

**KIESO AND
WEYGANDT**

GAAP/FASB/AICPA/CPA/AAA
SEC/FEI/GASB/CMA/NAA/IRS
IA/IMA/FSA/AGA/CIA/GAAP
GAAP/CMA/NAA/IRS/IA/IMA
FSA/AGA/CIA/GASB/FASB
AICPA/CPA/AAA/SEC/FEI/GAAP

**INTERMEDIATE
ACCOUNTING**

**FIFTH
EDITION**

FIFTH EDITION

INTERMEDIATE ACCOUNTING

DONALD E. KIESO Ph.D., C.P.A.

Northern Illinois University
DeKalb, Illinois

JERRY J. WEYGANDT Ph.D., C.P.A.

University of Wisconsin
Madison, Wisconsin

JOHN WILEY & SONS

New York Chichester Brisbane
Toronto Singapore

Text and cover designer Madelyn Lesure
Copy editors Romyne Ponleithner and Stephen Perine
Copy editing supervisors Susan Winick and Barbara Heaney
Production Manager David Smith
Illustrator John Balbalis, with the assistance of the Wiley Illustration
Department

Material from the Uniform CPA Examinations and Unofficial Answers, copyright © 1963, 1964, 1965, 1966, 1967, 1968, 1969, 1970, 1971, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1979, 1980, 1981, 1982, 1983, 1984, 1985 by the American Institute of Certified Public Accountants, Inc., is adapted with permission.

This book contains quotations from *Accounting Research Bulletins*, *Accounting Principles Board Opinions*, *Accounting Principles Board Statements*, *Accounting Interpretations*, and *Accounting Terminology Bulletins*, copyright © 1953, 1956, 1966, 1968, 1969, 1970, 1971, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1979, 1980, 1981, 1982 by the American Institute of Certified Public Accountants, Inc.

This book contains citations from various FASB pronouncements. Copyright © by Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905 U.S.A. Reprinted with permission. Copies of complete documents are available from Financial Accounting Standards Board.

Material from the Certificate in Management Accounting Examinations, Copyright © 1975, 1976, 1977, 1978, 1979, 1980, 1981, 1982, 1983, 1984, 1985 by the National Association of Accountants, is adapted with permission.

Material from the Certified Internal Auditor Examinations, Copyright © May 1984, November 1984 by The Institute of Internal Auditors, is adapted with permission.

Copyright © 1986 by John Wiley & Sons, Inc.

All rights reserved. Published simultaneously in Canada.

Reproduction or translation of any part of this work beyond that permitted by Sections 107 and 108 of the 1976 United States Copyright Act without the permission of the copyright owner is unlawful. Requests for permission or further information should be addressed to the Permissions Department, John Wiley & Sons.

Library of Congress Cataloging-in-Publication Data

Kieso, Donald E.

Intermediate accounting.

Includes indexes.

I. Accounting. I. Weygandt, Jerry J. II. Title

HF5635.K5 1986 657'.044 85-29535

ISBN 0-471-88716-1

Printed in the United States of America

10 9 8 7 6 5 4

ABOUT THE AUTHORS

Donald E. Kieso, Ph.D., CPA, received his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, and the Illinois CPA Society. Most recently he has served as a member of the Board of Directors of the Illinois CPA Society, the Board of Governors of the American Accounting Association's Administrators of Accounting Programs Group, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving as a member of the American Assembly of Collegiate Schools of Business Accounting Accreditation Visitation Committee, the Board of Directors of Aurora University, and the Ethics Committee of the Illinois CPA Society.

Jerry J. Weygandt, Ph.D., CPA, is Professor of Accounting at the University of Wisconsin-Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review*, *Journal of Accounting Research*, the *Journal of Accountancy*, and other professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the *Accounting Review*. In addition, he is actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served as a consultant to a number of businesses and state agencies on financial reporting issues and currently is serving on an FASB task force that is examining the problems of "accounting for income taxes." Professor Weygandt recently received the Chancellor's Award for Excellence in Teaching; he is currently serving as Secretary-Treasurer of the American Accounting Association.

PREFACE

The fifth edition of *Intermediate Accounting* discusses in depth the traditional (intermediate) financial accounting topics as well as the recent developments in accounting valuation and reporting practices promulgated by the leading professional accounting organizations and applied by practitioners in public accounting and industry. Explanations and discussions of financial accounting theory are supported and illustrated by examples taken directly from practice and authoritative pronouncements.

Continuing to keep pace with the complexities of the modern business enterprise, we have added many new topics, clarified some of the existing coverage, added numerous illustrations, and updated all material where necessary. To provide the instructor with greater flexibility in choosing topics to cover or omit, we have continued the use of judiciously selected appendices. The appendices are concerned primarily with complex subjects, lesser used methods, or specialized topics.

The text is newly reorganized into six major parts.

1. Financial Accounting Functions and Basic Theory
(Chapters 1 to 6)
2. Assets—Recognition and Measurement
(Chapters 7 to 12)
3. Liabilities—Recognition and Measurement
(Chapters 13 and 14)
4. Stockholders' Equity, Dilutive Securities, and Investments
(Chapters 15 to 18)
5. Issues Related to Income Measurement
(Chapters 19 to 23)
6. Preparation and Analysis of Financial Statements
(Chapters 24 to 27)

Benefiting from the comments and recommendations of adopters of our fourth edition, we have made significant revisions. Explanations where necessary have been expanded, complicated discussions and illustrations have been simplified, realism has been integrated to heighten interest and relevancy, and new topics and coverage have been added to maintain currency.

We have attempted to balance our coverage so that the conceptual discussion and procedural presentation are mutually reinforcing. The study of concepts develops an understanding of procedures, and the performance of procedures enriches an understanding of the concepts. Accountants must act as well as think; therefore, we have given equal emphasis to *how* and to *why*.

We believe that individuals can account for events and phenomena best if they fully understand the nature of the phenomena and comprehend the economic consequences of the events. An appreciation for the behavioral and economic consequences of accounting and reporting alternatives is equally important. To this end, we have provided coverage that develops perspective as well as an understanding of the business transactions and other events for which enterprises account and report.

REVISIONS AND NEW FEATURES

Some of the additions, significant revisions, and new features of this edition are as follows. We reorganized the chapters on assets and liabilities by arranging the asset chapters in one

section entitled “Assets—Recognition and Measurement” and grouping the liability chapters together under the title “Liabilities—Recognition and Measurement.” Throughout the text, but most especially in Chapters 1 through 5, we have integrated coverage of the FASB’s most recent concepts statements. To Chapter 4 has been added a new appendix containing comprehensive coverage of measuring and reporting discontinued operations. References to the specimen financial statements and notes of Safeway Stores, Incorporated in an appendix to Chapter 5 have been integrated throughout the book. Chapter 6, on the time value of money, has been completely rewritten with many new illustrations and extensive use of time diagrams and formulas.

Chapter 7 has been shortened by moving the discussion of “marketable securities” to Chapter 18 and reorganized by covering receivables in the order of (1) recognition, (2) valuation, and (3) disposition. In addition, the new coverage in Chapter 7 on “transfer of receivables” is simplified by placing comprehensive illustrations in a new appendix. The inventory coverage in Chapters 8 and 9 has been enhanced by additional illustrations, a minor reorganization of topics, and the integration of current developments in practice. In our plant asset chapters (Chapters 10–12) we revised the coverage on “capitalized interest,” “trademarks and trade names,” and “rearrangement and reinstallation costs,” and expanded the coverage on “deferred payment contracts,” “permanent impairment in value,” and “research and development costs.” Most significantly, we have added a new appendix to Chapter 13 that covers “accounting for costs of computer software.”

The liabilities and stockholders’ equity topics of Chapters 13 through 17 have also been revised by minor reorganizations, revisions, and integrations of recent professional pronouncements. With the relocation of the topic of “temporary investments” from Chapter 7 to Chapter 18, both current and noncurrent marketable equity securities are covered in one chapter. To keep Chapter 18 from becoming too long and complicated, we have moved our discussion of “changing to and from the equity method” to an appendix of that chapter.

Our revenue recognition chapter now contains expanded coverage of the “cost recovery method,” new coverage on “revenue from bartering,” and integrated coverage on “guidelines for revenue recognition.” The coverage on “originating and reversing differences,” “reporting deferred income taxes,” and differentiation of the three methods of interperiod tax allocation in Chapter 20 has been expanded and clarified. Chapter 21, on accounting for pension costs, has been completely rewritten to conform to the profession’s new requirements. Our coverage of the statement of changes in financial position, Chapter 24, now begins with and emphasizes the cash basis over the working capital basis to conform to recent trends in practice. And our Chapter 25 coverage of price-level accounting has been rewritten to conform to recent professional pronouncements that emphasize current cost accounting over constant dollar accounting. Finally, to help students we have added a new section on fundamental concepts as a summary to each chapter.

QUESTIONS, CASES, EXERCISES, AND PROBLEMS

At the end of each chapter we have provided a comprehensive set of review and homework material consisting of questions, short cases, exercises, and problems. For this edition all exercises and problems have been revised, and the end-of-chapter material has been supplemented with many new cases and problems, nearly all of which have been class tested.

The questions are designed for review, self-testing, and classroom discussion purposes as well as homework assignments. The cases generally require essay as opposed to quantitative solutions; they are intended to confront the student with situations calling for conceptual analysis and the exercise of judgment in identifying problems and evaluating alternatives. Typically, an exercise covers a specific topic and requires less time and effort to solve

than cases and problems. The problems are designed to develop a professional level of achievement and are more challenging to solve than the exercises.

Probably no more than one-fourth of the total case, exercise, and problem material must be used to cover the subject matter adequately; consequently, problem assignments may be varied from year to year.

SUPPLEMENTARY MATERIALS

Accompanying this textbook is an improved and expanded package of supplements consisting of instructional aids for either students or instructors. The following supplements are available for student use (upon instructor approval): (1) a *Student Study Guide* (written by Raymond J. Clay); (2) a *Practice Set* (Rockford Corporation), fifth edition with a *Computerized Version* (prepared by James H. Perkins); (3) ruled *Working Papers I* for all problems in Chapters 1–14 and ruled *Working Papers II* for all problems in Chapters 14–27; (4) *Cases in Financial Accounting* (prepared by David Mielke, Donald E. Kieso and Jerry J. Weygandt); and (5) *Solving Intermediate Accounting Problems using Supercalc 3* (spreadsheet software included) and *Solving Intermediate Accounting Problems using Lotus 1-2-3* (templates), by David R. Koeppen, Sharon O'Reilly, Donald E. Kieso, and Jerry J. Weygandt.

The following supplements are available for instructor use: (1) a comprehensive *Solutions Manual* for all end-of-chapter assignment material; (2) a separate *Instructor's Manual* (by Mary Noble); (3) overhead projector *Transparencies* for all text exercises and problems; (4) an *Examination Booklet and Tests*; (5) *Microtest*, a computerized test bank available for IBM-PC, TRS-80 and Apple-compatible microcomputers; (6) *Microtutor*, a study guide tutorial on microcomputer disk; (7) solutions to the Practice Set, Spreadsheet Applications, and Cases, and (8) a *Checklist of Key Figures*, available free in quantity.

ACKNOWLEDGMENTS

We thank the many users of our fourth edition who contributed to this revision through their comments and constructive criticism. Special thanks are extended to the primary reviewers of our fifth edition manuscript:

Floyd D. Beams
Virginia Polytechnic Institute and
State University
John C. Borke
University of Wisconsin–Platteville
Paula Harbecke
University of Maryland
Wayne Higley
University of Nebraska

Marilyn Hunt
Central Florida University
Melvin McClure
University of Maine
Curtis Norton
Northern Illinois University
Thomas Nunamaker
Washington State University
Gene Rozanski
Illinois State University

Other colleagues in academe who have provided helpful criticisms and made valuable suggestions as adopters of the previous edition or reviewers of selected topics include: Robert J. Brill of St. Bonaventure University; Don Etnier, University of Wisconsin–Eau Claire; Patrick R. Delaney, Ray McClary, Kap Shin, and Thomas Sterling Wetzel of Northern Illinois University; Walker Fesmire, University of Michigan–Flint; M. Zafar Iqbal, California Polytechnic State University; William Larson, Indiana University; Willard J. Lawrence, Austin Community College; Thomas Linsmeier of University of Iowa;

Darwin Casler, Central Michigan University; Bala G. Dharan, Rice University; W. David Brooks, Chemeketa Community College; Randy Howard, Eastern Montana College; Jiwan Merchia and James Tucker of Drexel University; Malcolm McClure of Illinois State University; and Emmanuel Nyadroh, University of Illinois—Chicago.

From the field of professional accountancy we owe thanks to the following practitioners, for their technical advice: Michael Crooch, Douglas W. Kieso, and John E. Stewart of Arthur Andersen & Co.; Michael Baker of Price Waterhouse & Co.; Carol Krennek of Wolf & Company; and Scott Szykowny of Peat, Marwick, Mitchell & Co.

We appreciate the exemplary support and professional commitment given us by our office manager, Donna R. Kieso, our word processor operator, Debra J. Kieso, our typist, Enid Weygandt, and by the production and editorial staffs of John Wiley & Sons, including Romaine Ponleithner and Barbara Heaney; and John Beresford, Judy Nolan, and the staff of Allservice Phototypesetting. We especially thank our production manager, David Smith, and our editor, Lucille Sutton, for their counsel on and commitment to this edition.

We appreciate the cooperation of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board in permitting us to quote from their pronouncements. We also acknowledge permission from the American Institute of Certified Public Accountants, the Institute of Management Accounting, and the Institute of Internal Auditors to adapt and use material from the Uniform CPA Examinations, the CMA Examinations, and the CIA Examinations, respectively.

If this book helps teachers instill in their students an appreciation for the challenges and limitations of accounting, if it encourages students to evaluate critically and understand financial accounting theory and practice, and if it prepares students for advanced study, professional examinations, and the successful pursuit of their careers in accounting or business, then we will have attained our objective.

Suggestions and comments from users of this book will be appreciated.

*DeKalb, Illinois
Madison, Wisconsin
January, 1986*

Donald E. Kieso
Jerry J. Weygandt

CONTENTS

PART 1

FINANCIAL ACCOUNTING FUNCTIONS AND BASIC THEORY 1

CHAPTER 1 The Environment of Financial Accounting and the Development of Accounting Standards 3

Nature and Environment of Financial Accounting 3 Financial Statements and Financial Reporting 4; Environmental Factors that Influence Accounting 4; Accounting Influences Its Environment 5; Objectives of Financial Reporting 6 **The Development of Accounting Standards 7** The Need to Develop Standards 7; Historical Perspective 7; Parties Involved in Standard-Setting 8; American Institute of Certified Public Accountants (AICPA) 8; Financial Accounting Standards Board (FASB) 9; Governmental Accounting Standards Board 12; The Securities and Exchange Commission 12; The American Accounting Association 14; Other Influential Organizations 14 **Changing Role of the AICPA 15** Generally Accepted Accounting Principles 16; Standard-Setting in a Political Environment 17; Continued Interest in Standard-Setting 18; Summary 21

CHAPTER 2 Conceptual Framework Underlying Financial Accounting 25

Nature of a Conceptual Framework 26 **Development of a Conceptual Framework 26** **First Level: Basic Objectives 27** **Second Level: Fundamental Concepts 28** Qualitative Characteristics of Accounting Information 29; Basic Elements 32 **Third Level: Recognition and Measurement Concepts 33** Basic Assumptions 33; Basic Principles of Accounting 35; Constraints 41; Summary of the Structure 44

CHAPTER 3 A Review of the Accounting Process 55

Procedures Employed in Accounting 56 Basic Terminology 56 **Double-Entry Accounting Recording Process 57** **The Accounting Cycle 58** **Identification and Recording of Transactions and Other Events 59** **Journalization 60** **Posting to the Ledger 61** **Unadjusted Trial Balance 62** **Adjustments 63** Prepaid Expenses 64; Unearned Revenue 64; Accrued Liabilities or Expenses 65; Accrued Assets or Revenues 66; Estimated Items 66 **Summary of Adjustments Section 68** **Year-End Procedure for Inventory and Related Accounts 68** **Closing 69** **Post-Closing Trial Balance 71** **Reversing Entries 71** Reversing Entries for Prepaid Items 72; Reversing Entries for Accrued Items 73 **The Accounting Cycle Summarized 74** **Using a Work Sheet to Prepare Financial Statements 74** Adjustments Entered on the Work Sheet 74; Adjusted Trial Balance Columns 75; Income Statement and Balance Sheet Columns 75; Ending Inventory 76; Income Taxes and Net Income 77; Eight-Column and Twelve-Column Work Sheets 77; Preparation of Financial Statements from Work Sheet 77; Statement of Income 77; Statement of Retained Earnings 77; Balance Sheet 78; Closing and Reversing Entries 80; Monthly Statements, Yearly Closing 80

APPENDIX 3-A Specialized Journals and Methods of Processing Accounting Data 82
Special Journals 82 Cash Receipts Journal 82; Posting from Cash Receipts Journal 83; The

Sales Journal 84; Purchases Journal (Voucher Register) 85; Cash Payments Journal (Check Register) 87; Flexibility in Selection of Journals 87; Journals Not Always “Books” 88
Methods of Processing Accounting Data 88 Accounting or Bookkeeping Machines 89; Punched-Card Equipment 89; Computers 89

APPENDIX 3-B Conversion of Cash Basis to Accrual Basis 90

CHAPTER 4 Statement of Income and Retained Earnings 113

Importance of Statements of Income 113 **Limitations of Income Statement 114** Capital Maintenance Approach versus Transaction Approach 115; Elements of the Income Statement 116; Single-Step Income Statements 117; Multiple-Step Income Statements 117; Intermediate Components of the Income Statement 118; Condensed Income Statements 120; Professional Pronouncements and the Income Statement 120; Summary 128 **Intraperiod Tax Allocation 128** Extraordinary Losses 130; Extraordinary Gains 131; Prior Period Adjustments 131 **Earnings Per Share 132** **Statement of Retained Earnings 134** Items Disclosed 134; Combined Statement of Income and Retained Earnings 135 **The Conceptual Framework—Its Implications 135**

APPENDIX 4-A Accounting for Discontinued Operations 138 **First Illustration—No Phase-Out Period 138** **Second Illustration—Phase-Out Period 139** **Third Illustration—Extended Phase-Out Period 140** **Extended Phase-Out—Additional Examples 141** **Disclosure Requirements 142**

CHAPTER 5 Balance Sheet and Statement of Changes in Financial Position 161

SECTION 1 Balance Sheet 161 **Usefulness of the Balance Sheet 161** **Limitations of the Balance Sheet 162** **Classification in the Balance Sheet 163** Current Assets 164; Current Liabilities 166; Long-Term Investments 167; Property, Plant, and Equipment, and Intangible Assets 167; Other Assets 168; Long-Term Liabilities 168; Owners' Equity 169 **Additional Information Reported 171** Gain Contingencies 171; Loss Contingencies 171; Valuations and Accounting Policies 172; Contracts and Negotiations 172; Post-Balance Sheet Events 173 **Techniques of Disclosure 174** Parenthetical Explanations 174; Notes 175; Cross Reference and Contra Items 176; Supporting Schedules 176 **Balance Sheet Form 177** **Questions on Terminology 177** **SECTION 2 Statement of Changes in Financial Position 179** **Conceptual Framework Project—Its Implications 181**

APPENDIX 5-A Specimen Financial Statements 183

CHAPTER 6 Accounting and the Time Value of Money 216

Applications of Time Value Concepts 216 **Nature of Interest 217** **Choosing an Appropriate Interest Rate 218** Simple Interest 219; Compound Interest 219; Compound Interest Tables 220 **Fundamental Variables 222** **Single Sum Problems 223** Future Amount of a Single Sum 223; Present Value of a Single Sum 224; Single Sum Problems—Solving for Other Unknowns 226 **Annuities 228** Future Amount of an Ordinary Annuity 228; Future Amount of an Annuity Due 230; Illustrations of Future Amount of Annuity Problems 232; Present Value of an Ordinary Annuity 234; Present Value of an Annuity Due 235; Illustrations of Present Value of Annuity Problems 236 **Complex Situations 238** Deferred Annuities 238; Valuation of Long-Term Bonds 240 **Interpolation of Tables to Derive Interest Rates 241**

PART 2**ASSETS—RECOGNITION AND MEASUREMENT 262****CHAPTER 7 Cash and Receivables 263**

SECTION 1 Cash 263 Nature and Composition of Cash 263 Management and Control of Cash 264 Using Bank Accounts 265; Electronic Funds Transfer (EFT) 265; The Imprest Petty Cash System 266; Physical Protection of Cash Balances 267; Reconciliation of Bank Balances 268 **Reporting Cash 270** Restricted Cash 270; Bank Overdrafts 272; Cash Equivalents 272 **SECTION 2 Receivables 272** Accounts Receivable 273 Recognition of Accounts Receivable 273; Valuation of Accounts Receivable 275; Disposition of Accounts Receivable 279 **Notes Receivable 284** Recognition of Notes Receivable 285; Valuation of Notes Receivable 289; Disposition of Notes Receivable 290 **Conceptual Issues Related to the Transfer of Receivables 292** Accounts and Notes Receivable: Balance Sheet Presentation 293

APPENDIX 7-A Four-Column Bank Reconciliation 295 Reconciliation of Receipts and Disbursements 295

APPENDIX 7-B Comprehensive Illustrations of Transfers of Receivables 298
Transfer of Receivables Without Recourse 298 Transfer of Receivables with Recourse 299

CHAPTER 8 Valuation of Inventories: A Cost Basis Approach 321

Major Classifications of Inventory 321 Management Interest in Accounting for Inventories 322 Determining Inventory Quantities 323 Basic Issues in Inventory Valuation 325 Physical Goods to be Included in Inventory 325 Goods in Transit 325; Consigned Goods 326; Special Sale Agreements 326; Effect of Inventory Errors 328 Costs to be Included in Inventory 329 Product Costs 329; Period Costs 329; Treatment of Purchase Discounts 330; Manufacturing Costs 331; Variable Costing Versus Absorption Costing 332 What Cost Flow Assumption Should be Adopted? 333 Specific Identification 334; Average Cost 335; First-In, First-Out (FIFO) 336; Last-In, First-Out (LIFO) 337; Last-In, First-Out—A Pooled Approach 338; Dollar-Value LIFO 339; LIFO Approaches—A Comparison 343; LIFO Approaches—Advantages and Disadvantages 344; Major Advantages of LIFO 344; Major Disadvantages of LIFO 345 Basis for Selection 346 Inventory Valuation Method—Summary Analysis 348

CHAPTER 9 Inventories: Additional Valuation Problems 368

Lower of Cost or Market 368 Rationale for Lower of Cost or Market 369; How Lower of Cost or Market Works 370; Methods of Applying Lower of Cost or Market 371; Recording “Market” Instead of Cost 372; Evaluation of Lower of Cost or Market Rule 374 Valuation at Net Realizable Value 375 Valuation Using Relative Sales Value 376 Valuation Using Standard Costs 377 Purchase Commitments—A Special Problem 377 The Gross Profit Method of Estimating Inventory 379 Computation of Gross Margin Percentage 379; Appraisal of Gross Profit Method 381 Retail Inventory Method 381 Retail Method Terminology 382; Retail Inventory Method with Markups and Markdowns 383; LIFO Retail 385; Subsequent Adjustment 388; Special Items Relating to Retail Method 389; Appraisal of Retail Inventory Method 390 Financial Statement Presentation of Inventories 391

APPENDIX 9-A Special LIFO Reporting Problems 393 Initial Adoption of LIFO 393 LIFO Reserve 395 Interim Reporting Problems 395

APPENDIX 9-B Base Stock Method 396**CHAPTER 10 Acquisition and Disposition of Property, Plant, and Equipment 413**

Acquisition of Property, Plant, and Equipment 413 Cost of Land 414; Cost of Buildings 415; Cost of Equipment 415; Self-Constructed Assets 415; Interest Costs During Construction 416
Acquisition and Valuation 420 Cash Discount 420; Deferred Payment Contracts 421; Lump Sum Purchase 422; Issuance of Stock 422; Exchange of Property, Plant, and Equipment (Non-monetary Assets) 423; Acquisition and Disposition by Donation or Gift 428 **Costs Subsequent to Acquisition 429** Additions 430; Improvements and Replacements 430; Rearrangement and Reinstallation 431; Repairs 432; Summary 433 **Dispositions of Plant Assets 433** Sale of Plant Assets 434; Involuntary Conversion 434; Miscellaneous Problems 435 **Other Asset Valuation Methods 435**

APPENDIX 10-A Casualty Insurance 437 Coinsurance 437 Recovery from Multiple Policies 438 Accounting for Casualty Losses 439

CHAPTER 11 Depreciation and Depletion 456

Depreciation—A Method of Cost Allocation 456 Factors Involved in the Depreciation Process 456 Depreciable Base for the Asset 457; Estimation of Service Lives 457 **Methods of Cost Apportionment (Depreciation) 459** Activity Method 459; Straight-Line Method 460; Decreasing Charge Methods 461 **Special Depreciation Systems 462** Inventory Systems 463; Retirement and Replacement Systems 463; Group and Composite Systems 464; Compound Interest Methods 465 **Selection of Depreciation Method 465** **Special Depreciation Issues 466** Depreciation and Partial Periods 466; Depreciation and Replacement of Fixed Assets 468; Revision of Depreciation Rates 468 **Impairment in Value—A Difficult Accounting Question 469** **Disclosure of Property, Plant, and Equipment, and Depreciation 470** **Investment Credit 472** Cost Reduction or Deferral Method 472; Tax Reduction or Flow-Through Method 473; Comparison of Deferral Versus Flow-Through 473 **Depletion 473** Establishment of Depletion Base 475; Write-off of Resource Cost 476; Controversy Concerning Oil and Gas Accounting 477; Special Problems in Depletion Accounting 478 **Financial Reporting of Natural Resources and Depletion 480**

CHAPTER 12 Intangible Assets 495

Valuation of Purchased Intangibles 496 **Amortization of Intangible Assets 496** **Specifically Identifiable Intangible Assets 497** Patents 497; Copyrights 498; Trademarks and Trade Names 499; Leaseholds 499; Organization Costs 500; Franchises and Licenses 501; Property Rights 502 **Goodwill 502** Methods of Measuring Goodwill 503; Excess of Cost over the Fair Value of Net Assets Acquired 503; Excess Earning Power 505; Other Methods of Valuation 508; Amortization of Goodwill 509; Negative Goodwill—Badwill 510; Reporting of Intangibles 511 **Research and Development Costs 512** Costs Associated with R & D 513 Financial Statement Presentation 514 Conceptual Questions 515 **Deferred Charges and Long-Term Prepayments 516**

APPENDIX 12-A Accounting for Computer Software Costs 517 Diversity in Practice 517 The Profession's Position 517 Reporting of Computer Software Costs 518

PART 3**LIABILITIES—RECOGNITION AND MEASUREMENT 534****CHAPTER 13 Current Liabilities and Contingencies 535**

What is a Liability? 535 Nature of Current Liabilities 536 Valuation of Current Liabilities 537 Differences in Current Liabilities 537 Determinable Current Liabilities 537
 Accounts Payable 537; Notes Payable 538; Short-Term Obligations Expected to be Refinanced 539; Disclosure of Short-Term Obligations Expected to be Refinanced 541; Dividends Payable 541; Returnable Deposits 542; Liability on the Advance Sale of Tickets, Tokens, and Certificates 543; Collections for Third Parties 543; Accrued Liabilities 544; Conditional Payments 549 **Contingencies 553 Accounting for Contingent Liabilities 553; Litigation, Claims, and Assessments 554; Disclosure of Loss Contingencies 555; Guarantee and Warranty Costs 557; Premiums and Coupons Offered to Customers 559; Risk of Loss Due to Lack of Insurance Coverage 561 Disclosure of Current Liabilities in the Financial Statements 561**

CHAPTER 14 Long-Term Liabilities 575

Nature of Long-Term Liabilities 575 Bonds Payable 576 Valuation of Bonds Payable—Discount and Premium 577; Accounting for the Issuance of Bonds 578; Effective Interest Method 580; Classification of Discount and Premium 583; Costs of Issuing Bonds 583; Treasury Bonds 584 Extinguishment of Debt 584 Reacquisition of Debt 585; In-Substance Defeasance 585; Reporting Gains and Losses 587 Long-Term Notes Payable 588 Notes Issued Solely for Cash 589; Notes Exchanged for Cash and Some Right or Privilege 589; Noncash Transactions 590; Imputing an Interest Rate 591; Accounting for Interest Imputation 591; Mortgage Notes Payable 592 Short-Term Obligations Expected to be Refinanced 593 Off-Balance Sheet Financing 593 Research and Development Arrangements 594; Project Financing Arrangements 594; Captive Finance Companies 595; Rationale for Off-Balance Sheet Financing 595 Reporting Long-Term Debt 596

APPENDIX 14-A Accounting for Troubled Debt Restructurings 599 Settlement of Debt at Less than Carrying Amount 600 Continuation of Debt with Modification of Terms 601 No Gain or Loss Recognized 602; Recognition of Gain and Loss 604 Justification for Not Recognizing Gain or Loss 604 Summary of Accounting for Troubled Debt Restructurings 605

APPENDIX 14-B Illustration of Serial Bond Amortization and Redemption Before Maturity 606 Amortization of Premium or Discount on Serial Bonds 606; Straight-Line Amortization 606; Bonds Outstanding Method 607; Effective Interest Method 608 Redemption of Serial Bonds Before Maturity 609 Straight-Line Method 609; Bonds Outstanding Method 609; Effective Interest Method 610

PART 4**STOCKHOLDERS' EQUITY, DILUTIVE SECURITIES, AND INVESTMENTS 623****CHAPTER 15 Stockholders' Equity: Contributed Capital 624**

The Nature of Stockholders' Equity 624 Sources of Equity 624; What is Capital? 625 The Corporate Form of Entity 626 State Corporate Law 626; Capital Stock or Share System 627;

Variety of Ownership Interests 628; Limited Liability of Stockholders 628; Formality of Profit Distribution 629 **Characteristics of Preferred Stock 630** Features of Preferred Stock 630; Debt Characteristics of Preferred Stock 631 **Accounting for the Issuance of Stock 633** Par Value Stock 633; No-Par Stock 634; Stock Sold on a Subscription Basis 635; Stock Issued in Combination with Other Securities (Lump Sum Sales) 637; Stock Issued in Noncash Transactions 638; Assessments on Stock 639; Costs of Issuing Stock 639 **Reacquisition of Shares 640** Methods of Accounting for Treasury Stock 641; Retirement of Treasury Stock 645; Donated Treasury Stock 646; Treasury Stock in the Balance Sheet 646 **Additional Paid-In Capital 648** **Donated and Revaluation Capital 648** **Basic Records Related to Stock 649**

CHAPTER 16 Stockholders' Equity: Retained Earnings 659

Retained Earnings 659 Dividend Policy 660; Legality of Dividends 660; Financial Condition and Dividend Distributions 661; Types of Dividends 662 **Appropriations of Retained Earnings 671** Reasons for Retained Earnings Appropriations 672; Recording Appropriations of Retained Earnings 672; Disclosure of Restrictions on Retained Earnings 673; Appropriations or Disclosures for Contingencies and for Self-Insurance 674; Statements Presenting Changes in Retained Earnings and Paid-in Capital; 676 **Trends in Terminology 677** **Quasi Reorganization 679**

CHAPTER 17 Dilutive Securities and Earnings Per Share Calculations 694

SECTION 1 Dilutive Securities and Compensation Plans 695 **Accounting for Convertible Debt 695** At Time of Issuance 695; At Time of Conversion 695; Induced Conversions 697; Retirement of Convertible Debt 697 **Convertible Preferred Stock 698** **Stock Warrants 698** Stock Warrants Issued with Other Securities 699; Rights to Subscribe to Additional Shares 701 **Stock Compensation Plans 701** Accounting for Stock Compensation Plans 702; Stock Option Plans 703; Stock Appreciation Rights 706; Performance-Type Plans 708; Conceptual Issues Involving Stock Compensation Plans 709 **SECTION 2 Computing Earnings Per Share 711** **Simple Capital Structure 712** **Weighted Average Number of Shares 712** **Complex Capital Structures and Dilutive Securities 715** Primary Earnings Per Share 716; Common Stock Equivalents 716; Convertible Securities 716; "If Converted" Method 717; Options, Warrants, and Their Equivalents 719; Contingent Issuance Agreement 722; Antidilution 723; Earnings Per Share Presentations and Disclosures 724; Summary 725

APPENDIX 17-A Comprehensive Earnings Per Share Illustration 728 **Primary Earnings Per Share 730** **Fully Diluted Earnings Per Share 733**

CHAPTER 18 Investments—Temporary and Long-Term 752

SECTION 1 Temporary Investments 752 **Marketable Securities 753** Acquisition of Marketable Equity Securities 753; Accounting for Changes in Market Value—Marketable Equity Securities 753; Disposition of Marketable Equity Securities 757; Valuation at Market 758 **Marketable Debt (Nonequity) Securities 758** **Financial Statement Disclosure of Temporary Investments 760** **SECTION 2 Long-Term Investments 761** **Investments in Bonds 762** Accounting for Bond Acquisitions 762; Computing Prices of Bond Investments 763; Amortization of Bond Premium and Bond Discount 763; Sale of Bond Investments Before Maturity Date 766 **Long-Term Investments in Stocks 767** Effect of Ownership Interest 768; Cost Method 769; Equity Method 770; Lower of Cost or Market Method 773; Market Value

Method 775; Applicability of Methods 776; Revenue from Investments in Stocks 777; Dividends Received in Stock 777; Stock Rights 778 **SECTION 3 Cash Surrender Value and Funds 780 Cash Surrender Value of Life Insurance 780 Funds 781 Entries for Funds 782; Funds and Reserves Distinguished 783**

APPENDIX 18-A Changing From and To the Equity Method 785 *Change in Method from the Equity Method 785* *Change in Method to the Equity Method 786*

PART 5

ISSUES RELATED TO INCOME MEASUREMENT 807

CHAPTER 19 Revenue Recognition 808

Guidelines for Revenue Recognition 809 Revenue Recognition at Point of Sale (Delivery) 810 Revenue Recognition Before Delivery 812 Percentage-of-Completion Method 814; Completed-Contract Method 819; Accounting for Long-Term Contract Losses 820; Disclosures in Financial Statements 823; Other Revenue Recognition Bases in Advance of Delivery 823 **Revenue Recognition After Delivery 824** Installment Sales Accounting Method 825; Cost Recovery Method 833; Summary of Product Revenue Recognition Bases 835 **Revenue from Bartering 836**

APPENDIX 19-A Revenue Recognition for Special Sales Transactions 837

Franchises 837 The Franchise Sales Phenomenon 837; Initial Franchise Fees 839; Illustration of Entries for Initial Franchise Fees 839; Continuing Franchise Fees 840; Bargain Purchases 840; Options to Purchase 840; Illustration of Entries for Continuing Fees, Bargain Purchases, and Options 841; Franchisor's Costs 842; Disclosures of Franchisors 842 **Consignments 842**

APPENDIX 19-B Accounting for Service Sales Transactions 843 *Service Industries and Service Transactions 844* **Revenue and Expense Recognition for Service Transactions 845** **Methods of Service Revenue Recognition 846** Specific Performance Method 846; Completed Performance Method 846; Proportional Performance Method 846; Collection Method 847; Summary of Service Revenue Recognition Methods 847

CHAPTER 20 Accounting for Income Taxes 863

Principles of Tax Allocation 863 Interperiod Tax Allocation 863; Reasons for Interperiod Tax Allocation 865; Deferred Income Taxes 866; Intraperiod Tax Allocation 867; Interperiod Tax Allocation—Specific Differences 868; Originating and Reversing Differences—Additional Clarification 869; Timing and Permanent Differences Illustrated 870 **Financial Statement Presentation 872** Balance Sheet Presentation 872; Income Statement Presentation 874 **Interperiod Tax Allocation—Practical Problems 876** Gross Change Method 876; Net Change Method 877; Illustration of Gross Change and Net Change Methods 877; Criteria for Choosing Between Methods 879 **Interperiod Tax Allocation and Depreciation Deductions 879** **A Comprehensive Illustration 881** Additional Information 882 **Appropriateness of Interperiod Tax Allocation 884** Comprehensive Allocation Versus Partial Allocation 884; Conceptual Approaches to Deferred Income Taxes 885; Continued Debate 888; Future Prospects 889 **Accounting for Net Operating Losses 889** Loss Carryback 890; Loss Carryforward 891; Disclosure Requirements 894; Concluding Comments 894

APPENDIX 20—A The With and Without Technique 895**CHAPTER 21 Accounting for Pensions 911**

Types of Pension Plans 911 Employer Versus Plan Accounting 912 The Actuary's Role 914 Actuarial Funding Methods 915 Actuarial Funding Methods—A Closer Look 916 Accumulated Benefits Approach 917; Benefits/Years-of-Service Approach 918 Accounting Issues 921 Cost of Pension Plan 921 Service Cost 922; Interest 923; Expected Return on Plan Assets 924; Prior Service Cost 925 Gains and Losses 928 Illustrative Accounting Entries 930 Case A—Pension Expense and Pension Funding the Same 930; Case B—Pension Expense Higher than Pension Funding 931; Case C—Pension Expense Lower than Pension Funding 932; Case D—Amendment to the Existing Plan 933 Minimum Liability 934 Transition—A Special Implementation Problem 936 Reporting Pension Plans in Financial Statements 936 Comprehensive Illustration 938 Composition of Pension Expense 938; Financial Statement Presentations—1986 940; Subsequent Periods 942; Pension Entries—1987 943; Pension Entries—1988 943; Pension Entries—1989 944 The Pension Reform Act of 1974 945 Multiemployer Plans 946 Postemployment Benefits 946 Termination Benefits Paid Employees 947 Pension Terminations 947 Concluding Observation 948

CHAPTER 22 Accounting for Leases 965

Lease Provisions 965 Advantages of Leasing 966 Conceptual Nature of a Lease 967 Accounting for Leases—A Brief Background 968 Accounting by Lessees 969 Examination of Capitalization Criteria 970; Asset and Liability Accounted for Differently 972; Capitalized Lease Method Illustrated (Lessee) 973; Operating Method (Lessee) 975; Comparison of Capital Lease with Operating Lease 976 Accounting by Lessors 977 Economics of Leasing 977; Classification of Leases by the Lessor 978; Direct Financing Method (Lessor) 979; Classification of Lease Obligation/Net Investment (Ordinary Annuity) 983; Operating Method (Lessor) 984 Special Accounting Problems 984 Residual Values 985; Sales-Type Lease (Lessor) 990; Bargain Purchase Option (Lessee) 991; Initial Direct Costs (Lessor) 992; Sale-Leaseback 992 Lease Accounting—The Unsolved Problem 995 Reporting Lease Data in Financial Statements 996 Disclosures Required of the Lessee 996; Disclosures Required of the Lessor 997; Illustrated Disclosures 997 Illustrations of Different Lease Arrangements 999 Harmon, Inc. 1000; Arden's Oven Co. 1001; Mendota Truck Co. 1001; Appleland Computer 1002

APPENDIX 22—A Real Estate Leases and Leveraged Leases 1004 Leases Involving Real Estate 1004 Land 1004; Land and Building 1004; Real Estate and Equipment 1005 Leveraged Leases 1005

CHAPTER 23 Accounting Changes and Error Analysis 1018

Accounting Changes 1019 Types of Accounting Changes 1019; Correction of an Error in Previously Issued Financial Statements (Not an Accounting Change) 1019 Changes in Accounting Principle 1019 Cumulative-Effect Type Accounting Change 1021; Retroactive-Effect Type Accounting Change 1023; Change to the LIFO Method of Inventory 1025 Change in Accounting Estimate 1026 Reporting a Change in Entity 1027 Reporting a Correction of an Error 1028 Summary of Accounting Changes and Correction of Errors 1030 Error Analysis 1032 Balance Sheet Errors 1032; Income Statement Errors 1032; Balance Sheet and

Income Statement Effect 1032; Counterbalancing Errors 1033; Noncounterbalancing Errors 1035; Comprehensive Illustration: Numerous Errors 1036; Preparation of Financial Statements 1038

PART 6

PREPARATION AND ANALYSIS OF FINANCIAL STATEMENTS 1059

CHAPTER 24 Statement of Changes in Financial Position 1060

Evolution of a New Statement 1060 What is Meant by Changes in Financial Position? 1061

Cash Basis 1061; Working Capital Basis 1062; All Financial Resources Concept 1062

SECTION 1 Cash Basis 1063 Appeal of the Cash Basis 1063 Illustration of the Cash

Approach 1064 First Illustration 1064; Second Illustration—Butterfield Services Inc. 1066;

Third Illustration—Doral Products Inc. 1067 **Sources of Information for Statement of**

Changes 1071 Special Problems in Statement Analysis 1071 Adjustments similar to Depreci-

ation 1071; Noncash Transactions 1072; Extraordinary Items 1073; Net Losses 1074; Other

Working Capital Changes 1074 **Comprehensive Illustration—Use of a Work Sheet 1075**

Analysis of Work Sheet Transactions 1078; Preparation of Statement 1083 **Cash Provided by**

Operations—Indirect Versus Direct Approach 1084 Indirect Approach 1084; Direct

Approach 1085; Comparative Advantages of the Two Approaches 1087 **Forms of Presenta-**

tion 1087 SECTION 2 Working Capital Basis 1089 Working Capital Illustration 1089 The

Flexibility in Disclosure and Format Continues 1095 Usefulness of Statement of Changes in

Financial Position 1095

APPENDIX 24-A The T-Account Approach to Preparation of the Statement of Changes in

Financial Position 1097 T-Accounts Illustration 1098 Summary of T-Account

Approach 1102

CHAPTER 25 Financial Reporting and Changing Prices 1127

Alternative Financial Reporting Approaches 1127 Constant Dollar Accounting (General Price-

Level Model) 1128; Current Cost Accounting (Specific Price-Level Model) 1129; Current

Cost/Constant Dollar Accounting 1130; Simplified Example of the Various Methods 1130

Professional Pronouncements 1131 Organization of this Chapter 1132 Constant Dollar

Accounting 1132 Measuring General Price-Level Changes 1133; Restatement in Common

Dollars 1133; Monetary and Nonmonetary Classifications 1134; Effects of Holding Monetary

and Nonmonetary Items 1135; Selection of a Constant Dollar Index 1136; Constant Dollar

Accounting—Lia Corporation 1136; Adjustment of Balance Sheet Items 1139; Adjustment of

Combined Income and Retained Earnings Statement Items 1140; Purchasing Power Gain or

Loss 1141; Advantages and Disadvantages of Constant Dollar Accounting 1143 **Current Cost**

Accounting 1144 Current Cost—Complex Illustration 1144; Current Cost Accounting—Lia

Corporation 1146; Adjustment of Balance Sheet Items 1146; Adjustment of Income Statement

Items 1146; Advantages and Disadvantages of Current Cost 1149 **FASB Price-Level Account-**

ing 1150 FASB Approach—Lia Corporation 1151 Adjustment of Income Statement

Items 1152; Adjustment of Balance Sheet Items 1153; Total Holding Gain 1154; Five-Year

Summary 1155 **Additional Price-Level Accounting Problems 1157** Recoverable Amounts 1157;

Income Taxes 1158; Determination of Current Costs 1158; Restatement of Prior Years'

Financial Statements 1158 **Comparative Analyses 1159 Effects of Price-Level Adjusted Infor-**

mation 1161 Continued Experimentation 1161

APPENDIX 25-A Current Cost/Constant Dollar Accounting 1163 Balance Sheet

Adjustments 1164 Income Statement Adjustments 1164 Current Cost/Constant Dollar

Financial Statements 1165