
Intermediate Accounting

James Don Edwards, Ph.D., C.P.A.

J. M. Tull Professor of Accounting

Johnny R. Johnson, Ph.D., C.P.A.

Roger A. Roemmich, Ph.D., C.P.A.

all of the
School of Accounting
University of Georgia

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This text is designed for use by undergraduate or graduate students who have completed a reasonably comprehensive course in the fundamentals of financial accounting. The text can be easily adapted to a quarter or semester system. The text is very comprehensive in the treatment of the more difficult intermediate accounting topics, and the reasons behind accounting treatments are emphasized. Therefore, the text should provide the student with an excellent background for accounting practice and the financial accounting aspects of the various professional examinations.

Ten unique features. *Intermediate Accounting* contains ten features not found in traditional intermediate accounting texts. First, it is comprehensive in the technical topics that the students will encounter frequently throughout their professional careers. For example, Chapter 13 discusses in detail capitalization of interest. Likewise, Chapter 24 presents an in-depth discussion of accounting for income taxes; examples and problems consider accounting for investment credits and interperiod tax allocation together, instead of in separate chapters as in most texts. Chapter 18 illustrates all the common types of lease problems in a comprehensive set of examples. These examples are constructed to add complexities in small increments so students can more easily master the material.

Also, Chapter 25 covers thoroughly the statement of changes in financial position. Instead of presenting a number of transactions and simply illustrating how these transactions affect the statement, we first explain a general approach which can be used to determine the effect of any transac-

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tion on working capital. Then we use the general approach to illustrate several comprehensive problems.

A second unique feature of this text is that we emphasize theory and logic in explaining various accounting issues. The conceptual base from Chapters 1-5 is integrated throughout the text. Also, present and future value concepts are introduced early and are used extensively in explaining issues throughout the text. Moreover, in our discussion of every major issue in the text we emphasize not only the procedure and techniques but also the logic behind the issue. We believe this treatment will be especially effective for more complicated topics, such as accounting for changing prices, dollar-value Lifo, pensions, leases, income taxes, and the statement of changes in financial position.

A third unique feature of the text is that it is very practice oriented. Nearly every chapter contains actual examples of real-life problems and an explanation of how the problems are solved and why they are solved in a particular manner. Also, the text contains numerous examples from corporate annual reports and the American Institute of CPA's annual *Accounting Trends and Techniques*. Finally, the text provides a comprehensive coverage of the more difficult practice problems, such as pensions, leases, taxes, and the statement of changes.

A fourth unique feature is that each chapter contains a comprehensive summary. These summaries should be especially helpful to students as they review for examinations.

A fifth unique feature of this text is that Chapter 3 contains a comprehensive illustration of the accounting process. This comprehensive illustration brings together each part of the accounting process from journalizing transactions through the preparation of financial statements.

A sixth unique feature is that Appendix A at the end of the text contains a set of comprehensive present and future value tables. Interest rates in these tables increase in one-half percent increments from .5 percent to 20 percent, and the present value tables cover 120 periods.

A seventh unique feature is that Appendix B at the end of the text discusses a general framework

for researching financial accounting problems. This appendix should help students to better understand how many technical answers must be obtained in practice.

An eighth unique feature of this text is the comprehensive nature of the *Solutions Manual* and *Student Study Guide*. For example, in the *Solutions Manual*, each solution is supported with detailed computations and explanations. Similar detail is also provided in the *Student Study Guide*. The *Student Study Guide* was prepared by the authors and contains a wide variety of questions, exercises, problems, and cases on each major point covered in the text.

A ninth unique feature of this text is that most chapters contain a number of AICPA or CMA adapted multiple-choice questions. We believe that, in view of the trend towards more objective questions on the professional examinations, exposure to multiple-choice questions is now a necessary part of intermediate accounting.

In addition to the multiple-choice questions included in the body of the text, the text is accompanied by a separate volume of CPA and CMA multiple-choice questions. These questions are adapted from the CPA and CMA examinations which were given between May 1976, and November 1980, inclusive. This volume is catalogued according to the chapters of the text and also includes the unofficial suggested solutions for each question along with an explanation for the solution.

A tenth feature that is unique for a first edition is that every chapter in the text has been extensively class tested. This classroom testing was done at both the University of Georgia and the University of Nebraska at Lincoln.

Organization. The text is organized into 27 chapters. These chapters are grouped into five parts.

The first five chapters of the book constitute Part One of the text. These chapters emphasize the development of accounting theory and practice, the basic accounting tenets, the accounting model, the statement of earnings and retained earnings, and the balance sheet.

Part Two of the text contains the discussion of the basic balance sheet accounts and the related

revenue and expense accounts. This part begins with Chapter 6, which discusses cash and temporary investments. Next, Chapter 7 discusses present and future value concepts. Part Two then continues with a discussion of notes and accounts receivable; inventories; current and contingent liabilities; property, plant, and equipment; depreciation and depletion; intangible assets; long-term investments; and long-term liabilities.

Part Three discusses the special problems involved in accounting for leases and pensions. Chapter 18 is devoted exclusively to leases; Chapter 19 discusses pensions.

Part Four discusses the special problems in accounting for equity capital of corporations. Part Four begins with Chapter 20, which discusses the problems in accounting for contributed capital. Chapter 20 is followed by chapters on retained earnings and treasury stock transactions; convertible securities and stock warrants, rights and options; and book value per share and earnings per share.

Part Five of the text discusses special accounting problems. It includes chapters in accounting for income taxes, the statement of changes in financial position, analyzing and comparing financial statements, and accounting for changing prices.

Questions, cases, exercises, and problems. Each chapter contains a variety of questions, decision cases, exercises, and problems. These end-of-chapter items provide opportunity for students and faculty to choose the mix of theory and problems and topic coverage desired. Cases are designed to demonstrate trade-offs in difficult areas and to provide a vehicle for students to develop their written communication skills.

End-of-chapter material is provided for every major issue discussed in the chapter, and these materials, as indicated earlier, contain a wide variety of CPA and CMA adopted items. In adopting items from professional exams, however, care was taken to modify the item so as not to ask a question, case, exercise, or problem which had not been covered at that point in the text.

Supplementary material. This text is accompanied by the following supplementary material: (1) *Student Study Guide*, (2) *Examination Questions*

and Solutions, (3) *Comprehensive Solutions Manual*, (4) *Working Papers*, (5) *Practice Set*, (6) *Solutions to Practice Set*, (7) *Checklist of Key Figures*, and (8) *CPA and CMA Multiple-Choice Questions and Solutions*. Also, transparencies are provided for most exercises and problems.

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James Don Edwards
Johnny R. Johnson
Roger A. Roemmich

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The accounting process

PART ONE

Development of accounting theory and practice

If a 19th-century accountant were reincarnated today, he would be amazed at the differences between the accounting of his day and that of the 20th century. Businesses have changed drastically during the last 100 years, and accounting has changed to meet the needs of the modern business world. Accounting has evolved in response to changes in the size of businesses, the relationship between owners and the businesses, the term of existence of businesses, and many other factors. Indeed, all the changes in the accounting profession have made the practice and study of accounting more complex, but more rewarding, than ever before. This chapter will examine a number of fundamental concepts which underlie the modern accounting function. It will explore the nature of accounting, the environment of accounting, the objectives of accounting, the nature of generally accepted accounting principles (GAAP), the history of organized efforts to establish accounting principles, the standard-setting process today, GAAP and the audit function, qualitative characteristics of accounting information, and the role of each of the major participants in the principle-determining process.

THE NATURE OF ACCOUNTING

Accounting may be defined as "a service activity which provides quantitative information, usually financial in nature, for use in making economic decisions."¹ In order to understand the nature of

¹ *Accounting Principles Board Statement No. 4*, "Basic Concepts and Accounting Principles," (New York: American Institute of CPAs, 1970), par. 40.

this service activity better, several basic characteristics of modern accounting need to be explored.

One essential difference between modern accounting and earlier accounting is the separation of owners from the business entity. An owner who manages his or her own business can determine by inspection quantities of assets held by the business. However, today many owners and other interested parties have little or no direct role in a business, so they require the maintenance of detailed records to establish management's accountability for assets and obligations of the business. This accounting function which maintains records of assets held and liabilities owed is called the *stewardship function*. The stewardship function is becoming more complex and more important as the typical business experiences growth in its assets and liabilities, and the number of locations in which the assets are held.

Going concern assumption

The duration of businesses is another important factor in the evolution of accounting. Nineteenth-century businesses tended to have a very short term of existence, so a high degree of accounting precision could be achieved. Detailed records of all expenditures and receipts were maintained, and at the end of the business venture these expenditures and receipts were compared to determine the earnings for the business during its life.

However, 20th-century businesses are generally assumed to have an indefinite term of existence. These *going concerns* require sophisticated accounting systems to provide timely information for use

in making economic decisions. Preparation of timely information requires providing information to users at the end of *periodic intervals*. Accounting statements for going concerns measure the current financial position of the enterprise and the change in financial position resulting from efforts and events during the latest accounting period. Thus, there is a direct relationship between the current assumption that businesses are going concerns and the need to provide timely accounting information at regular intervals.

Time periods and the use of estimates and judgments

The indefinite duration of modern businesses has other implications for accounting. For example, public confidence in the accounting profession is dependent upon a reputation for providing reliable financial information. Reliable measurement of the revenues produced and the costs incurred would be maximized if it were possible to wait until the ultimate disposition of a good or last act of service for a customer were performed. However, providing accounting information on a timely basis for going concerns requires the accountant to record accounting information while substantial uncertainties may exist. This trade-off between reliability and timeliness is unfortunate but necessary. Economic decisions based upon the best information available at the time the decisions are made are more effective than less timely decisions based upon more complete information.

The complexity and uncertainty which accom-

many economic activity seldom permit precise measurements of financial information. For example, problems in determining the degree of completion make measurement of incomplete transactions difficult. The value of partially performed services, the cost or effort expended in connection with the performance of a service, and many other problems are associated with identifying revenues and expenses with a particular time period. When substantial uncertainties such as these exist, the accountant must prepare accounting records based upon his or her best estimate of how uncertainties will be resolved.

Cash versus accrual accounting

The two basic approaches of modern accounting are cash-basis accounting and accrual accounting.

When an economic transaction is not recorded until cash is paid or received, the principles of the cash basis of accounting are being applied. Cash-basis accounting offers two primary advantages for recording economic transactions. First, reliability is increased because transactions are recorded only when all phases of the transaction are complete.² Second, recording the transaction is simpler because fewer estimates and judgments are required. In addition, when payment is made or received before the completion of an economic transaction, the exchange of cash provides reliable evidence of financial resources exchanged up to that point.

However, the cash basis of accounting is inappropriate for most businesses. Reaching a fair determination of earnings for a period also requires recognition and measurement of noncash resources and obligations. Although measuring changes in noncash resources and obligations requires many estimates, this measure generally provides a better picture of earnings than that provided by cash-basis accounting.

The method which recognizes changes in resources and obligations is called the accrual concept of accounting. The accrual concept requires that

changes in assets and liabilities resulting from the earnings process be recognized in the period when they occur, rather than when they are paid. The merits of the accrual concept are illustrated in the following example.

Surem Co. began operations on January 1, 1982. During 1982, Surem had cash sales of \$60,000 and cash expenses of \$48,000. At the end of 1982, Surem had accounts receivable from 1982 sales of \$10,000 and accounts payable for 1982 expenses of \$32,000. During 1983, Surem realized substantial growth in cash receipts to \$250,000, but cash disbursements grew to \$270,000. Surem had accounts receivable of \$66,000 and accounts payable of \$12,000 at the end of 1983.

Under the cash basis of accounting, the earnings for 1982 and 1983 would be computed as follows:

	1982	1983	Total
Revenue	\$60,000	\$250,000*	\$310,000
Less: Expenses ...	48,000	270,000†	318,000
Earnings (loss)	<u>\$12,000</u>	<u>(\$20,000)</u>	<u>(\$8,000)</u>

* \$10,000 of the \$250,000 represents 1982 sales on account.

† \$32,000 of the \$270,000 represents 1982 expenses paid in 1983.

Note that part of the 1983 revenues and part of 1983 expenses under the cash basis of accounting are attributable to 1982 operations. Also, at the end of 1983, \$66,000 of revenues and \$12,000 of expenses have not been recognized.

Under the accrual basis of accounting, the earnings for 1982 and 1983 would be computed as follows:

	1982	1983	Total
Revenues	\$70,000 *	\$306,000 ‡	\$376,000
Less: Expenses ..	80,000 †	250,000 §	330,000
Earnings (loss)	<u>(\$10,000)</u>	<u>\$ 56,000</u>	<u>\$ 46,000</u>

* \$60,000 cash sales + \$10,000 credit sales

† \$48,000 cash expenses + \$32,000 credit expenses

‡ \$240,000 (250,000 - 10,000) cash sales + \$66,000 credit sales

§ \$238,000 (270,000 - 32,000) cash expenses + \$12,000 credit expenses

² The cash basis may not be more reliable in cases where cash costs such as warranty costs follow the receipt of cash.

The \$54,000 difference in total earnings can be attributed to the change in noncash resources and

obligations over the two-year existence of Surem Co. At the end of 1982, cash receipts exceeded cash disbursements by \$12,000. However, Surem had increased its Accounts Receivable by \$10,000 and its Accounts Payable had increased by \$32,000. If all accounts had been settled, Surem would have recorded a loss of \$10,000. In 1983 Accounts Receivable increased by \$56,000 and Accounts Payable decreased by \$20,000. If all accounts had been settled, Surem would have recorded net earnings of \$56,000 instead of a loss of \$20,000.

This example illustrates a fundamental question: Should reported earnings be based on changes in resources and obligations resulting from operations, or only on cash receipts and cash disbursements resulting from operations? The accrual approach bases earnings upon changes in resources and obligations, thereby providing a much better picture of operating efficiency than does the cash approach, which places emphasis upon operations but also requires collections and payments for recognition in measuring earnings.

Cash basis of accounting

Although, as indicated in the previous section, the cash basis of accounting is not generally accepted, it is frequently used by many businesses. In some cases, because of the nature of a particular business, the results of the cash basis do not differ significantly from the results of the accrual basis. For such a business, the cash basis is acceptable. In other cases, a business may use the cash basis for internal reporting purposes but convert to the accrual basis for external reporting purposes.

In still other cases, a business may issue cash basis statements even if the cash basis produces results which are significantly different from the accrual basis. These statements are not prepared in accordance with generally accepted accounting principles, and this fact must be noted on the financial statements. Other requirements for these statements are discussed in auditing courses and are not repeated here. Instead, the emphasis in this text is on understanding how the cash basis works.

Although conceivably there are many variations

of the cash basis, the cash basis which is used most frequently in practice differs from the accrual basis in only one way: accounts receivable and accounts payable are not recognized in the accounts. Instead, entries are made when cash is received or paid. The following transactions of the Arevalo Company are used to contrast the cash basis (on the left) and the accrual basis (on the right).

Cash basis Accrual basis

1. Obtained a \$10,000 loan from the Peoples National Bank.

Cash	10,000	Cash	10,000
Notes Payable	10,000	Notes Payable	10,000

Key feature: Since there are no accounts receivable or accounts payable, the entries under the two methods are the same. Notice that a note payable, but not an account payable, is recognized under the cash basis because cash is received when the note payable is issued.

2. Recorded accrued salaries of \$2,000.

No entry		Salary Expense	2,000
		Salaries Payable	2,000

Key feature: Under the cash basis, salaries payable are not recognized. However, notes payable are recognized.

3. Paid the \$2,000 of salaries.

Salary Expense	2,000	Salaries payable	2,000
Cash	2,000	Cash	2,000

Key feature: Under the cash basis, expenses are recorded when paid.

4. Received equipment (cost \$3,000) under f.o.b. destination terms.

No entry		Equipment	3,000
		Accounts Payable	3,000

Key feature: Under the cash basis, purchases are not recorded until paid.

5. Received \$1,000 of revenue in advance.

Cash	1,000	Cash	1,000
Unearned Revenue	1,000	Unearned Revenue	1,000

Key feature: Since cash is received, the entries are the same.