



INTERMEDIATE

ACCOUNTING

FIFTH EDITION

LANNY G. CHASTEEN

RICHARD E. FLAHERTY

MELVIN C. O'CONNOR

INTERMEDIATE ACCOUNTING FIFTH EDITION

LANNY G. CHASTEEN
Oklahoma State University

RICHARD E. FLAHERTY
Arizona State University

MELVIN C. O'CONNOR
Michigan State University

McGraw-Hill, Inc.

New York St. Louis San Francisco Auckland Bogotá
Caracas Lisbon London Madrid Mexico City Milan
Montreal New Delhi San Juan Singapore Sydney
Tokyo Toronto

Intermediate Accounting

Copyright ©1995, 1992, 1989, 1987, 1984 by McGraw-Hill, Inc. All rights reserved. Printed in the United States of America. Except as permitted under the United States Copyright Act of 1976, no part of this publication may be reproduced or distributed in any form or by any means, or stored in a data base or retrieval system, without the prior written permission of the publisher.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 DOW DOW 9 0 9 8 7 6 5 4

ISBN 0-07-011087-5

This book was set in Times Roman by York Graphic Services, Inc.
The editors were Johanna Schmid, Alan Sachs, and Linda Richmond;
the designer was Joseph A. Piliero;
the production supervisor was Richard A. Ausburn.
The photo editor was Kathy Bendo; the photo researcher was Ede Rothaus.
R. R. Donnelley & Sons Company was printer and binder.

Permissions Acknowledgments

Material from Uniform CPA Examination Questions and Unofficial Answers, copyright © 1951, 1952, 1953, 1954, 1957, 1959, 1961, 1962, 1963, 1964, 1965, 1966, 1967, 1968, 1969, 1970, 1971, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1980, 1981, 1982, 1983, 1984 by the American Institute of Certified Public Accountants, Inc., is adapted with permission.

Material from the Certificate in Management Accounting Examination, copyright © 1977, 1978, 1981 by the National Association of Accountants, is reprinted and/or adapted with permission.

Material is reprinted, with permission, from the 1975 Chartered Accountants Examination, published by the Canadian Institute of Chartered Accountants, Toronto, Canada.

Materials issued by the FASB are copyright © by Financial Accounting Standards Board, 401 Merritt 7, P.O.B. 5116, Norwalk, CT 06856-5116, and reprinted with permission. Copies of the complete document are available from the FASB.

Page 154: From *The Wall Street Journal*, March 5, 1993. Reprinted by permission of the Wall Street Journal, © 1993 Dow Jones & Company, Inc. All Rights Reserved Worldwide.

Page 271: Herbert S. Bailey, Jr., "Quoth the Banker, 'Watch Cash Flow.'" Reprinted with permission from *Publishers Weekly*, January 13, 1975, published by R. R. Bowker Company, a Xerox Company. Copyright © 1975 by Xerox Corporation.

Pages 313 and 742: From "As IBM's Woes Grew, Its Accounting Tactics Got Less Conservative" in *The Wall Street Journal*, April 7, 1993. Reprinted by permission of The Wall Street Journal, © 1993 Dow Jones & Company, Inc. All Rights Reserved Worldwide.

Page 364: From "Did Drexel Get What It Deserved?" in *Fortune*, March 12, 1990. Copyright © 1990 Time, Inc. All Rights Reserved. Reprinted by permission.

Page 608: From "FASB Votes to Make Banks and Insurers Value Certain Bonds at Current Prices" in *The Wall Street Journal*, April 14, 1993. Reprinted by permission of The Wall Street Journal, © 1993 Dow Jones & Company, Inc. All Rights Reserved Worldwide.

Page 689: From "Junk Buy-Backs Take Off: Issuers Spring at Discounts" in *The Wall Street Journal*, June 1, 1990. Reprinted by permission of The Wall Street Journal, © 1990 Dow Jones & Company, Inc. All Rights Reserved Worldwide.

Page 725: From "Suit Leasing Firm Can Help You Fit the Company Image" by Gale Tollin, as appeared in *Tulsa World*, March 22, 1981. Copyright © 1981 Associated Press. Reprinted by permission.

Page 971: From "American Express to Cut Earnings by \$146 Million" as appeared in *Tulsa World*, January 13, 1988. Copyright © 1988 Associated Press. Reprinted by permission. Also, from "Ford Motor Co. Loses \$7.4 Billion in '92" as appeared in *Tulsa World*, February 11, 1993. Copyright © 1993 Associated Press. Reprinted by permission.

Library of Congress Cataloging-in-Publication Data

Chasteen, Lanny G., (date).

Intermediate accounting / Lanny G. Chasteen, Richard E. Flaherty, Melvin C. O'Connor.—
5th ed.

p. cm.

Includes bibliographical references and index.

ISBN 0-07-011087-5

I. Accounting. I. Flaherty, Richard E., (date). II. O'Connor, Melvin C. III. Title.
HF5635.C474 1995
657'.044—dc20

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 bachelor's degree from the University of Texas at Austin, and master's and doctorate degrees 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 Society of Certified Public Accountants' Outstanding Accounting Educator Award. 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 Deloitte & Touche. Professor Chasteen is a member of the American Accounting Association (AAA), the Accounting Administrators 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. He has served on committees of the American Accounting Association, the Federation of Schools of Accountancy, and currently serves on the Board of Governors of the Accounting Administrators Program Group of the AAA.

Richard E. Flaherty, Ph.D., CPA, is a professor of accounting at Arizona State University and Executive Director of the Accounting Education Change Commission. He received his bachelor's, master's, and doctorate degrees from The University of Kansas. Professor Flaherty previously taught at Oklahoma State University and the University of Illinois. He also served as a research associate for the Financial Accounting Standards Board. He has served as a consultant on financial reporting issues to a number of businesses and has taught in numerous professional development programs. Professor Flaherty has published articles on financial accounting theory and practice in such journals as *The Accounting Review*, *The CPA Journal*, and the *Journal of Accounting, Auditing & Finance*. Also, Professor Flaherty is the author of Accounting Education Research Monograph No. 3, *The Core of the Curriculum for Accounting Majors*, published by the American Accounting Association. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants (AICPA), the Arizona Society of Certified Public Accountants, the Financial Executives Institute, Beta Alpha Psi, Beta Gamma Sigma, and Delta Sigma Pi. He has served the AAA as chairman of its Committee to Nominate Notable Contributions to the Accounting Literature. He has also served the AICPA as a member of the Board of Examiners, a member and chair of the Theory Subcommittee of the Board of Examiners, on the Grading Subcommittee and on the Practice Analysis and Practice Analysis Implementation Task Forces, and as chair of the CPA Examination Change Implementation Task Force of the Board of Examiners. He has served on a number of AACSB committees, including the Accounting Accreditation Committee (chair, 1993–94), Candidacy Committee, and Peer Review Improvement Task Force (chair, 1994–95). Also, he has served on the Board of Governors of the Administrators of Accounting Programs Group of the AAA and on the Board of Directors of the Federation of Schools of Accountancy.

Melvin C. O'Connor, Ph.D., CPA, is a professor of 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 at Michigan State, and has been twice recognized as Michigan State's Beta Alpha Psi Professor of the Year. His articles on financial accounting theory and practice have been published in *The Accounting Review*, the *Journal of Accountancy*, *Management Accounting*, and the *Financial Analysts Journal*. The topics of his publications include financial statement analysis, materiality standards, replacement cost accounting, and accounting in the oil and gas industries. Also, Professor O'Connor is the coauthor 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*. Professor O'Connor 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. He has served on many AAA committees, including the Committee on Financial Accounting Standards, and is a past president of the AAA Administrators of Accounting Programs Group. 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 has been a member of the AICPA Practice Subcommittee of the Board of Examiners, is on the editorial board of *Issues in Accounting Education*, and is a three-term charter member of the Accounting Education Change Commission.

Preface

The extremely favorable response to previous editions indicates that our view of accounting education and of the role of intermediate accounting within the education process is shared by many accounting instructors. We continue to believe that accounting education should prepare students both to do accounting and to understand and critically evaluate accounting. Intermediate accounting should reflect these dual objectives. While most intermediate accounting textbooks share these two objectives and appear, on the surface, to be very similar in terms of content and organization, our text and supporting materials do have several distinctive characteristics.

ORGANIZATION AND COVERAGE

Based on input from adopters and reviewers, the chapter sequence has been altered somewhat from the fourth edition. We describe the environment of financial accounting in Chapter 1 and present a conceptual framework for financial accounting and reporting in Chapter 2. The accounting process and the resulting financial statements are discussed in Chapters 3, 4, 5, and 6. As discussed later in the preface, Chapter 6 has been revised to a more introductory level of presentation of the statement of cash flows. The statement of cash flows is revisited in more depth in Chapter 21. Revenue recognition is the subject of Chapter 7, which may be used at any point in the course. Asset accounting and reporting are covered in Chapters 8 through 12. Accounting for financial instruments is covered in Chapters 13 and 14. The special topics of leases, pensions and other postretirement benefits, and income taxes are presented in Chapters 15, 16, and 17, respectively. Chapter 18 covers contributed capital and retained earnings. Chapter 19 covers accounting changes and error corrections. Earnings per share is the subject of Chapter 20. Chapter 21 is a two-part chapter which covers the statement of cash flows and segment and interim reporting. Time value of money concepts and sample applications continue to be presented in an appendix at the end of the text. Adopters may cover this material at any point in their course. FASB pronouncements and other FASB actions through early 1994 have been incorporated in the text. The major changes resulting from FASB activities since the publication of the fourth edition are presented in Chapters 13 and 14 (mark-to-market accounting), 17 (income taxes), and 18 (stock options).

CONCEPTUAL INTEGRATION WITH A STRONG PROCEDURAL ORIENTATION

We introduce and discuss in detail the conceptual framework of accounting in Chapters 1 and 2. This framework is used throughout the text to explain and evaluate accounting procedures. To further our objective of integrating the conceptual framework throughout the text, we include a summary of important topics and concept applications at the end of each chapter. These summaries reinforce the relationship between the conceptual framework and the procedures discussed in the chapter, in addition to providing a review of chapter highlights. Also, alternative accounting procedures and disclosure alternatives are evaluated routinely in terms of their usefulness in predicting and assessing cash flows to the company.

As in previous editions, we have made a major effort to enhance the presentation and readability of the material. Characteristics of the fourth edition which have been favorably received have been retained and expanded. In addition, we have made several significant changes in the organization of material to facilitate the learning process.

PRESENTATION AND READABILITY

Most intermediate accounting textbooks do an adequate job of describing accounting procedures for the straightforward accounting topics, such as inventory cost flows, depreciation accounting, and accounting for receivables. However, our coverage of even these relatively simple topics stands out when compared to competing texts, because we do more than describe accounting procedures. Our presentation of procedures is amply illustrated, with many exhibits, margin notes, and references to real-world situations. Moreover, references to the conceptual framework are woven through our procedural discussions to emphasize the relationship between accounting concepts and procedures.

Users of the first four editions have reinforced our belief that we present the more complex accounting topics in a clear, concise, and thorough manner. Rather than shying away from controversial and difficult problem areas, we attack them head-on, using the conceptual framework to critically evaluate the accounting alternatives. We have added summary exhibits and illustrations of several key topics to clarify the issues discussed. In addition, we have again increased the number of margin notes in this edition. We have used appendixes to enhance the flow of the chapters and to improve instructor flexibility in terms of content coverage.

END-OF-CHAPTER MATERIAL

Our end-of-chapter material is extensive and diverse. There are nearly 1,000 cases, exercises, and problems in the text. Much of the problem material that appeared in the fourth edition has been revised, and many new cases have been added. Much of the new end-of-chapter problem material is of moderate difficulty. The new material has been class-tested, and the solutions to all end-of-chapter material have been thoroughly reviewed by the authors and by outside reviewers.

OTHER IMPORTANT FEATURES

Early Presentation of Revenue Recognition 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 early in the text (Chapter 7). This placement also reflects the authors' preference for introducing conceptual material early in the course. However, this chapter may be covered at any time after Chapter 2.

Complex Issues Treated in a Flexible Manner 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 presentation is organized so that the material may be covered in varying degrees of detail.

Short-Term and Long-Term Investments Covered in One Chapter Because there are more similarities than differences between accounting for short-term and long-term investments, coverage within a single chapter is pedagogically sound and efficient.

Present and Future Value Coverage Concepts of present and future value are discussed in an appendix at the end of the text and are used in several chapters. Time diagrams are used extensively throughout the text to clarify the concepts of present and future value.

Flexibility The organization of the fifth edition allows a great amount of flexibility to users. As an example, the text appendix on present value can be covered at any point in the course. Many users may wish to cover this material as a tool along with the accounting cycle (Chapter 3). Others may wish to cover the present value material immediately prior to Chapter 14 on debt instruments. Still others may choose not to spend any class time on this material but instead have the students use it as a resource when dealing with accounting issues that require present value concepts and applications. As another example, having the statement of cash flows presented at two different levels of complexity at two different places in the text increases flexibility in coverage. Some users may wish to cover both chapters. Others may prefer only the early, introductory level of coverage of the statement of cash flows, while still others, whose students have a working knowledge of the statement of cash flows, may choose to use only the in-depth coverage of the statement in Chapter 21.

Relationship between Accounting and the Environment Accounting issues are frequently evaluated in terms of their historical development and economic consequences. For example, the oil and gas accounting controversy is discussed in Chapter 12, the politics of accounting for leases is discussed in Chapter 15, and political influences on accounting for pensions and other postretirement benefits are described in Chapter 16.

Ethics and Professionalism in Accounting Ethics is a topic of growing concern to the general public, businesses, and the accounting profession. In fact, people speak of an “ethics crisis” in business, although many opinion polls indicate that the public’s perception of corporate ethics has not changed much in the last ten years. The accounting profession, in particular, is given high marks for ethical conduct. Nevertheless, sensing an obligation to promote high ethical standards, we include in Chapter 1 a section on the importance of ethics in financial accounting and reporting. Elsewhere in the text are illustrations that often have ethical implications. For example, the revenue recognition illustrations on pages 307 and 315–316 in Chapter 7 may have ethical considerations. As another example, the illustrations on pages 616 and 617 in Chapter 13 may raise ethical issues. In addition, several cases throughout the text deal with ethical issues.

International Accounting Standards The globalization of business has led to an increased awareness of and interest in accounting standards in other countries. Also, the development of international accounting standards is beginning to have an impact on worldwide accounting standards. Throughout the text, to provide the student with some perspective from which to view U.S. accounting standards, we have added comparisons of U.S. accounting standards to those of other developed countries and to international accounting standards.

Extensive Use of Real-World Examples Numerous excerpts from actual financial statements are presented to relate the text coverage to the practice of accounting. For example, a complete set of financial statements for Bristol-Myers Squibb is included in the appendix to Chapter 4 and is referenced in several chapters. We have drawn on the published financial statements of many other companies, such as McDonald’s, Ford, and Tenneco, to demonstrate reporting practices.

Major Changes in the Fifth Edition

- Chapter 6 on the statement of cash flows has been completely rewritten to cover the statement at an introductory level, in recognition of the fact that many students who study from this text may have had little, or no, exposure to this topic in introductory

accounting. The statement of cash flows is revisited in more depth in Part A of Chapter 21. The latter coverage incorporates such topics as leases, pensions, deferred taxes, and mark-to-market accounting. Real world examples of both the direct and indirect approaches to presenting the operating activities section of the statement of cash flows are provided.

- Error analysis and correction has been moved from Chapter 3 to Chapter 19. The resulting material in Chapter 3 is a thorough review of the accounting process and the accounting cycle using a single set of data throughout the chapter. Additionally, a section on converting from cash-basis accounting to an accrual basis of accounting has been added at the end of Chapter 3.
- Detailed coverage of accounting changes has been moved from Chapter 4 to Chapter 19. The resulting content of Chapter 19—accounting changes and error analysis and correction—is similar to many existing intermediate accounting textbooks.
- Segment and interim reporting has been moved from Chapter 4 to Chapter 21. Chapter 21 is a two-part chapter dealing with the statement of cash flows (Part A) and segment and interim reporting (Part B).
- Contingencies has been moved from Chapter 5 to Chapter 8. This change, in conjunction with the changes listed above, allows students to focus primarily on format issues related to the income statement and balance sheet in Chapters 4 and 5.
- Chapter 12 contains a summary of the FASB *Exposure Draft* on impairments of long-lived assets and Chapter 18 provides coverage of the FASB *Exposure Draft* on the use of stock options as compensation.
- Chapters 13 and 14 on financial instruments have been revised to include the accounting and reporting requirements of *Statement of Financial Accounting Standards No. 115* on “mark-to-market accounting.” Chapter 14 also contains coverage of *Statement of Financial Accounting Standards No. 114* on loan impairments, including impairments associated with troubled debt restructurings.
- Chapter 16 on pensions and other postretirement benefits has undergone a substantive revision. Because the concepts and, in most cases, the procedures that underlie accounting for a pension plan are identical to those of a health care plan, these topics are covered together, rather than separately as was done in the fourth edition. We believe that this approach is more efficient, eliminates unnecessary duplication, and strengthens students’ understanding of the accounting issues associated with pensions and other postretirement benefit plans.
- Chapter 17 has been updated to reflect the requirements of *Statement of Financial Accounting Standards No. 109* on accounting for income taxes.
- In addition to many new exercises and problems in the end-of-chapter materials, the authors have added several new cases. Many of these cases are “open-ended” and do not necessarily have a “right” answer.
- Many new real-world examples of reporting practices have been added.

The text is accompanied by a full ancillary program with items designed to complement your teaching efforts and your students’ learning process. If you would like information and costs on the supplemental materials, please contact your local McGraw-Hill representative. We value both your interest and our supplements.

SUPPLEMENTARY LEARNING AIDS

Student Mastery Guide by John Cumming and Clayton Hock (both at Miami University, Oxford, Ohio). Each chapter contains a list of chapter 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.

Working Papers By Diane Adcox (University of North Florida). This supplement provides students with the forms necessary to work the problems and exercises at the ends of chapters in the text. There are two volumes of working papers; one for each half of the text.

Sails Away Practice Set by Nancy O'Rourke Tang and Donald Tang (both at Portland State University). Based on a combined wholesaling, retailing, and service concern, the *Practice Set* is designed to provide students with a comprehensive review of the accounting process and practice in the application of concepts and skills. Students are given the opportunity to assess a series of complex events to determine year-end accrual, disclosure, or adjustment, and to complete a full set of financial statements, including all related footnotes.

Computer-Assisted Practice Set by Louis F. Biagioni (Indiana University). GEMCO is a challenging computer-assisted practice set available for use in the intermediate accounting course. Class-tested by the author, it teaches students the accounting cycle while familiarizing them with computer accounting systems. GEMCO requires students to record transactions, make adjusting entries, and generate the reports of the General Microcomputers Company, Inc. Transactions for two months are provided. Those for the first month are to be done manually. Three sets of transactions, ranging from simple to difficult, provided for the second month are to be done on computer. An electronic spreadsheet template is provided for the completion of the statement of cash flows. The package includes extensive HELP screens and tutorials that make the programs educational and unique. Available for use with the IBM PC/PC-XT and true compatibles.

Intermediate Accounting Problem Solver by Dilip D. Kare and Thomas L. Barton (both at University of North Florida). Students will be able to solve more than 160 exercises and problems from the text. This modern and user-friendly software runs directly from DOS on any IBM compatible computer. A computer symbol in the margin of the text identifies the exercises and problems that can be solved using this software.

AccKnowledge Software for Intermediate Accounting by Thomas L. Barton and Dilip D. Kare (both at University of North Florida). This package is designed to help students learn some of the toughest Intermediate Accounting Topics including leases, pensions, bonds, and earnings per share. AccKnowledge helps students not only with the number crunching, but also with the many complicated rules found in these subjects. Available for IBM compatible computers.

Student Interactive Spreadsheet Software by Glenn E. Owen (University of California, Santa Barbara). Using this software, students work with problems from the text and observe the effects of changing variables and scenarios. Available for IBM compatible computers and Macintosh computers.

TEACHING AIDS

Instructor's Resource Manual by Stephen J. Dempsey (University of Vermont) and Janet Kimbrell (Oklahoma State University). This manual increases the breadth of teaching materials available to professors. Each chapter begins with a restatement of the chapter objective. This section is followed by a detailed lecture outline and a point-by-point chapter review. 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.

Solutions Manual This volume provides fully worked solutions to all 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 Manual for Sails Away Practice Set by Nancy O'Rourke Tang and Donald Tang (both at Portland State University). This booklet contains completed journal entries, income statements, and worksheets for the manual practice set. A sample grading sheet is included.

Check Figures 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 at an intermediate stage in the solution process.

Transparencies Solutions from the *Solutions Manual* for all 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 transparencies set.

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 problems and essays.

Computerized Test Bank: RHTest and MicroTest RHTest and MicroTest give access to a broad range of testmaking functions. Instructors can prepare tests quickly and easily. This powerful program allows instructors to view questions as they are selected for a test; scramble questions to create different versions of the test; add questions; edit questions; select questions by type (multiple-choice, true-false, matching, essay, or short answer), objective, and difficulty; and view and save a test. It includes all the questions available in the printed test bank. RHTest is available for the IBM PC/PC-XT and true compatibles; MicroTest is available for the Macintosh.

Instructors Interactive Spreadsheet Software by Glenn E. Owen (University of California, Santa Barbara). Using problems from the text, instructors can engage in what-if scenarios and demonstrate the effects of changing variables. Available for IBM compatible computers and Macintosh computers.

Presentation Software by Glenn E. Owen (University of California, Santa Barbara). A complete set of computerized instructional materials that can be easily projected in class to highlight lectures and stimulate student involvement. Consists of animated illustrations, graphics, demonstration problems, definitions, charts, and more. Available for IBM compatible computers.

Accounting Case Videotapes This video package consists of eight vignettes covering various accounting topics. A correlation chart in the accompanying Critical Thinking Guide coordinates the various topics with the text chapters. The Critical Thinking Guide by Mark S. Bettner (Bucknell University) provides for each vignette: a brief summary, the key concepts and topics, suggested homework assignments, student handouts, small group activities, discussion questions, and teaching notes.

ACKNOWLEDGMENTS Many individuals have contributed generously of their time in the development of the fifth edition. Their comments and suggestions on accounting teaching matters as well as on technical issues have been invaluable. They are: Diana L. Adcox, *University of North Florida*; Michele Blazek, *University of New Mexico*; Russell F. Briner, *The University of Texas at San Antonio*; Clifford D. Brown, *Bentley College*; Thomas A. Buchman, *University of Colorado at Boulder*; Stephen J. Dempsey, *The University of Vermont*; Carleton Donchess, *Bridgewater State College*; Alan H. Falcon, *Loyola Marymount University*; Martha A. Fasci, *The University of Texas at San Antonio*; William Geary, *College of William and Mary*; Robert Gruber, *University of Wisconsin–Whitewater*; Stuart B. Keller, *University of Kentucky*; James M. Kurtenbach, *Iowa State University*; Raef Lawson, *University at Albany*; Susan A. Lynn, *University of Baltimore*; John A. Marts, *University of North Carolina–Wilmington*; David Meeting, *Cleveland State University*; David Plumlee, *The University of Kansas*; Kris K. Raman, *University of North Texas*; Barbara R. Stewart, *Towson State University*; Mary Tharp, *Kirkwood Community College*; Joel E. Thompson, *Northern Michigan University*; and David N. Wiest, *University of Massachusetts–Boston*.

We also want to thank the many instructors who provided valuable assistance in previous editions, including: John Alcorn, *Morehead State University*; Deborah Beard, *Southeast Missouri State University*; Lila Bergman, *City University of New York/Hunter College*; Maureen H. Berry, *University of Illinois*; William E. Blouch, *Loyola College*; Clifford D. Brown, *Bentley College*; Thomas Buchman, *University of Colorado*; Joseph Bylinski, *University of North Carolina*; Ronald E. Carlson, *St. Cloud State University*; Janice Carpenter, *Northern Arizona University*; Robert C. Chang, *University of Bridgeport*; Eugene G. Chewning, Jr., *University of South Carolina*; Joseph C. Colgan, *Fort Lewis College*; Doris M. Cook, *University of Arkansas*; James S. Cox, *Ohio University*; Joann Noe Cross, *University of Wisconsin/Oshkosh*; David M. Dennis, *University of South Florida*; C. Dwayne Dowell, *Texas Tech University*; John A. Elfink, *Southeast Missouri State University*; David R. Finley, *University of Houston*; Mary L. Fischer, *University of Texas/Tyler*; John D. Fitzsimmons, *Western Connecticut State University*; Thomas Frecka, *University of Notre Dame*; Monica D. Frizzell, *Western Connecticut State University*; Gouranga Ganguli, *University of Texas/Pan American*; David R. Ganz, *University of Missouri/St. Louis*; Bruce R. Gaumnitz, *University of Cincinnati*; Carol B. Gaumnitz, *University of Northern Kentucky*; Joyce S. Goldstone, *Adelphi University*; Ellsworth Granger, Jr., *Mankato State University*; Marcia Halvorsen, *University of Cincinnati*; John M. Hassell, *University of Texas/Arlington*; Carol Anne Hilton, *Ohio University*; Robert E. Holtfreter, *Fort Hays State University*; Dennis Hudson, *University of Tulsa*; Herbert G. Hunt III, *University of Vermont*; H. Fenwick Huss, *Georgia State University*; Allen L. Karnes, *Southern Illinois University*; Tim Kelley, *University of San Diego*; Robert Kirsch, *Bowling Green State University*; Thomas P. Klammer, *University of North Texas*; Harry E. Knight, *Southern Oregon State University*; Louis Lebensbaum, *Adelphi University*; Susan A. Lynn, *University of Baltimore*; Malcolm McKenzie McClure, *Illinois State University*; Reed McKnight, *Fort Lewis College*; Robert E. Malcom, *Pennsylvania State University*; R. David Mautz, Jr., *Virginia Polytechnic Institute and State University*; Paul B. Miller, *University of Colorado/Colorado Springs*; Thomas I. Miller, *Murray State University*; Ralph M. Newkirk, Jr., *Rutgers University*; Marcia S. Niles, *University of Idaho*; Priscilla O’Clock, *Mankato State University*; Emeka Ofobike, *University of Akron*; Dorian Olson, *Moorhead State University*; William H. Parrott, *University of South Florida*; Victor S. Pastena, *State University of New York/Buffalo*; Mahmood A. Qureshi, *California State University/Northridge*; Charles Reichert, *University of Wisconsin*; Sara Ann Reiter, *State University of New York/Birmingham*; John Rich, *Emporia State University*; Frederick M. Richardson, *Virginia Polytechnic Institute and State University*; John

T. Rigsby, *Mississippi State University*; Donald Rogoff, *California State University/Northridge*; Jeffrey Romine, *Northeast Missouri State University*; Eugene R. Rozanski, *Illinois State University*; Victoria S. Rymer, *University of Maryland*; Clayton Sager, *University of Wisconsin*; William Schwartz, *Temple University*; Mary Alice Seville, *Oregon State University*; Matthew J. Stephens, Jr., *Wharton School, University of Pennsylvania*; Barbara Stewart, *Towson State University*; Donald Tang, *Portland State University*; Nancy O'Rourke Tang, *Portland State University*; Michael Trebesh, *Alma College*; Terry Unruh, *Oral Roberts University*; Nancy A. Wagner, *Georgia Southern College*; Larry E. Watkins, *Northern Arizona University*; Paul Wertheim, *East Carolina University*; Michael D. Wilson, *University of Wisconsin*; and David A. Ziebart, *University of Illinois*. W. David Albrecht, *Bowling Green University*; Matthew J. Anderson, *Michigan State University*; Joseph H. Anthony, *Michigan State University*; Mary Barnum, *Grand Valley State University*; Barney R. Cargile, *University of Alabama*; Gyan Chandra, *Miami University*; Stephen J. Dempsey, *University of Vermont*; Matthew Dowling, *San Francisco State University*; Joanne Duke, *San Francisco State University*; Martin Freedman, *State University of New York at Binghamton*; Julia Grant, *Ohio State University*; James W. Greenspan, *University of Cincinnati*; George C. Holdren, *University of Nebraska*; Carol Olson Houston, *San Diego State University*; Kenneth H. Johnson, *Mississippi State University*; Calvert C. McGregor, *University of South Carolina*; Donald R. Nichols, *Texas Christian University*; Kathy Petroni, *Michigan State University*; Susan Pourciau, *Florida State University*; Charles Ransom, *Oklahoma State University*; D. Shores, *University of Washington*; Sheldon R. Smith, *Brigham Young University-Hawaii*; and Michael G. Tearney, *University of Kentucky*.

We also wish to thank John A. Marts (*University of North Carolina/Wilmington*) and Virginia H. Bakay (*University of Nevada at Las Vegas*) for reviewing the end-of-chapter assignment material. They carefully checked the questions, cases, exercises, and problems for consistency with text discussions and reworked our solutions, examining them for accuracy, completeness, and clarity.

We appreciate the cooperation of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board for allowing us to draw on their pronouncements for much of the text discussion. We also acknowledge permission from the American Institute of Certified Public Accountants, the Canadian Institute of Chartered Accountants, the Certified General Accountants Association of Canada, and the Institute of Management Accounting of the National Association of Accountants to adapt materials from their professional examinations.

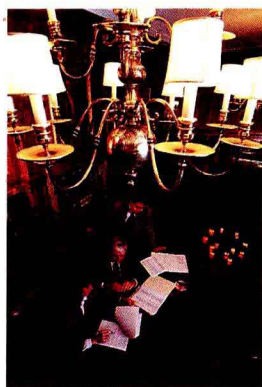
Finally, we are most appreciative of the outstanding assistance and guidance provided by the professionals in the College Division of McGraw-Hill: Linda Richmond, senior editing supervisor, for her careful attention to presentation and detail; Judy Howarth, associate editor, for her efforts in attending to the preparation of ancillary materials; and Richard Ausburn, production supervisor. We particularly wish to recognize Johanna Schmid and Alan Sachs, senior accounting editors, for their overall leadership on the project.

Lanny G. Chasteen
Richard E. Flaherty
Melvin C. O'Connor

Contents

Preface xxi

Chapter 1



Financial Accounting and Reporting: An Introduction and Historical Development 1

THE ENVIRONMENT AND ROLE OF FINANCIAL ACCOUNTING AND REPORTING 2

The economic environment 2 Uses and users of financial accounting information 3 The economic environment and its relationship to financial accounting and reporting 4

THE NATURE AND CONTENT OF FINANCIAL ACCOUNTING AND REPORTING 8

Generally accepted accounting principles (GAAP) 8 The importance of ethics in financial accounting and reporting 10 Financial reporting in relation to other information used in decision making 11

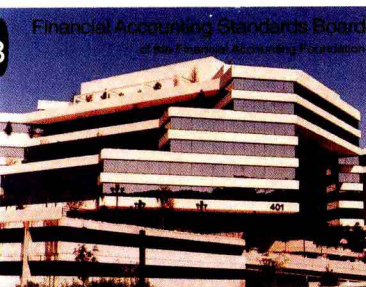
THE HISTORICAL DEVELOPMENT OF FINANCIAL ACCOUNTING AND REPORTING 13

The pre-formal-theory era 13 The problem-solving era 14 The conceptual framework era 17 Standard setting as a political process 21 Other groups that influence theory and practice 22 International standard-setting developments 24

SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 25

Questions 26 Cases 27 Exercises 32

Chapter 2



Financial Accounting and Reporting: A Theoretical Structure 34

ENVIRONMENTAL ASSUMPTIONS 37

The accounting entity assumption 37 The periodicity assumption 37 The going concern assumption 37 The monetary assumption 38

OBJECTIVES OF FINANCIAL REPORTING 38

Characteristics and limitations of financial statement information 38 The role and objectives of financial accounting and reporting 39

QUALITATIVE CHARACTERISTICS OF USEFUL ACCOUNTING INFORMATION 41

Primary qualitative characteristics 42 Secondary qualitative characteristics 44
Other considerations and constraints 44 Qualitative characteristics at the international level 46

THE ELEMENTS OF FINANCIAL STATEMENTS 46

Definitions and relationships of the elements 46 Financial statements based on the elements 50 Effects of economic events 51

RECOGNITION AND MEASUREMENT PRINCIPLES FOR THE ELEMENTS 52

The fundamental recognition principle 52 Principles underlying the conventional system (GAAP) of determining income 53 Alternative systems of determining income 61

DISCLOSURE AND METHODS OF FINANCIAL STATEMENT PRESENTATION 65

Disclosure 65 Methods of presentation 67

SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 68

Questions 69 Cases 70 Exercises 79

Chapter 3



The Accounting Process: A Review 87

ECONOMIC EVENTS CAPTURED BY AN ACCOUNTING SYSTEM 88

THE ACCOUNTING EQUATION USED TO EXPRESS FINANCIAL EFFECTS OF ECONOMIC EVENTS 88

Accounts 90 Effects of transactions on the accounting equation 91 Real and nominal accounts 91

THE ACCOUNTING PROCESS OR CYCLE 93

Collecting data about economic events 94 Analyzing data about economic events 94 Recording economic events in a journal 95 Posting to ledger accounts 101 Preparing an unadjusted trial balance 103 Preparing adjusting entries 105 Preparing the adjusted trial balance 113 Preparing the financial statements 113 Preparing closing entries 117 Preparing a postclosing trial balance 120 Reversing entries 121

PROPRIETORSHIP AND PARTNERSHIP ACCOUNTING ENTITIES 123

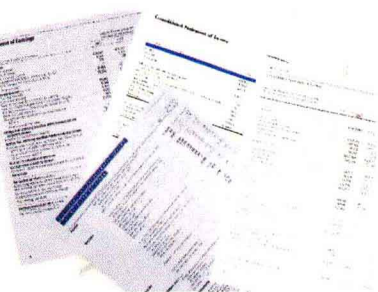
CASH-BASIS ACCOUNTING VS. ACCRUAL ACCOUNTING REVISITED 124

SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 126

APPENDIX 3-1: USE OF A WORKSHEET 127

Questions 130 Cases 132 Exercises 133 Problems 141

Chapter 4



The Income Statement and Statement of Retained Earnings 151

INCOME MEASUREMENT 152

REPORTING INCOME INFORMATION 153

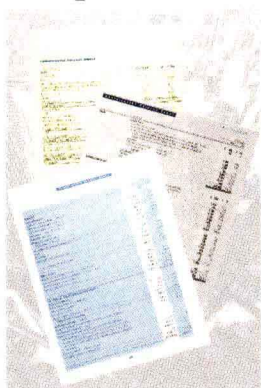
Income statement format under GAAP 153 Earnings per share 164 Unresolved income-reporting issues 165

STATEMENT OF RETAINED EARNINGS 166

Prior period adjustments 166 Combined statement of income and retained earnings 167

SUMMARY OF PRESENTATION OF INCOME INFORMATION 167**SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 167****APPENDIX 4–1: ACTUAL FINANCIAL STATEMENTS OF THE BRISTOL-MYERS SQUIBB COMPANY 170**

Questions 184 Cases 184 Exercises 187 Problems 192

Chapter 5**The Balance Sheet (Statement of Financial Position) 197****USES OF THE BALANCE SHEET 198****CLASSIFICATION AND VALUATION IN THE BALANCE SHEET 199**

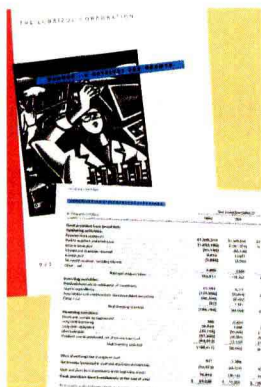
Current assets 200 Current liabilities 202 Noncurrent assets 205 Long-term liabilities 206 Owners' (stockholders') equity 207

UNCLASSIFIED BALANCE SHEETS 209**NOTES AND SUPPLEMENTARY INFORMATION 209**

Long-term commitments 211 Property, plant, and equipment 211 Accounting policies 211 Subsequent events 212

SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 214**APPENDIX 5–1: ANALYSIS OF FINANCIAL STATEMENTS 215**

Questions 235 Cases 237 Exercises 243 Problems 250

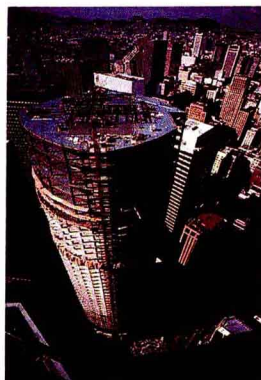
Chapter 6**The Statement of Cash Flows 262****HISTORICAL BACKGROUND 263****OVERVIEW OF THE STATEMENT OF CASH FLOWS 265****USEFULNESS OF THE STATEMENT OF CASH FLOWS 267****PREPARATION OF THE STATEMENT OF CASH FLOWS 272**

Cash flows from operating activities 273 Cash flows from investing and financing activities 282 Cash flows from investing activities 282 Cash flows from financing activities 283 Summary of statement of cash flows preparation 285 Summary of cash flow reporting objectives 285

REPORTING NET CASH FLOWS FROM OPERATING ACTIVITIES—AN EVALUATION 285**EVALUATION OF FINANCIAL STATEMENTS 287****SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 287**

Questions 288 Cases 289 Exercises 291 Problems 298

Chapter 7



Revenue Recognition and Income Determination 307

AN OVERVIEW OF REVENUE CONCEPTS 309

The revenue earning process 309 Recognition and the realization principle 309

REVENUE RECOGNITION AT THE POINT OF SALE 310

Sales made on credit 311 Costs incurred after the point of sale 311 Return privileges 311 Service transactions 313

REVENUE RECOGNITION DURING PRODUCTION 314

Long-term construction contracts 314 Service transactions 323 Products requiring aging 324

REVENUE RECOGNITION AT COMPLETION OF PRODUCTION 324

REVENUE RECOGNITION DURING CASH COLLECTION 327

The installment method 328 The cost-recovery method 332 Evaluation of cash-collection methods 333

SUMMARY OF REVENUE AND INCOME RECOGNITION CONCEPTS 333

SPECIALIZED APPLICATIONS OF REVENUE RECOGNITION CONCEPTS 334

Franchises 334 Real estate sales and retail land sales 336 Barter transactions 337 Other industry standards 337

SUMMARY OF IMPORTANT TOPICS AND CONCEPT APPLICATIONS 338

APPENDIX 7-1: CONSIGNMENT SALES 339

Questions 341 Cases 341 Exercises 347 Problems 353

Chapter 8



Cash, Current Receivables and Liabilities, and Contingencies 363

CASH 364

Petty cash 365 Reconciliation of cash balances 366 Cash disclosures: overdrafts and compensating balances 368

RECEIVABLES 369

Accounts receivable 369 Short-term notes receivable 377 Using receivables to secure immediate cash 379

LIABILITIES AND THEIR VALUATION 384

DETERMINABLE CURRENT LIABILITIES 385

Trade accounts payable 385 Short-term (current) notes payable 386 Dividends payable 387 Collections for third parties 387 Accrued liabilities 388 Prepayments and deposits from customers 391

CURRENT LIABILITIES DEPENDENT ON OPERATING RESULTS 391

Income taxes payable 392 Bonuses payable 392

CONTINGENCIES 393

Loss contingencies 393 Gain contingencies 398