



INTERMEDIATE ACCOUNTING

Third Edition ■

Nikolai ■ Bazley
Schroeder ■ Reynolds

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ABOUT THE AUTHORS

Loren A. Nikolai

Loren A. Nikolai, Ph.D., CPA, is the Ernst & Whinney Professor in the School of Accountancy, University of Missouri, Columbia. He received his M.B.A. from St. Cloud State University and his doctorate degree from the University of Minnesota. Professor Nikolai has taught at the University of Wisconsin at Platteville and at the University of North Carolina at Chapel Hill. He has received awards for outstanding teaching at both the University of Wisconsin at Platteville and the University of Missouri. He holds a CPA certificate in the state of Missouri and previously worked for the 3M Company. Professor Nikolai is the lead author of *Principles of Accounting* and *Financial Accounting* textbooks (Kent Publishing Company). He has published numerous articles in *The Accounting Review*, *Journal of Accounting Research*, *The CPA Journal*, *Management Accounting*, *Policy Analysis*, *Academy of Management Journal*, *Journal of Business Research*, and other professional journals. He was also lead author of a monograph published by the National Association of Accountants. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Missouri Society of CPAs, and the National Association of Accountants. He has chaired or served on several American Accounting Association committees, and is Director of Education-Elect for 1984–85.

John D. Bazley

John D. Bazley, Ph.D., CPA, is Associate Professor of Accounting in the School of Accountancy at the University of Denver. Dr. Bazley earned a B.A. from the University of Bristol in England and an M.S. and Ph.D. from the University of Minnesota. He has also taught at the University of North Carolina at Chapel Hill and holds a CPA certificate in the State of Colorado. He has taught national professional development classes for a major CPA firm. Dr. Bazley is coauthor of *Principles of Accounting* and *Financial Accounting* (Kent Publishing Company). Dr. Bazley has published articles in professional journals, including *The Accounting Review*, *Management Accounting*, and the *Academy of Management Journal*. He is also a coauthor of a monograph on Environmental Accounting published by the National Association of Accountants. He is a member of the American Institute of Certified Public Accountants, the Colorado Society of Certified Public Accountants, the American Accounting Association, and the National Association of Accountants.

Richard G. Schroeder

Richard G. Schroeder, D.B.A., CPA, is Professor and Chairman in the Department of Accounting at the University of Texas at El Paso. He previously taught at Texas A & M University, the University of Kentucky, the University of Nevada, Las Vegas, and Bemidji State University in Minnesota. Dr. Schroeder received his M.B.A. from Northwestern University and his doctorate from Arizona State University. A Certified Public Accountant, he is the author of numerous publications and has had articles published in *Accounting*, *Organizations and Society*, the *Journal of Accountancy*, *The Accounting Review*, *The Internal Auditor*, *Management Accounting*, *The CPA Journal*, and *Managerial Planning*. Additionally, he is the coauthor of *Accounting Theory: Text and Readings* and contributed a coauthored chapter to *Cost Accountants Handbook*. Dr. Schroeder was also the corecipient of a Peat, Marwick, Mitchell Foundation Research in Auditing Grant and has held a number of official positions in the Southeastern American Institute of Decision Sciences. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the National Association of Accountants, and is on the editorial board of *Advances in Accounting*.

Isaac N. Reynolds

Isaac N. Reynolds, Ph.D., is Professor of Accounting in the School of Business Administration, University of North Carolina at Chapel Hill, where he has received the Standard Oil (Indiana) Foundation, Inc. Teaching Award. He received the Ph.D. and M.S. from UNC. Dr. Reynolds has taught as a visiting professor in the Graduate School of Accountancy at Northeastern University in Boston. He has done consulting work with several not-for-profit organizations and has diverse professional accounting experience. He is the author of three elementary accounting texts and has published articles in such journals as *The Accounting Review* and the *Atlanta Economic Review*. He is the author of a monograph published by the UNC School of Business Administration entitled, *An Analysis of Depreciation Methods and Bases*. Dr. Reynolds has presented numerous programs on the trends in elementary accounting to schools in the United States and Puerto Rico. He is active in the American Accounting Association, the National Association of Accountants, and as an associate in the local chapter of the North Carolina Association of CPA's. He has served on numerous committees of each of these organizations.

PREFACE

OVERVIEW

Accountancy is a growing and dynamic discipline requiring ever-increasing knowledge in many areas. Intermediate accounting is one of those areas. Although the subject material of intermediate accounting is expanding and becoming more technical, it can be made relevant and readily understandable by a textbook that contains (1) the frequent use of examples, (2) clear direct discussion which anticipates the student's learning process, (3) up to date and authoritative treatment of current accounting theory and practice, (4) illustrations taken from the financial statements of real corporations, and (5) plentiful and varied assignment materials. We feel that we have incorporated these teaching and learning tools into this textbook.

Intermediate Accounting Third Edition is a comprehensive, yet readable text. Our goal has been to achieve the most educationally effective blend of theory and practice relating to the current intermediate accounting body of knowledge presented in a pedagogically sound format. Generally accepted accounting principles are clearly identified and the related theory discussed, in conjunction with a thorough explanation of the corresponding practices and procedures. Key terms, concepts, definitions, and official statements are **boldfaced**; italics are used for *emphasis*. Illustrations of journal entries, supporting schedules, and financial statement disclosures are frequently used to clarify concepts or procedures. Where there is a theoretical disagreement on an accounting principle, we present a succinct and objective discussion of the alternative views. Numerous excerpts from actual annual reports, each identified by the company logo in the text margin, illustrate the proper disclosure for many topics and help students to appreciate the immediate relevance of classroom work to real-world accountancy practice. The 1983 financial report of the Coca-Cola Company is also included in its entirety in Appendix A at the end of the book.

We have included an abundance of end-of-chapter assignment materials, divided into questions, cases, exercises, and problems. The questions primarily address key concepts and terms in the chapter. The cases focus on the various theoretical and conceptual issues within the chapter. Each exercise reinforces a chapter topic at a relatively elementary level. The problems either consolidate a number of chapter topics or else focus on a comprehensive analysis of a single topic. Many problems and cases have been selected from past Uniform CPA Examinations, and are so designated. A boldfaced note is included beside each case, exercise, and problem number to indicate the subject content.

SPECIFIC FEATURES

The text is organized primarily in a balance sheet format and consists of 5 parts containing 25 chapters, as follows:

- Part I Financial Reporting: Concepts, Procedures, and Financial Statements (Chapters 1–5)
- Part II Financial Reporting: Asset Measurement and Income Determination (Chapters 6–12)
- Part III Financial Reporting: Valuation of Liabilities and Investments (Chapters 13–15)
- Part IV Financial Reporting: Stockholders' Equity (Chapters 16–18)
- Part V Financial Reporting: Special Topics (Chapters 19–25)

Some of the major features of the chapters are summarized as follows:

1. *FASB conceptual framework.* Students are introduced to the “conceptual framework” in Chapter 1. This involves an identification and discussion of the objectives of financial reporting (Exhibit 1-8) and the qualitative characteristics of useful accounting information (Exhibit 1-9). It also includes an explanation of the relationship between the conceptual framework and the standard setting process (Exhibit 1-6). Throughout the text, reference is made back to the objectives and qualitative characteristics in evaluating accounting practices.
2. *Asset and liability concepts, definitions, and measurement.* Because the FASB defines revenues and expenses in terms of changes in assets and liabilities, a clear understanding of asset and liability concepts and definitions as well as alternative measurement approaches (i.e., current cost, current exit value) is necessary. These topics are introduced in Chapter 3. The concept and definition of liabilities is reinforced and expanded later in Chapter 13, which is the first of two chapters on liabilities.
3. *Revenue and expense recognition.* Revenue and expense recognition alternatives are discussed in an Appendix to Chapter 4. Included are revenue recognition issues related to current topics (i.e., franchises, retail land sales, product financing agreements), revenue recognition criteria (collectibility, transfer of risk), and alternative methods (i.e., installment sales, proportional performance).
4. *Use of flowcharts and diagrams.* Numerous flowcharts and diagrams helpful in the students’ learning process are incorporated in the text. For instance, Chapter 18 includes a flowchart for earnings per share (Exhibit 18-9), Chapter 10 includes a flowchart for similar productive asset exchanges (Exhibit 10-3), and Chapter 12 includes a diagram for classifying intangibles (Exhibit 12-1).
5. *Present value and future value.* Chapter 5 is a self-contained unit on present value and future value, included early in the text because of their increasing use in financial accounting. For each aspect, the concept is diagrammatically stated, and then the student is “walked through” the analysis by the use of arithmetic calculations, formulas, and tables in an integrative discussion.
6. *Computational steps.* Many complex computational procedures have been reduced to a series of “steps” outlined in a list format. For instance, a series of steps for dollar value LIFO calculations are included in Exhibit 8-14 of Chapter 8. Similar lists of steps are included in Chapter 9 for the gross profit inventory method, retail inventory method, and dollar-value LIFO retail method.
7. *Back-to-back coverage of long-term liabilities and investments.* Due to the reciprocal nature of accounting for certain liabilities and assets (i.e., bonds payable and investments in bonds, notes payable and notes receivable), these topics are presented in back-to-back chapters. This facilitates the students’ understanding of these complex issues.
8. *Summary exhibits.* Helpful summary exhibits are included at appropriate points in the text. For instance, Exhibit 4-9 summarizing corporate earnings topics, Exhibit 20-1 summarizing the criteria and classifications for leases, Exhibit 21-8 summarizing the impacts on financial statements of the methods used for accounting changes and errors, and Exhibit 25-18 summarizing the broadened disclosure requirements of the APB and FASB.
9. *Inflation accounting.* Chapter 24 presents a detailed discussion of this important topic. Emphasis is placed on a thorough discussion and illustration of the *FASB Statement No. 33* supplemental disclosure requirements. Comprehensively adjusted financial statements are discussed in an Appendix to the chapter.
10. *Flexibility in coverage.* Certain chapters have been written, to the extent possible, to allow flexibility in reading assignments. Appendix to Chapter 4 on revenue recognition may be deleted or deferred, depending on the instructor’s preference. Chapter 5 may be deferred until before Chapter 10 (the first application of present value). Others may prefer earlier assignment

of Chapter 21 (accounting changes) due to occasional references to different types of changes throughout the text.

11. *CPA review index.* A special “CPA review index” is included at the end of the text (Appendix C). This index contains a cross listing of the specific AICPA adapted problems and cases in the text with the year and month of the Uniform CPA Examination from which they are drawn. This index should increase the value of the text for students who use it to prepare for the examination.

MAJOR CHANGES

Numerous changes have been made in this third edition. Several of the major changes are summarized as follows:

1. *Separation of text into parts.* As noted earlier, the textbook is divided into five parts. Each part begins with an introduction. The introduction includes both an explanation of the purpose of the chapters in that part and a brief overview of the concepts and procedures discussed in each chapter.
2. *More emphasis on the environment of accounting.* In Chapter 1, Exhibit 1-5 has been added; it outlines the FASB operating procedures for issuing a statement of concepts or standards. Included in the related explanation is a discussion of decision making in a sociopolitical environment.
3. *Continued expansion of theory.* Based on the FASB conceptual framework introduced in Chapter 1, later chapters relate the discussion of specific topics to the objectives of financial reporting, qualitative characteristics of accounting information, and to such concepts as liquidity, financial flexibility, risk, and operating capability. This integrated discussion of accounting theory is *not* at the expense of the sound, procedural pedagogy established in the earlier editions; we continue a balanced presentation of theory and practice.
4. *New discussion of SEC and its integrated disclosures.* A knowledge of the operations of the SEC is becoming increasingly important as it applies to financial reporting. In addition, the SEC has developed an “integrated” set of disclosure requirements that enable a company to satisfy certain Form 10-K disclosures by reference to its annual report. Chapter 3 discusses the items that must be included in the annual report. Chapter 25 summarizes the operations of the SEC and discusses the documents that must be filed with the SEC by regulated companies, which are of concern to accountants.
5. *Conceptual reporting guidelines.* The FASB has suggested several conceptual guidelines to improve financial reporting. Chapter 3 contains a new section dealing with the concepts to guide the reporting of assets and liabilities. Chapter 4 contains a new section dealing with the concepts to guide the display and placement of income statement items.
6. *Clarification of accounting for temporary investments in equity securities.* The discussion of this topic in Chapter 6 has been clarified in two respects. First, because of the short-term nature of these temporary investments, the examples in the text (and related homework) have been revised to reflect quarterly adjustments. Second, a new section on reclassifications of investments from current to noncurrent has been added.
7. *Modification of accounting for notes receivable discounted.* The discussion of this topic in Chapter 7 has been modified so that interest revenue is recognized only for the period the note has been held prior to discounting. A set of steps has been added to clarify the necessary computations.
8. *Expansion of discussion of compensated absences.* An example has been added in Chapter 13 to illustrate the accounting for the accrual and payment of a company’s liability for compensated absences. The related homework has been revised accordingly.

9. *Orientation for changes in equity.* In Chapter 16, a diagram (Exhibit 16-1) and related discussion have been added to identify the various changes in owners' equity and to orient the reader to the subsequent discussion.
10. *Clarification of earnings per share procedures.* The well-explained earnings per share discussion in Chapter 18 is further refined by clarifying the definition of a common stock equivalent, including a diagram for applying the treasury stock method, and expanding the description and evaluation of the cash yield test.
11. *Expansion of stock dividend discussion.* The theoretical discussion of stock dividends and their similarity to a stock split is expanded in Chapter 18 to reflect the similar economic substance of the two items.
12. *Rearrangement of special topics.* Because of the increased importance of certain topics, the later chapters of the text have been rearranged. The statement of changes in financial position is now the first chapter (19) in Part V, accounting for changing prices has been moved forward to Chapter 24, and additional aspects of financial reporting and financial analysis is the final chapter (25) in the text.
13. *Addition of direct method for cash provided by operations.* The FASB is concerned with improving the predictive value and feedback value of the statement of changes in financial position. A new section has been added to Chapter 19 to discuss and illustrate the direct method of reporting cash inflows from operations and cash outflows for operations on this statement. New homework is also included.
14. *Expanded explanation of accounting changes.* In Chapter 21, the explanations of the cumulative effect, prospective, and retroactive methods of accounting for changes and errors have been expanded to clarify these difficult topics. Exhibit 21-8 has been added to summarize these methods.
15. *Revision of discussion of accounting for pensions.* The discussion of the conceptual issues concerning defined benefit plans has been considerably expanded and moved from the Appendix to the main portion of Chapter 22. The discussion of the accounting procedures for pensions also has been expanded and clarified. An Appendix on the current developments in pension accounting concludes the chapter.
16. *Revision of income taxes discussion.* Chapter 23 has been substantially revised on a conceptual and procedural level. The chapter now includes a conceptual discussion of comprehensive and partial allocation, as well as operating loss carrybacks and carryforwards. The procedural discussion now includes an additional example of the net change method and an expanded explanation of balance sheet disclosures. The investment tax credit discussion has also been moved to this chapter.
17. *Expanded and revised homework assignments.* Additional problems, mostly of an integrative type, have been added to several chapters. The numbers (and solutions) have been changed in over 70 percent of the homework material.

SUPPLEMENTARY MATERIALS

In addition to the textbook, several supplementary aids are available. For the student, these include:

1. *A Study Guide* prepared by Loren A. Nikolai and Theodora Arthur, University of Missouri, and Natalie Krawitz, Stephens College. The study guide includes an outline of each chapter along with self-evaluation exercises and supplemental short-answer homework assignments and accompanying solutions.
2. *A Spreadsheet Problems for Intermediate Accounting* prepared by Don E. Collins, Franklin University; Loren Nikolai; and John D. Bazley.

3. A "Your Name" Company: Accounting Practice Set for the Computer, prepared by Thomas W. Charles and Frederic M. Steiner, University of Delaware.
4. Two manual review Practice Sets prepared by David Gotlob, Indiana University and Loren A. Nikolai. Practice Set I, "Boone Office Supply," focuses on accounting for a sole proprietorship and includes source documents. Practice set II, "Crockett Automotive Parts," deals with accounting for a wholesaling corporation.
5. Working Papers for the problems; selected ones are partially completed.
6. A Check List of key answers to the problem assignments.

For the instructor, the supplementary aids include:

1. A Solutions Manual for all homework materials. The manual (divided into two volumes) includes a suggested solution for each question, case, exercise, and problem, all supporting calculations, and helpful notes to the instructor concerning any difficult areas within each problem. Also included at the beginning of each chapter is a content analysis of the exercises and problems in that chapter.
2. An Instructor's Manual containing, for each chapter, a list of objectives, synopsis, a lecture outline, instructional notes, and a content analysis of exercises and problems by topic.
3. A Test Bank of examination materials for each chapter. These materials include multiple-choice and short-answer problems.
4. A set of Transparencies (set in large type) for all numerical problems and selected exercises. Included in the set are several "teaching visuals" for lecture purposes.
5. A Newsletter, THE INTERMEDIATE ACCOUNT, designed to keep instructors up to date on current accounting developments. This newsletter is published once a year, during the summer. Organized by text chapter, it summarizes any new accounting developments and pronouncements which occurred or were issued during the previous period. The newsletter should enable each instructor to easily integrate the most current accounting information into his or her course. Instructors who have adopted **Intermediate Accounting** should write to the Accounting Editor, Kent Publishing Company, 20 Park Plaza, Boston, MA 02116 to request inclusion on the mailing list for the newsletter.

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Loren A. Nikolai

John D. Bazley

Richard G. Schroeder

Isaac N. Reynolds

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Third Edition

INTERMEDIATE ACCOUNTING

LOREN A. NIKOLAI, Ph.D., CPA

Ernst & Whinney Professor
School of Accountancy
University of Missouri—Columbia

JOHN D. BAZLEY, Ph.D., CPA

Associate Professor
School of Accountancy
University of Denver

RICHARD G. SCHROEDER, D.B.A., CPA

Professor
College of Business Administration
University of Texas at El Paso

ISAAC N. REYNOLDS, Ph.D.

Professor
School of Business Administration
University of North Carolina at Chapel Hill

Kent Publishing Company, Boston, Massachusetts

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External decision makers use financial accounting information to make investment- and credit-related decisions. This information is reported (communicated) to external users primarily by financial statements and related supporting schedules and footnotes. To adequately communicate financial accounting information, an accountant must know the underlying concepts and basic procedures of a financial accounting information system. In addition, knowledge of these concepts and procedures is essential for understanding the recording and processing of more complex transactions and events. Furthermore, knowledge of what information is reported and how the information is reported is helpful in understanding the recording, processing, and information-accumulating steps that precede the reporting of financial accounting information. The purpose of Part I (Chapters 1–5) is to provide this knowledge.

Chapter 1 focuses on the FASB “conceptual framework” and related accounting principles. It begins by identifying the external users of accounting information and their decisions—to buy, to sell, or to hold securities. Generally accepted accounting principles (GAAP) are defined, followed by a discussion of the groups that have established or influenced GAAP. The conceptual framework is introduced with an explanation of the relationship between the conceptual framework and the standard setting process. The objectives of financial reporting are then discussed. The general objective of providing useful information for making rational investment, credit, and similar decisions is logically integrated with the derived objective of providing information useful in assessing external users’ cash receipts. This external user objective, in turn, is linked to the objective of providing information useful in assessing an enterprise’s cash flows. Finally, three specific objectives are derived from this enterprise objective: to provide information about economic resources and claims to these resources, about earnings and its components, and about funds flows.

A hierarchy of qualitative characteristics of useful information follows the objectives. The overall characteristic of decision usefulness is separated into the primary qualities of useful accounting information, namely relevance and reliability. Relevance and reliability are then explained in terms of their “ingredients.” Relevance (i.e., the capacity to make a difference in a decision) is a function of predictive value, feedback value, and timeliness. Reliability (i.e., validity and freedom from error and bias) is a function of representational faithfulness, verifiability, and neutrality. Comparability (including consistency), a secondary and interactive quality between two items of information, completes the hierarchy, which is bounded by cost/benefit and materiality constraints. Numerous accounting assumptions and conventions that influence GAAP are introduced at this point, including, among others, matching, accrual accounting, realization, historical cost, going-concern, periodicity, and conservatism.

In Chapter 2 the accounting process is reviewed. The chapter begins with a definition of an accounting system and identifies four components: (1) the framework, (2) the input source documents, (3) the records used to store accounting information, and (4) the output documents. After linking the accounting equation to the double-entry system and defining input, storage, and output documents, the accounting cycle is explained by means of a complete example. The example illustrates the procedures for journalizing, posting, and preparing a trial balance, adjusting entries, an adjusted trial balance, financial statements,