, Storrs; John Lacey, University of Southern California; George Lazar, Owens Technical College; Yu Ku Li, State University of New York at Brockport; Judy McClean, Moorehead State University; Robert Pommerich, Loras College; Mary Stone, University of Alabama, Birmingham; and Paul Zatko, Owens Technical College.

We are especially indebted to Profs. Joseph F. Guy of Georgia State University and Walter A. Parker of Central Connecticut State College for their superb review of the sixth edition end-of-chapter problem material for accuracy and clarity.

We wish to acknowledge the attention given to this revised sixth edition and its many supplements by the editorial staff of McGraw-Hill, especially Robert D. Lynch and Larry Goldberg.

Our sincere appreciation goes to the American Institute of Certified Public Accountants for giving us permission to quote from many of its pronouncements and to adapt questions and problems from the Uniform CPA Examinations. All quotations and adaptations from the Uniform CPA Examinations are copyrighted by the American Institute of Certified Public Accountants.

We also are grateful to the Financial Accounting Standards Board for granting us permission to quote from its *Statements*, *Discussion Memoranda*, *Interpretations*, and *Exposure Drafts*. All quotations used are copyrighted by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A., and are reprinted with permission. Copies of the copyrighted documents are available from the Financial Accounting Standards Board.

Finally, we thank Walt Disney Productions for permitting us to include excerpts from its annual report in this edition.

A. N. Mosich

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