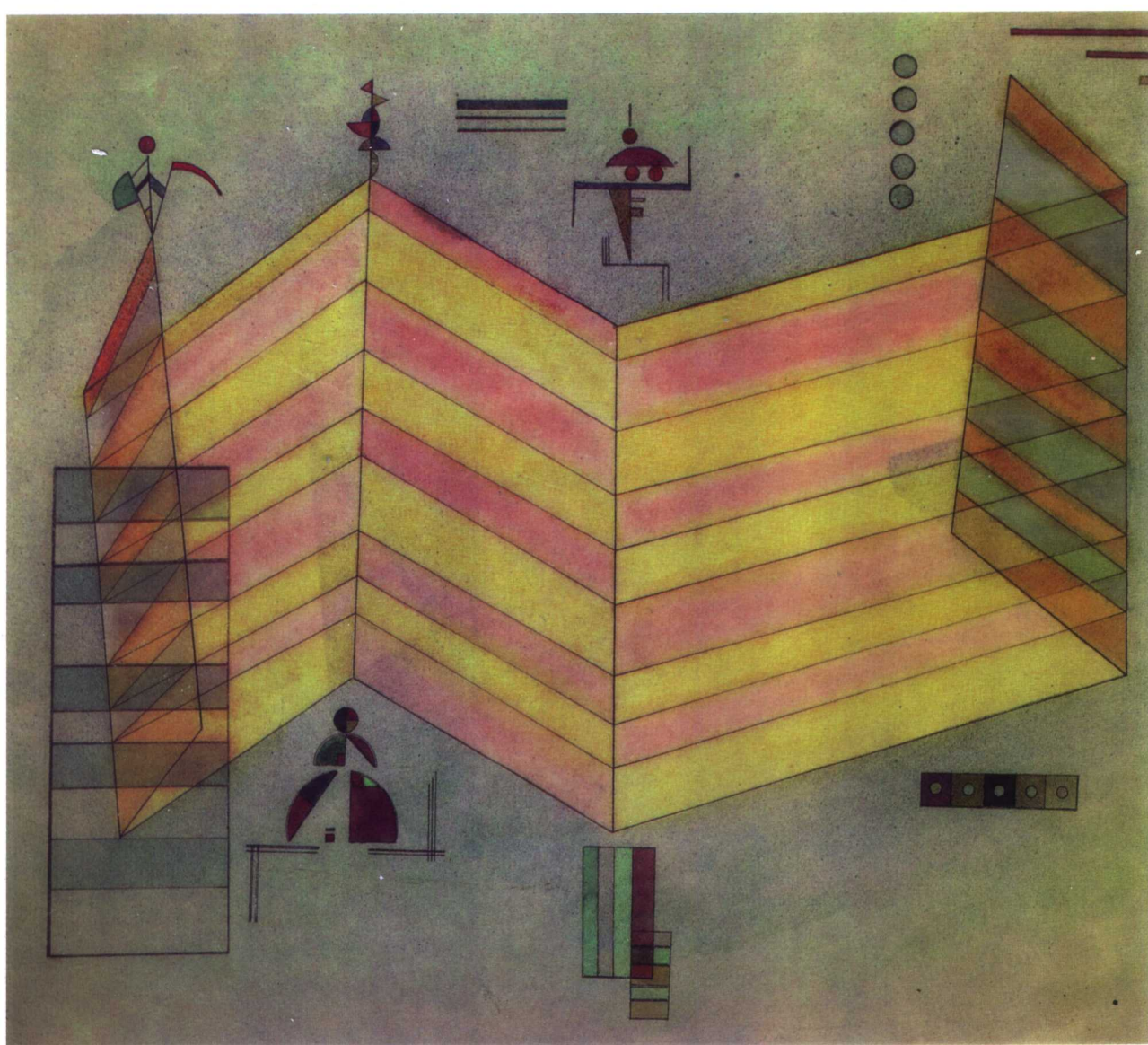


**INTERMEDIATE**

**6**  
E D I T I O N

# **ACCOUNTING**



**LANNY G. CHASTEEN  
RICHARD E. FLAHERTY  
MELVIN C. O'CONNOR**



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# **ACCOUNTING**

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## Intermediate Accounting

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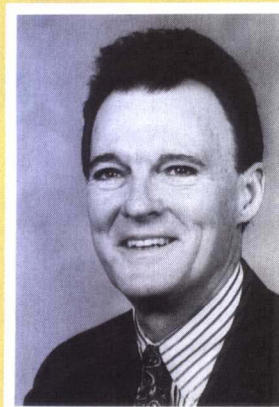
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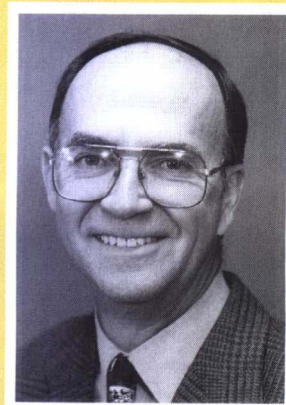


## ABOUT THE AUTHORS

**Lanny G. Chasteen, Ph.D., CPA**, is the Arthur Andersen Alumni Centennial Professor and Head of the School of Accounting at Oklahoma State University. He holds a B.B.A. from the University of Texas at Austin, and an M.B.A. and Ph.D. from the University of Arkansas. Professor Chasteen has published articles on financial accounting theory and practice in *The Accounting Review*, *Abacus*, the *Journal of Accounting Education*, *Issues in Accounting Education*, and the *Journal of Accountancy*. He has received the Outstanding Teacher Award in the College of Business Administration at OSU and the Oklahoma Outstanding Accounting Educator Award from the Oklahoma Society of Certified Public Accountants. In addition to his 28 years on the OSU faculty, Professor Chasteen has taught at the University of Texas at Austin, the University of Arkansas, Texas Tech University, the University of Texas at Arlington, and the University of Tulsa. His public accounting experience was with Haskins and Sells (now Deloitte & Touche). Professor Chasteen is a member of the American Accounting Association (AAA), the Administrators of Accounting Program Group of the AAA, the American Institute of Certified Public Accountants, the Financial Executives Institute, the Oklahoma Society of Certified Public Accountants, Beta Alpha Psi, and Beta Gamma Sigma, and has served on committees of these organizations. Professor Chasteen is also active in accreditation activities of the American Assembly of Collegiate Schools of Business (AACSB).



**Richard E. Flaherty, Ph.D., CPA**, is professor of accounting at Arizona State University and served as the Executive Director of the Accounting Education Change Commission from 1993–1996. Formerly, he was Director of the School of Accountancy at Arizona State University. He received his B.S., M.S., and Ph.D. degrees from The University of Kansas. Professor Flaherty previously served on the faculties of Oklahoma State University and the University of Illinois. He also served as a research associate at the Financial Accounting Standards Board, has served as a consultant on financial reporting issues to a number of businesses, and has taught in numerous professional development programs. He has published articles on financial accounting theory and practice in several journals, including *The Accounting Review* and the *CPA Journal*. In addition, he is the author of Accounting Education Research Monograph No. 3, *The Core of the Curriculum for Accounting Majors*, published by the American Accounting Association.



Professor Flaherty is a member of the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), the Financial Executives Institute (FEI), the Arizona Society of Certified Public Accountants, Beta Alpha Psi, and Beta Gamma Sigma. He has served on a number of AAA committees, and currently serves on the Accounting Education Advisory Committee and the Accounting Accreditation Committee. Also, he has served on the Board of Examiners of the AICPA and on numerous committees, subcommittees, and task forces of the Board. He has been on the Board of Directors of the Arizona Chapter of the FEI, the Board of Trustees of the Arizona Society's Foundation for Education and Research, and on the governing boards of the AAPG and the Federation of Schools of Accountancy. He has also been actively involved in the AACSB, having served as Chair of the Accounting Accreditation Committee and the Peer Review Improvement Task Force, and as a member of several peer review teams and other committees.





**Melvin C. O'Connor, Ph.D., CPA**, is the Deloitte & Touche Professor of Accounting and Director of the Program in Professional Accounting at Michigan State University. He earned his bachelor's, master's, and doctorate degrees at The University of Kansas. Professor O'Connor has been Chairperson of the Department of Accounting and Director of the Accounting Doctoral Program, has been twice recognized as the outstanding teacher in the Department of Accounting, and in 1994–1995 received the Withrow Award as the outstanding teacher in the College of Business. He has published in *The Accounting Review*, the *Journal of Accountancy*, *Management Accounting*, and the *Financial Analysts Journal*. Professor O'Connor is a co-author of two monographs published by the National Association of Accountants—*Replacement Costing: Complying with Disclosure Requirements* and *Replacement Cost Disclosures: A Study of Compliance with the SEC Requirement*. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Michigan Association of Certified Public Accountants, Phi Kappa Phi, Beta Gamma Sigma, and Beta Alpha Psi. Professor O'Connor has been a member of the AAA Council, has served on many AAA committees, including the Committee on Financial Accounting Standards, is a past president of the AAA Administrators of Accounting Programs Group, and has been a member of the Editorial Board of *Issues in Accounting Education*. He also served for several years as a member of the Accounting Accreditation and Visitation Committees of the American Assembly of Collegiate Schools of Business. Professor O'Connor was a charter member of the Accounting Education Change Commission and was the only accounting educator to serve on the Commission throughout its entire existence.

***To Our  
Families***



## PREFACE

We were originally motivated to write this book because we recognized the need for an intermediate accounting book that would help students sharpen their ability to think, while simultaneously teaching the important financial accounting procedures. We are grateful for the positive response we have had to our approach in previous editions. We want to thank the many instructors and students who have taken the time to contact us and share their comments. We carefully considered their feedback while preparing this edition.

The sixth edition of Intermediate Accounting continues our vision for a more conceptual approach to intermediate accounting and offers many significant improvements. We hope that you will benefit from using this text in your course.

### Strong Conceptual Orientation

#### ... Along with a Balance of Procedures

Like other texts, our text provides a *conceptual framework* which is introduced in Chapters 1 and 2. Unique to our text, this framework is then consistently used throughout the text to explain and evaluate accounting procedures. Developing an understanding of the bigger picture benefits students not only in this course, but throughout their college experience and beyond. Along the way, students develop stronger communication, intellectual, and interpersonal skills. Students gain the ability to critically evaluate accounting practices and contribute to improvements when necessary. We feel that this conceptual orientation is consistent with the goals and recommendations of the Accounting Education Change Commission (AECC).

The organization of the book continues to include *early flexible coverage of rev-*

### MAJOR THEMES OF THE SIXTH EDITION

#### CONCEPTUAL

Financial statements are prepared in accordance with the time period assumption.

To provide relevant and timely information, corporations prepare financial statements periodically in accordance with the *periodicity (or time-period) assumption*. The accounting equation shown in Exhibit 3-1 may be interpreted within a time-period context. The first two equations in Exhibit 3-1 apply at the *end* of an accounting period. The third equation shows that the change in retained earnings *during* a period equals the beginning-of-period retained earnings plus net income for the period less dividends declared during the period. The last equation shows that net income *for the period* equals revenues less expenses plus gains less losses.

These margin notes appear frequently throughout the text to explain the underlying concepts behind various procedures.

### The Accounting Entity Assumption

The essence of the accounting entity assumption is that accountants account for and report the financial information of a specific *accounting* entity. Thus the **accounting entity assumption** establishes boundaries or limits as to what information should be included in the financial statements of a given accounting entity. For example, you learned in introductory accounting that the economic activities of a single (sole) proprietorship are accounted for separately from the personal economic activities of the proprietor.

The accounting entity for which financial reports are prepared may or may not correspond to a legal entity. For example, under certain circumstances the accounting entity may be a corporation (a legal entity), a division or department within a corporation (within a legal entity), or a group of legal entities (for which consolidated

#### CONCEPTUAL

The accounting entity assumption limits the transactions and events that should be reported in an entity's financial statements.



*revenue recognition.* We firmly believe that a thorough understanding of revenue recognition criteria as a means of compensating for uncertainty about future cash flows is essential to understanding specific accounting procedures. Therefore, revenue recognition is presented in Chapter 7, but can be covered at any time after Chapter 2. We were the first to offer this organization, but other books have since followed our lead.

The necessary procedural aspects of accounting have been kept intact. We continue to thoroughly present, explain, and illustrate common accounting procedures and reporting alternatives. They are evaluated routinely in terms of their usefulness in predicting and assessing cash flows to the company and to investors and creditors.

### Student Friendly Focus

For the sixth edition, we have added new features that make this text extremely accessible and easy to understand.

- **Learning objectives** now open each chapter to prepare students for the important material ahead of them. These objectives also appear as margin notes to alert students where an objective is discussed. The learning objectives are summarized at the end of the chapter to reinforce content and to serve as a study tool.
- **Key terms** are highlighted in boldface text within the chapter and are listed at the end of each chapter with a page reference to the location in the chapter where the term is defined.
- **Margin icons** direct students to interesting and important chapter material. These icons, appearing both within the text and end-of-chapter material, have the following functions:



**Real World** Signify numerous excerpts from actual financial statements that are presented to relate the text coverage to the practice of accounting.



**International** Highlight frequent discussions of how accounting practices vary by country and how they compare to the U.S. standards.



**Economic Consequences** Indicate places in the text that discuss how the economic environment may be affected by financial accounting and reporting practices.



**Ethics** High ethical standards are imperative for the future of the accounting profession; therefore, we raise ethical issues throughout the text, and include a number of cases dealing with ethical issues.



**Group Assignment** Appear in the end-of-chapter material and feature assignments which are amenable to group activities.



**Research Problem** Denote where students must study authoritative literature to support their answers.



**Critical Thinking** Appear beside the end-of-chapter problems that require analysis, synthesis, and/or evaluation by students.



**Financial Reporting** Show students problems that relate to actual financial statements.



**Writing Assignment** Appear in the end-of-chapter material where students must demonstrate writing skills.



## Stronger Problem Material

In an effort to strengthen student skills, we have greatly improved our *end-of-chapter assignments*. We have added more critical thinking exercises, more group assignments, and new financial reporting problems related to the **General Electric Annual Report** (located in Appendix B).

In addition, Professor Fred Mittelstaedt of the University of Notre Dame has prepared a number of exciting, integrative cases based on real accounting situations. Teaching notes for these cases appear in the Instructor's Manual.

### DIGITAL EQUIPMENT CORPORATION RESTRUCTURING CASE

Digital Equipment Corporation was founded in 1957. It designs, manufactures, sells, and services networked computer systems. As of the end of fiscal 1996, approximately 65 percent of Digital Equipment's revenue was derived outside the United States. In 1996, Digital Equipment had consolidated revenue of \$14,563 million, a net loss of \$111.8 million, and total assets of \$10,075 million. It also had 59,100 employees.

Read the accompanying *Business Week* article and answer the questions using the financial statement excerpts that appear below. All questions relate to fiscal 1996 unless otherwise specified.

1. According to the *Business Week* article, what are some of Digital Equipment's problems?
2. Why would Digital Equipment choose to show restructuring charges as a separate line item on its income statement? Note that it is part of operating income.

3. Show how operating income/loss for each year from 1994 to 1996 would change if Digital Equipment had not accrued restructuring costs in 1994 and 1996. In other words, how would income look if Digital had accounted for these costs as layoffs and asset disposals were actually made?

4. Why does GAAP require accrual of restructuring charges?

5. What entry would Digital Equipment have made in 1995 if at July 1, 1995 management balance for "Accrued restructuring charges" had been only \$100 million? Explain how this should be disclosed in notes and income statement. Base your answer on Note E and not on your answer to question 4.

6. The Securities and Exchange Commission questioned some firms about the treatment of restructuring charges. Why would a firm be concerned about a firm accruing too

Digital Equipment Corporation Restructuring Case

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served since the 1950s, and six of the nine outside directors are over 69 years old. It's time for more turnover.

There's plenty for activist board members to do. A top priority should be bolstering top management. Current directors have allowed Palmer to push aside several possible heirs apparent, including former Vice-President for Sales and Marketing Edward E. Lucente and Vice-President Enrico Pesatori. Each had problems. But Pesatori was never even replaced. Rather, Palmer has taken on his duties, managing the day-to-day operations of the Computer Systems Div.,

which brings in nearly half of Digital's revenues. Palmer now functions as chairman, CEO, president, and general manager. That's too many roles for one executive to handle at any company, let alone a struggling one.

The CEO has promised that DEC will be profitable in the current quarter. He's running out of time to deliver on his promises.

Judge, in Boston, and Sager, in New York, cover the computer industry.

### How to Get DEC Back on Track

By Paul C. Judge and Ira Sager

It's bad news, once again, at Digital Equipment Corp. The company is awash in red ink, posting on Oct. 22 a loss of \$65.9 million for the quarter ended on Sept. 28. Revenues declined 11%, to \$2.91 billion. The loss was a shocker: three times what Wall Street had expected. DEC's

lot of products and services at a lower price than its more customers. These DEC rivals have without neglecting customers, and they have done it. Using resellers would be a critical need. DEC has revenue per employee

#### Consolidated statements of operations Digital Equipment Corporation

(in thousands except per share data)

Year ended	June 29, 1996	July 1, 1995	July 2, 1994
<b>Revenues (Notes A and B)</b>			
Product sales	\$ 8,362,423	\$ 7,616,441	\$ 7,191,251
Service and other revenues	6,200,352	6,196,621	6,259,539
Total operating revenues	14,562,775	13,813,062	13,450,790

#### Note E: Restructuring actions

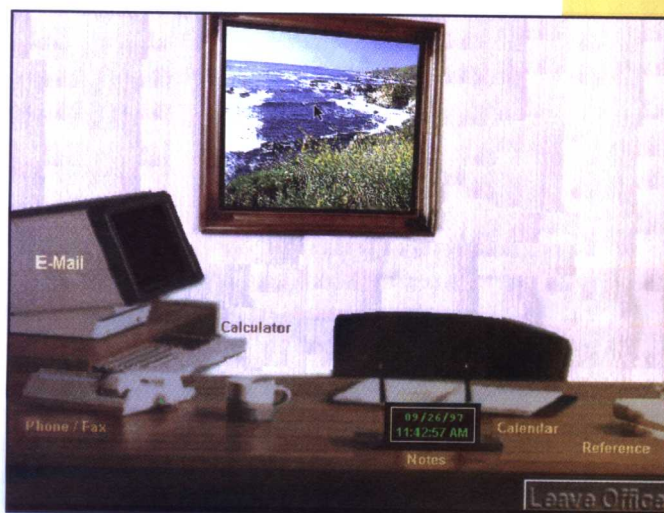
Accrued restructuring costs and charges include the cost of involuntary employee termination benefits, facility closures and related costs associated with restructuring actions. Employee termination benefits include severance, wage continuation, notice pay, medical and other benefits. Facility closure and related costs include disposal costs for property, plant and equipment, lease payments and related costs.

As the Corporation continues to implement its strategic plan and respond to external market conditions, there can be no assurance that additional restructuring actions will not be required. With regard to the completion of planned restructuring actions, there can be no assurance that the estimated cost of such actions will not change.

## Technology

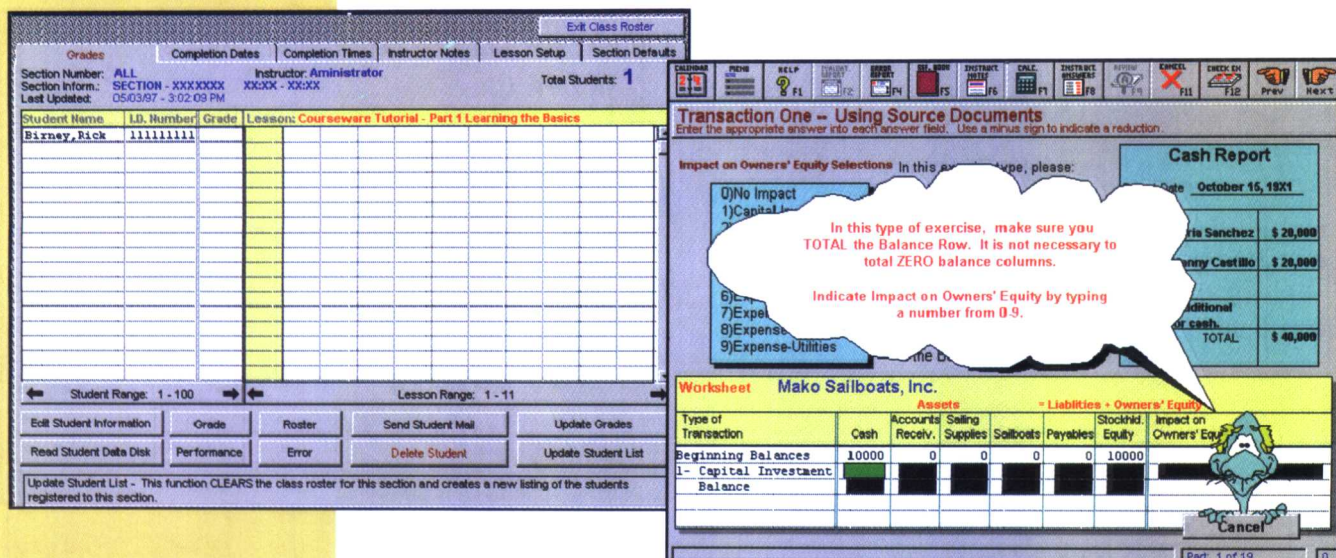
The most sophisticated intermediate accounting software available today, *Interactive Intermediate Accounting Lab*, by Ralph E. Smith and Rick Birney, was developed using the problem material from this text. This software package educates students on the mechanics of the accounting discipline, allowing more class time to be devoted to the conceptual learning of intermediate accounting. Both network and portable versions are available.

- As an employee for a virtual company, students enter an exciting virtual office complete with a fax machine, e-mail, and a desk calendar, which all play a functional role in the software.
- Students are motivated by salaries and promotions based on their performance working in this virtual company with their classmates.





- The instructor can manipulate the “calendar” of assignments the students are required to complete, and can also monitor the performance of a complete class roster.
- New Button Bar, Tutorial Lessons, and on-line reference make the program simple to learn and use.



- After completing the exercises, students come to class understanding the assigned material and prepared for advanced applications and collaborative exercises.
- Since instructors receive performance results prior to class, they can prepare according to concepts that were difficult for students to understand.
- If your students need a review of the accounting cycle, the *Interactive Financial Accounting Lab* is also available.

### Currency

As always, we are committed to providing the most up-to-date information available. The latest FASB pronouncements have been fully integrated where appropriate. Through the help of our publisher, the author team will continue to provide updates as they relate to the intermediate course throughout the life of this edition. The following list details many of the changes we have made on a chapter-by-chapter basis.

## CHAPTER-BY-CHAPTER CONTENT CHANGES IN THE SIXTH EDITION

- **Chapter 1** contains revised and enhanced coverage of international accounting and reporting standards, as well as the environment and role of financial accounting and reporting.
- **Chapter 2** now includes an additional section on the role of financial reporting in assessing management stewardship. An updated section on comprehensive income reflects the requirements of *FASB Statement No. 130*.
- **Chapter 3** presents an expanded overview of the accounting process. A complete set of transactions is used throughout the accounting cycle rather than using fragmented illustrations.
- **Chapter 4** now includes a brief discussion of the current operating performance approach and the all-inclusive approach to reporting income information. This coverage enables students to better understand the comprehensive income issue, which has also been updated in this chapter to incorporate the recently issued *FASB Statement No. 130*.



- Coverage of the statement of retained earnings, and prior period adjustments, has been moved to **Chapter 5** from **Chapter 4**. We have eliminated the coverage of currently-maturing obligations, callable obligations, and short-term obligations expected to be refinanced.
- **Chapter 6** modifications include a change of emphasis from the direct approach to the indirect approach for reporting cash flows from operating activities. We have also added material on cash flow analysis.
- We have subdivided **Chapter 8** into Part A (cash and current receivables) and Part B (current payables and contingencies). The end-of-chapter material has been subdivided accordingly. To reflect *FASB Statement No. 125*, we have also updated the material on using receivables to obtain immediate cash.
- The coverage of research and development costs in **Chapter 11** has been condensed.
- **Chapter 12** has been updated to reflect FASB activities related to liabilities for closure or removal of long-lived assets, and asset impairment.
- Based on the *FASB Exposure Draft*, **Chapters 13** and **14** include a discussion of derivatives and hedging activities. **Chapter 14** goes into some detail on accounting for derivatives and hedging activities and includes end-of-chapter material on the topic. Both chapters have been updated to reflect the comprehensive income reporting requirements of *FASB Statement No. 130*.
- **Chapter 16** has been completely revised to emphasize the conceptual aspects of "immediate recognition" of pension expense as contrasted to the "delayed recognition" approach which is permitted for some components of pension expense under *FASB Statement No. 87*. We have also incorporated a worksheet to account for the components of pension expense under the delayed recognition approach.
- In **Chapter 17**, we condensed the historical coverage leading to current requirements in accounting for income taxes. We made the comprehensive, multi-period example more concise by shortening it from five to four years.
- The coverage of stock options in **Chapter 18** has been updated to reflect *FASB Statement No. 123*. Coverage of stock subscriptions has been condensed. We have deleted coverage of donated treasury stock and scrip dividends.
- **Chapter 20**, covering earnings per share, has been completely rewritten based on *FASB Statement No. 128*. The chapter is shorter and more concise, but retains the conceptual aspects of previous editions.
- The section on segment reporting in **Chapter 21** has been revised to reflect the requirements of *FASB Statement No. 131*.

### Important Retained Features

- **Treatment of complex issues** A building block approach is used to present accounting for leases (Chapter 15), pensions and other postretirement benefits (Chapter 16), income taxes (Chapter 17), and earnings per share (Chapter 20). A conceptual introduction to these topics is followed by explanations of progressively more complex procedural issues. The presentations are organized so that the material may be covered in varying degrees of detail.
- **Bonds and notes** Accounting for bonds and notes from the standpoint of the issuer and the investor are covered in one chapter. Because most of the concepts and procedures applicable to bonds and notes apply to both issuer and investor, it is both pedagogically sound and efficient to study them together.
- **Present and future value coverage** Concepts of present and future value are discussed in Appendix A and are used in several chapters. Time diagrams are used extensively to clarify the concepts of present and future value.



■ **Flexibility** There is a great deal of flexibility in both sequencing and depth of coverage of various topics. Some examples:

- The present value appendix can be covered at any point or not covered at all.
- The statement of cash flows is covered at two different levels of complexity in two different places. Some instructors may prefer only the introductory level coverage in Chapter 6, while others may include the in-depth coverage in Chapter 21.
- The building block approach allows the instructor to choose the depth of coverage for complex topics such as leases, pensions and other postretirement benefits, income taxes, and earnings per share.

## SUPPLEMENTS FOR THE INSTRUCTOR

**Instructor's Manual** by Stephen J. Dempsey (University of Vermont). This manual increases the breadth of teaching materials available to professors. Each chapter begins with a restatement of the learning objectives. This section is followed by a detailed lecture outline. Lecture topics are provided, as are issues for reflection and discussion. An annotated bibliography suggests extra reading materials. A summary of chapter and problem material coverage and tables of assignment characteristics also are provided. Much of the material is accompanied by detailed illustrations that expand the extensive visual exhibits in the text. Teaching notes to accompany the integrative cases prepared by Fred Mittelstaedt (University of Notre Dame) are also included.

**Solutions Manual** by the authors. This volume provides fully worked solutions to questions, cases, exercises, and problems in the text. The solutions are thoroughly explained and each step is illustrated to enhance discussion of assignment and other materials.

**Solutions Transparencies** Solutions from the Solutions Manual for end-of-chapter exercises and problems are available on transparencies for use as a classroom aid in reviewing homework assignments. Fifty exhibits from the text and chapter outlines are also included in the transparency set.

**Check Figures** by the authors. This booklet provides key figures in the solutions to the end-of-chapter assignments. These figures allow students to check the accuracy of their work.

**Ready Shows, Ready Slides** by Paula Irwin (Muhlenberg College) are teaching enhancement packages. (See also "Ready Notes" under Supplements for Students).

**Ready Shows** A package of multimedia lecture enhancement aids that uses PowerPoint software to illustrate chapter concepts.

**Ready Slides** These selected four-color teaching transparencies are printed from the PowerPoint Ready Shows.

**Instructor's Manual for Understanding Corporate Annual Reports, 3/e** by William R. Pasewark (University of Houston). The manual contains extensive instructional and grading suggestions, and a 50-question exam. (See description under Supplements for Students.)

**Interactive Accounting Labs (Financial or Intermediate)** by Ralph E. Smith and Rick Birney (both of Arizona State University) were designed to educate students on the mechanics of the accounting discipline, allowing class time to be devoted to other learning activities. This software is interactive, motivating, and provides immediate feedback. The Administration Module and Gradebook features allow you to manipulate the assignments your students are required to complete and easily track their performance. This software is available in either network or portable stand-alone versions.



**Test Bank** by Alan H. Falcon (Loyola Marymount University) and John A. Marts (The University of North Carolina—Wilmington). The Test Bank includes approximately 1,500 questions and problems. Each chapter offers multiple-choice questions, extended problems, and, in most chapters, essay questions. Also in this edition are guides to all questions indicating the topics tested by multiple-choice questions and the difficulty level of all questions.

**Computest** A computerized version of the manual testbank for more efficient use is available in the Windows platform.

**Teletest** By calling a toll free number, instructors can specify the content of exams and have a laser-printed copy of the exams mailed to them.

**Study Guide** by John Cumming and Clayton Hock (both of Miami University, Oxford, Ohio). Each chapter contains a list of objectives and a detailed chapter review. The Self-Study Learning section includes a review of key terms and concepts, true-false questions, multiple-choice questions, and extended problems—all with solutions. A final section discusses common errors.

**Work Papers** by Diane Adcox (University of North Florida). This supplement provides students with the forms necessary to work the problems and exercises at the end of each chapter in the text.

**Ready Notes** This booklet of Ready Show screen printouts enables students to take notes during Ready Show or Ready Slide presentations. This supplement changes the nature of note-taking. Rather than spending time copying material that is already in the book, students can focus on the most important aspects of what the instructor is saying.

**Understanding Corporate Annual Reports, 3/e** by William R. Pasewark (University of Houston) offers students hands-on experience in the analysis and understanding of corporate annual reports. This Practice Set requires students to obtain an annual report and then use the information to answer the questions. Appendices provide instructions for obtaining an annual report from a corporation, making industry comparisons, and referencing generally accepted accounting principles. The latest edition has been updated to include recent FASB Statements and a discussion of internet sources for corporate financial data.

**Interactive Accounting Labs (Financial or Intermediate)** by Ralph E. Smith and Rick Birney are available in portable versions for the individual user. (See descriptions under Supplements for the Instructor.)

**Seascapes Floral Expressions Practice Set** by Marilyn E. Vito and Gulprit Chhatwal (both of the Richard Stockton College of New Jersey). Designed to address the growing demand for accountants skilled in small business accounting and administration, this practice set asks students to analyze data common to a small business environment, while providing a review of basic accounting concepts. Sales transactions are presented in a variety of formats to simulate the complexity of small businesses involved in several different service and product lines. The practice set also includes supplemental stand-alone problems that build on the text end-of-chapter material. Students may complete the practice set manually or with its accompanying spreadsheet templates, available in Lotus and Excel.

**SPATS (Spreadsheet Applications Template Software)** This includes Excel templates for selected problems and exercises from the text. The templates gradually become more complex, requiring students to build a variety of formulas. "What if" questions are added to show the power of spreadsheets and a simple tutorial is included. Instructors may request either a free master template for students to use or copy, or shrink-wrapped versions are available for a nominal fee.



## SUPPLEMENTS FOR STUDENTS



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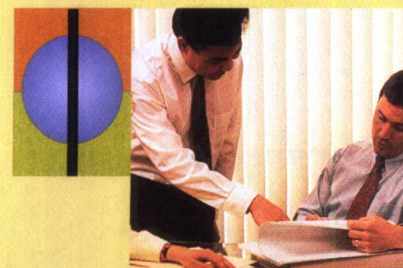
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