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Intermediate Accounting

18e

18e

INTERMEDIATE ACCOUNTING

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Intermediate Accounting, 18e
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PREFACE

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Currency + Context = Motivation

Motivation

From the smallest mom-and-pop retailer to the largest multinational corporation, businesses of all sizes are recognizing that accounting professionals are no longer simply "number crunchers" but rather essential partners in achieving the fundamental goals of their organization. When people understand accounting's critical role in managing a business and making business decisions, they are **motivated** to learn accounting. That is why *Intermediate Accounting*, *18e* provides a powerful connection between accounting and business today with:

- **Business strategy cases** at the start of each chapter that describe how a real-world firm such as MicroStrategy struggled with revenue recognition and the pressures on management to interpret revenue as positively as possible;
- **Coverage of high-interest and current topics** such as **earnings management, fair value**, and **International Financial Reporting Standards** (**IFRS**) as well as other issues that are driving accounting in today's business environment;
- **FASB codification activities** that link FASB research with real business situations and help readers understand both how to research and use authoritative guidance as well as why that guidance is important;
- **Real-world end-of-chapter case activities** that use the financial results of companies such as The Walt Disney Company, The Boston Celtics, Hewlett-Packard, and Dell to help readers connect accounting to business.

CURRENCY—Current and Relevant Coverage

One look at the business pages of any newspaper shows how illusory long-term success can be. Yesterday's runaway successes can quickly find themselves derailed by the new realities of today's business world. This is the first text to provide a real-world perspective that links accounting functions to the activities of business.

International Financial Reporting Standards topics, indicated by this symbol throughout the text, help students understand how accounting practices differ from country to country and reflect the increasingly global nature of business.

The international environment of business is dramatically changing the landscape of accounting. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to develop one set of accounting standards to be used by companies in countries around the world. No longer is the United States making the rules for the rest of the world to follow. Instead, the FASB and the IASB are working hand-in-hand as financial accounting standards converge at a pace that was not dreamed of even five years ago.

The international environment has greatly affected this textbook. Every chapter discusses relevant accounting standards and developments from both a U.S. and a global perspective. Each chapter begins with a discussion of the accounting standards and procedures used by companies complying with U.S. GAAP. Then those areas where U.S. GAAP and international accounting standards are significantly different are discussed so that the reader can understand how accounting standards around the world are similar and how they are different. A chapter on **Accounting in a Global Market** further emphasizes the role of International Financial Reporting Standards.

The objective of this approach is to develop in students the ability to see beyond the borders of the United States and understand that the global business environment is leading to global accounting standards. Users of this text will understand that they are not just learning U.S. GAAP. Instead, they are being prepared to be active participants in a global accounting environment with the ability to understand and apply international accounting standards as well as U.S. accounting standards.

Fair Value Accounting is another major topic affecting the accounting environment. The credit crisis of 2008 is blamed by some on the inappropriate use of fair value accounting. A module details the "why," "when," "where," and "how" for using fair values in financial statements. Because this concept of fair value accounting is so important and affects so many of the principles and topics discussed later in the text, it has been placed near the front of the text following the discussion of the financial statements.

A Chapter on Earnings Management in Part 1 establishes a framework for the remainder of the course. Students come to understand the importance and ramifications of earnings management through current, real-world examples, extracts from SEC enforcement actions, business press analysis, and the extensive use of academic research findings.

A new FASB Codification feature presents a relevant issue and related question in order to assist students in understanding how to use the FASB's new codification in research. This feature is found in each chapter and includes a description of the issue at hand, a specific question pertaining to that given issue, and suggestions for "Searching the Codification" in order to guide students in the right direction for research. Each feature includes an answer section at the end of the chapter, so that students can check their research and adjust their technique as needed. References throughout the textbook have been updated to reflect the FASB ASC (Accounting Standards Codification).

FASB CODIFICATION

The Issue: You are the accountant for a company in the carpet cleaning business. Because of your company's innovative cleaning system (no harsh detergents, no damaging brushes, and extremely small carbon footprint), you have been very successful and have begun to drive your competitors out of business. In fact, just today your company's CEO has decided to start buying a number of your competitors. As you walked out the door at the end of the day, she said: "You had better learn how to account for a bargain purchase."

The Question: What is a bargain purchase, and why is a bargain purchase likely to arise in this situation?

Searching the Codification: Bargain purchases are covered in this chapter, but you would like to show your boss that you can find accounting standards for yourself in the authoritative literature. The best place to start is in Topic 805 (Business Combinations), which is in the "Broad Transactions" collection of topics.

The Answer: The authoritative accounting standards relative to bargain purchases are described on page 10-43.

Up-to-Date *Intermediate Accounting, 18e* has been **completely updated** to reflect the latest changes in accounting standards, practices, and techniques. The real company information has been revised to account for recent changes in financial statements and other company reports.

EX 9-6 SCHEDULE OF COST OF GOODS MANUFACTURED

Bartlett Corporation
Schedule of Cost of Goods Manufactured
For the Year Ended December 31, 2013

Direct materials:		
Raw materials inventory, January 1, 2013	$ 21,350	
Purchases	107,500	
Cost of raw materials available for use	$128,850	
Less: Raw materials inventory, December 31, 2013	22,350	
Raw materials used in production		$106,500
Direct labor		96,850
Manufacturing overhead:		
Indirect labor	$ 40,000	
Factory supervision	29,000	
Depreciation—factory buildings and equipment	20,000	
Light, heat, and power	18,000	
Factory supplies	15,000	
Miscellaneous manufacturing overhead	12,055	134,055
Total manufacturing costs		$337,405
Add: Work in process inventory, January 1, 2013		29,400
		$366,805
Less: Work in process inventory, December 31, 2013		26,500
Cost of goods manufactured		$340,305

CONTEXT—Business Activities Emphasized in Organization

No other text works harder to demonstrate accounting's integral importance to an organization's decision-making capabilities. This book is organized as much as possible around the essential interrelationship between accounting procedures and the activities of business to provide students with the context behind the accounting that is discussed. The innovative structure is unsurpassed in preparing students to serve as trusted advisors on the front lines of business.

In an effort to streamline the sequence of chapters in the text, the table of contents accounts for a more traditional balance sheet order of topics while still maintaining the structure of covering topics as they relate to business activities. The investing chapters fall before the financing chapters, which results in a more familiar order of presentation for instructors and students.

Part 1—Foundations of Financial Accounting provides students with the fundamentals of financial accounting, including a full chapter on Earnings Management, and concludes with a module that covers the Time Value of Money as well as a module on Fair Value.

Part 2—Routine Activities of a Business gets down to business, integrating accounting into management by exploring operating and investing activities.

Part 3—Additional Activities of a Business examines financing activities, leases, income taxes, and employee compensation.

Part 4—Other Dimensions of Financial Reporting rounds out the comprehensive coverage with earnings per share; derivatives, contingencies, business segments, and interim reports; accounting changes; and financial statement analysis; as well as extended coverage of IFRS, which is found in the separate chapter, Accounting in a Global Market.

Why and How Framework follows each learning objective, as the authors provide additional reinforcement of the critical concepts by highlighting both the procedural aspects (the "how") as well as the context (or "why") for which they are applied. As they move through the chapter, students gain a greater understanding of both elements and can rationalize why businesses account for things the way they do. By exposing students to the "why" behind each concept, students are being trained to realize the business implications of various decisions made by companies and can take their careers head-on.

Supporting this framework are a number of critical-thinking elements that allow students to stretch their minds into the analysis of the relevant topics, a skill that will also be crucial as they move on in their studies and careers.

Overview of the Accounting Process

1 Identify and explain the basic steps in the accounting process (accounting cycle).

WHY It is important to understand how accounting information flows through an organization and how that information is captured by the accounting information system.

HOW The accounting process, often referred to as the accounting cycle, generally includes the following steps: analyze business documents, journalize transactions, post to ledger accounts, prepare a trial balance, prepare adjusting entries, prepare financial statements, close the nominal accounts, and prepare a post-closing trial balance.

Statement of Cash Flows "Revisited" in Chapter 21 provides coverage of the statement of cash flows in the second semester of the course. The book continues to provide a full chapter early in the text (Chapter 5) addressing the statement of cash flows and integrates this financial statement throughout the text, which results in the most comprehensive treatment of this important subject available.

Opening Scenario Questions are critical-thinking questions that follow the updated real company chapter openers. Solutions are provided at the end of each chapter so students can check their answers as they think about how they would approach accounting-related issues that businesses face.

QUESTIONS

1. Why do you think the price-to-sales ratio (as opposed to the price-earnings ratio) is often used in valuing the stocks of start-up technology companies, especially those related to the Internet?
2. On Monday, March 20, 2000, MicroStrategy issued a press release stating that revenues for the year 1999 were about $155 million, not $205 million as previously announced. This represented a drop of 24% in reported revenue. Why did a drop of just 24% in reported revenue result in a stock price drop of 62%? In other words, why wasn't the drop in stock price also 24%?
3. In early March 2000, MicroStrategy's board of directors received word that the company's auditor was requesting a revenue restatement. The board was reluctant to go forward with the restatement because of fears (justified, as it turns out) that the restatement would hurt the company's stock price. List and explain two or three arguments that you, as a member of the board, could have made in support of the restatement.

Answers to these questions can be found on page 8-41.

STOP&THINK

It would seem that the physical capital maintenance concept would provide the best theoretical measure of "well-offness." However, use of the physical capital maintenance concept of measuring income involves many practical difficulties. Identify ONE of those practical difficulties from the list below.

a) Difficulty in estimating depreciation lives
b) Difficulty in implementing internal control procedures
c) Difficulty in providing cash flow information
d) Difficulty in obtaining fair market values of assets and liabilities

Stop & Think multiple-choice questions have been written by the authors to accompany the Stop & Think boxed features. These critical-thinking boxes, found in every chapter, allow students to test their knowledge and then consult the answers found at the end of the chapter.

FYI

Before 2002, all gains and losses resulting from the early extinguishment of debt were reported as extraordinary. This classification was ended with the release of pre-Codification *SFAS No. 145* (now in FASB ASC paragraph 470-50-45-1); these gains and losses are now considered ordinary, subject to the normal criteria for extraordinary items.

FYI margin boxes often provide additional context to an important topic by emphasizing additional points of interest.

CAUTION

The most common error when computing bad debt expense is to confuse the two methods—percentage of sales and percentage of receivables. Remember that when you are using the percentage-of-sales method, bad debt expense is computed and the balance in the allowance account is then determined. When you are using the percentage-of-receivables method, the balance in the allowance account is computed, and then the amount of bad debt expense for the period is determined.

Caution provide students with important points to consider when thinking about more complex concepts and topics.

REVERSE SOLVABLE

New "Reverse Solvable" Problems at the end of chapters, identified by an icon, ask students to demonstrate mastery of relationships and accounting concepts by working with incomplete information and completing the missing information before completing the assignment.

Chapter Updates and Enhancements

Chapter 1

- New chapter-opening vignette focusing on the global financial crisis
- New extended discussion of FASB Accounting Standards Codification
- Update on the standard-setting process
- Introduction of the revised GAAP hierarchy and revised discussion of GAAP overall
- Further explanation of the convergence of U.S. GAAP and IASB standards
- New extended coverage of U.S. GAAP and IFRS similarities and differences

Chapter 2

- New discussion of *IFRS for SMEs* as alternative option to full-blown provisions of U.S. GAAP or IFRS
- New feature "Using the FASB's Codification"

Chapter 3

- Updated and revised opening case on Coca-Cola
- New feature "Using the FASB's Codification"
- New analysis of the proposed new balance sheet format
- Revised coverage on minority interest as related to the consolidated balance sheet

Chapter 4

- Updated exhibits
- New feature "Using the FASB's Codification"
- New, continued analysis (from Chapter 3) of the proposed new balance sheet format

Chapter 5

- Revised chapter-opening vignette regarding Circle K
- New feature "Using the FASB's Codification"
- Revised FASB-IFRS-Codification Summary

Chapter 6

- Updated exhibits
- Revised to reflect economic and housing crises

Time Value of Money Module

- Revised end-of-chapter material to reflect recent updates

Fair Value Module

- Revised to acknowledge pre-Codification provisions
- New FASB ASC references

Chapter 7

- Updated chapter-opening vignette to reflect global economic crisis
- New FASB ASC references
- New feature "Using the FASB's Codification"
- Updated exhibits

Chapter 8

- Revised Learning Objectives
- Expanded discussion of internal controls
- Updated and expanded discussion of Subtopic 605-25
- New review of some of the topics addressed in SAB 101
- Updated and expanded discussion of the asset-and-liability approach to revenue recognition that is currently being developed as a joint effort of the FASB and the IASB
- New feature "Using the FASB's Codification"
- Updated data and exhibits

Chapter 9

- New feature "Using the FASB's Codification"
- Updated data and exhibits

Chapter 10

- Updated references to FASB ASC throughout
- Discussion of pre-Codification material as well
- New feature "Using the FASB's Codification"
- Updated data and exhibits

Chapter 11

- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Updated data and exhibits

Chapter 12

- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Updated data and exhibits
- Updated discussion on the use of the fair value option for the reporting of financial assets and liabilities

Chapter 13

- Updated discussion of "perpetual approach" and both the FASB's and the IASB's opinions on it
- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Updated data and exhibits

Chapter 14

- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Updated data and exhibits
- Updated discussion on the classification of investment securities according to IFRS
- Updated discussion on equity method accounting according to IFRS

Chapter 15

- Updated chapter-opening vignette data
- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Updated data and exhibits
- Revised discussion of the profit deferral rule

Chapter 16

- New discussion regarding the FASB's attempts to use accounting theory to define what "income tax expense" means
- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Expanded discussion of accounting for uncertain tax provisions

Chapter 17

- Updated chapter-opening vignette to address the global economic crisis and health care reform
- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- New coverage of the IASB Exposure Draft, April 2010
- Updated information regarding GM and the effects of the economic crisis

Chapter 18

- New chapter-opening vignette focusing on China's position in the global economic world
- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Revised discussion on participating securities and the two-class method

Chapter 19

- Updated references to FASB ASC throughout
- New feature "Using the FASB's Codification"
- Added discussion of how IFRS affects derivatives, contingencies, business segments, and interim reports
- Analysis of pre-Codification provisions and the effects of FASB ASC in regards to these provisions
- Additional coverage of the accounting for contingent liabilities and contingent assets

Chapter 20

- Updated references to FASB ASC throughout
- New coverage of the proper reporting of accounting changes according to FASB ASC
- New feature “Using the FASB’s Codification”
- Updated exhibits and data

Chapter 21

- Revised comprehensive example of the statement of cash flows using Tesco, one of the largest supermarket chains in the United Kingdom
- New discussion of the FASB–IASB project on financial statement presentation
- Updated exhibits and data
- Updated references to FASB ASC throughout

Chapter 22

- Updated information regarding the economic crisis
- Revised information on the IASB
- Expanded discussion on the transfer of provision sources (U.S. GAAP vs. IFRS)
- Updated key differences between U.S. GAAP and IFRS
- Updated references to FASB ASC throughout
- New feature “Using the FASB’s Codification”

Chapter 23

- Updated chapter-opening vignette information and data
- Updated references to FASB ASC throughout
- New feature “Using the FASB’s Codification”

Reinforce Student Understanding

Unmatched End-of-Chapter Material

Widely regarded as providing the most varied and expansive set of problem assignments available, *Intermediate Accounting, 18e* continues to raise the bar to new heights. Only *Intermediate Accounting* features such a diverse set of traditional exercises, problems, and cases:

- 15–25 Questions per chapter to help assimilate chapter content
- More than 400 Practice Exercises written by the authors
- Discussion Cases for homework or class discussion
- Exercises to reinforce key concepts or applications

- Problems that integrate several concepts or techniques
- Sample CPA Exam Questions written to provide students with similar problems commonly found on the CPA exam
- Selected Exercises or Problems that have accompanying spreadsheet templates, marked with an icon

SPREADSHEET

REVERSE SOLVABLE

"Reverse Solvable" Problems at the end of chapters, identified by an icon, ask students to demonstrate mastery of relationships and accounting concepts by working with incomplete information to determine the data that is missing from the exercise, before completing the assignment.

Case Materials have been designed to help accelerate the development of essential skills in critical thinking, communication, research, and teamwork. Retention and application of key concepts build as future accountants and business professionals take advantage of a wide range of tools found in this innovative section. These cases satisfy the skills-based curriculum endorsed by the AICPA's Core Competency Framework and the recommendations of the Accounting Education Change Commission (AECC).

Deciphering Actual Financial Statements Cases enable students to analyze financial data from recent annual reports from companies such as The Walt Disney Company, Coca-Cola, and the Boston Celtics.

Researching Accounting Standards Cases ask students to visit the FASB's Web site to access designated pronouncements as they are applied to each chapter's topics.

Ethical Dilemma Assignments help develop the critical-thinking skills students will need as they wrestle with the business world's many "gray" issues.

Case 7-73

Ethical Dilemma

You recently graduated from college with your accounting degree. Your father's best friend is the director of the accounting department of a small manufacturing firm in the area, and you accepted a position on his staff. After a month on the job, you have noticed several deficiencies in the cash controls for the company. For example, the individual making the daily deposits at the bank is also in charge of updating accounts receivable. You also notice that the petty cash fund is under general control of everyone in the office (that means that no one person has ultimate responsibility) and that vouchers are seldom completed when cash is removed from the fund. You bring your concerns to the attention of your boss, your father's friend, and he comments:

> "I appreciate your concerns. I knew when we hired you that you were sharp, but you need to understand that not everything is done by the book here. We trust our employees. If we were to enforce rigid controls on cash, it would create a nontrusting work environment. We don't want that. Sure, a little money may turn up missing now and then, but it is a small price to pay. Now, don't you worry about it anymore."

What do you do now? Would you be comfortable working in an environment where there is a lack of control on cash? If a significant sum of money were to turn up missing and the control system was unable to determine who was responsible, what would that do to the trusting work environment? And remember, big sums of money never turned up missing until you came to work at the company.

The Cumulative Spreadsheet Analysis Case builds upon the lessons of each chapter to give students the opportunity to demonstrate and reinforce their understanding. Found at the end of Chapters 2–5, 7–20, and 23, each exercise requires students to create a spreadsheet that allows for numerous variables to be modified and their effects to be monitored. By the end of the course, students have constructed a spreadsheet that enables them to forecast operating cash flows for five years in the future, adjust forecasts for the most reasonable operating parameters, and analyze the impact of a variety of accounting assumptions based on the reported numbers.

Case 2-52 **Cumulative Spreadsheet Analysis**

Beginning with Chapter 2, each chapter in this text will include a spreadsheet assignment based on the financial information of a fictitious company named Skywalker Enterprises. The assignments start out simple—in this chapter you are not asked to do much more than set up financial statement formats and input some numbers. In succeeding chapters, the spreadsheets will get more complex so that by the end of the course you will have constructed a spreadsheet that allows you to forecast operating cash flows for five years in the future, adjust your forecast depending on the operating parameters that you think are most reasonable, and analyze the impact of a variety of accounting assumptions on the reported numbers.

So, let's get started with the first spreadsheet assignment.

Bonus Content

Web-Based Chapter Enhancements

In response to instructor requests, subject-enhancing material from previous editions of the text is available on the companion Web site. The result is a streamlined, easier-to-use text that provides ample supplement material for important topics.

CHAPTER	WEB MATERIAL
2	Illustration of Special Journals and Subsidiary Ledgers
5	Statement of Cash Flows—Indirect Method
7	Petty Cash Fund
8	Deposit Method: Franchising Industry
10	Complexities in Accounting for Capitalized Interest
13	Quasi-Reorganizations
	Complexities in Accounting for Stock-Based Compensation
14	Changes in Classification Involving the Equity Method
15	Real Estate Leases
16	Intraperiod Tax Allocation
17	Details of Accounting for Postretirement Benefits Other Than Pensions
	Detailed Pension Present Value Calculations
22	Foreign Currency
23	Impact of Changing Prices on Financial Statements

Give your students instant feedback and an online learning tool that will propel them forward in this course!

Introducing CengageNOW™ for Stice/Stice: *Intermediate Accounting, 18e*

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- End-of-chapter homework from the textbook written by the authors
- Integrated eBook
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- Ability to run reports to gauge individual class/student dynamics, report at institutional level or to accrediting bodies based on outcomes
- Flexible course management tools

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- Easy-to-use course management options that offer flexibility and continuity from one semester to another. Includes all end-of-chapter questions, Test Bank, eBook, study resources, and personalized learning plan. CengageNOW includes everything you and your students need to be successful.
- Different levels of feedback and engaging student resources to guide students through material and solidify learning.
- "**Smart Entry**" helps eliminate common typos and errors to help students do their best work and understand the concept behind each answer.
- The ability to analyze student work from the gradebook and generate reports on learning outcomes for accreditation and other purposes.
- Robust assignment options allow you to control your course and make the system work best for you and your students:
    - Set prerequisites for assignments or extra credit
    - Control the amount of feedback you give students
    - Control the rigor of assignments by selecting different question types or grading methods
    - Easily change point values of questions or individual student grades

What Is a Personalized Study Plan? It is offered in CengageNOW as a diagnostic tool with a Pre-Test, Customized Study Plan, and Post-Test for each chapter. It offers valuable study assets to empower students to master concepts. The resources available with the personalized study plan for *Intermediate Accounting, 18e* are:

- Crossword Puzzles
- Key Terms
- Flashcards
- Student PowerPoint Slides
- QuizBowl game
- eBook by learning objective

To order CengageNOW with Stice/Stice: *Intermediate Accounting, 18e*, contact your sales representative to decide which purchasing option best suits your classroom and students' needs.

For Instructors

Instructor's Resource CD, ISBN-10: 1-111-53454-3| ISBN-13: 978-1-111-53454-7 packages the Solutions Manual, Instructor's Resource Manual, Test Bank, ExamView®, Instructor PowerPoint® slides, Excel spreadsheet solutions, and Cumulative Spreadsheet Analysis solutions on one convenient CD-ROM.

Comprehensive Instructor Supplement Package

An unsurpassed package of supplementary resources allows you to make the most of your time while providing valuable assignments and assessment for your students.

To access the online instructor's resources for this text, please visit http://login.cengage.com/cb and search for Stice/Stice: *Intermediate Accounting, 18e* by author, title, or ISBN in the search bar. Add to your bookshelf. Make sure to select that you also want to add CengageNOW so that you can see what this valuable online resource has to offer!

Solutions Manual, Volume 1: ISBN-10: 1-111-53442-X| ISBN-13: 978-1-111-53442-4, **Volume 2:** ISBN-10: 1-111-53443-8 | ISBN-13: 978-1-111-53443-1, prepared by James D. Stice and Earl K. Stice, Brigham Young University.

This manual contains independently verified answers to all end-of-chapter questions, cases, exercises, and problems, written by the authors. Also available electronically on the (IRCD) and companion Web site.

Instructor's Resource Manual, prepared by Ira W. Bates, Florida A&M University.

This manual enhances class preparation with objectives, chapter outlines, teaching suggestions and strategies, and topical overviews of end-of-chapter materials. It also features assignment classifications with level of difficulty and estimated completion time, suggested readings on chapter topics, and transparency masters. A new transition guide has been added to make the move from 17e to 18e easier. The result is a comprehensive resource integration guide to supplement the course. Available electronically on the IRCD and companion Web site.

Test Bank and ExamView®, prepared by Fernando Rodriguez.

The revised and expanded test bank is available in both Word files and computerized ExamView versions. Test items include multiple-choice questions and short examination problems for each chapter, along with solutions. Analysis problems are included to coincide with the emphasis on decision making in the text. Available electronically on the IRCD.

Instructor's PowerPoint® Slides, prepared by Doug Cloud, Professor Emeritus, Pepperdine University.

Hundreds of slides in PowerPoint format can be used in on-screen lecture presentations or printed out and used as traditional overheads. Additionally, they can be printed and distributed to students, allowing students to concentrate on the professor instead of hurrying to copy down information. Available electronically on the IRCD and companion Web site.

Create a Custom Solution that Fits Your Exact Needs! This service develops personalized solutions to meet your business education needs. Match your learning materials to your syllabus and create the perfect learning solution. Consider the following when looking at your customization options for Stice/Stice: *Intermediate Accounting, 18e*:

- Remove chapters you do not cover or rearrange their order, creating a streamlined and efficient text.
- Add your own material to cover new topics or information or to easily provide students with content you are currently printing and handing out to them, saving you time in planning and providing students a fully integrated course resource.
- Add additional material such as cases or chapters from other textbooks.

Alternative Text Formats:

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Please see information about other text formats such as eBook, textbook rentals, and more under the student section.

For Students

SPREADSHEET

Excel Enhanced Spreadsheet Templates, prepared by Beth Woods, *Accuracy Counts*. Excel templates with validations are provided on the Web site for solving selected end-of-chapter exercises and problems that are identified in the text with a spreadsheet icon.

Robust Product Support Web Site

A robust Web site provides a wealth of resources for you and your students in *Intermediate Accounting* at no additional cost! With a multitude of chapter-enhancing features and study aids, these resources will allow students to excel in class and save you time in planning!

Book Resources Available

- Expanded Material Topics
- Instructor's PowerPoint Slides
- Instructor's Resource Manual
- Solutions Manual
- Transparency Masters

Available for Every Chapter

- Check Figures
- Crossword Puzzles
- Enhanced Spreadsheet Templates
- Interactive Quizzes
- Key Terms Flashcards
- Learning Objectives
- Problem Solving Strategy Guide
- Student PowerPoint Slides

To access additional course materials, please visit www.cengagebrain.com. At the CengageBrain.com home page, search for the ISBN of your title (from the back cover of your book) using the search box at the top of the page. This will take you to the product page where these resources can be found.

CengageBrain: www.cengagebrain.com

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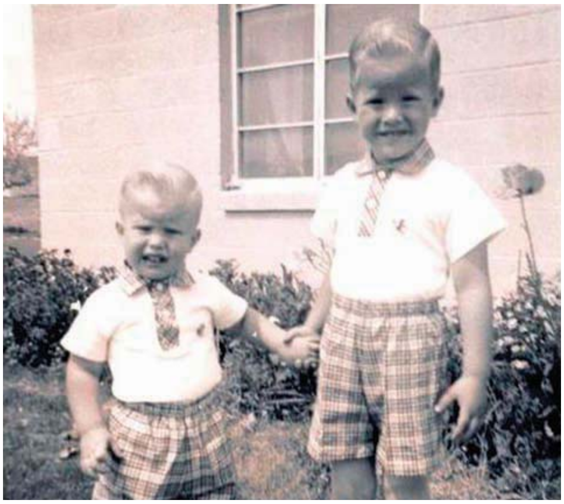

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P1 FOUNDATIONS OF FINANCIAL ACCOUNTING

CHAPTER 1 Financial Reporting

LEARNING OBJECTIVES

1 Describe the purpose of financial reporting and identify the primary financial statements.

2 Explain the function of accounting standards and describe the role of the FASB in setting those standards in the United States.

3 Recognize the importance of the SEC, AICPA, AAA, and IRS to financial reporting.

4 Realize the growing importance and relevance of international accounting issues to the practice of accounting in the United States and understand the role of the IASB in international accounting standard setting.

5 Understand the significance of the FASB's conceptual framework in outlining the qualities of good accounting information, defining terms such as asset and revenue, and providing guidance about appropriate recognition, measurement, and reporting.

6 Identify career opportunities related to accounting and financial reporting and understand the importance of personal ethics in the practice of accounting.

Hannelore Foerster/Bloomberg/Getty Images

It all started with a French accountant named René Ricol. In mid- 2008, Mr. Ricol was commissioned by French President Nicolas Sarkozy to write a report on the impact of the worldwide financial crisis of 2007 and 2008.[1] This 148-page report covers a variety of topics including the origins of the crisis, the ongoing response by governments and business, and 30 detailed recommendations for additional actions. But on page 53, Mr. Ricol wrote something that was to have explosive consequences. He wrote: “At present, it is important to ensure that . . . a level playing field between European and U.S. [accounting] rules is achieved.” By implication, according to Mr. Ricol, one reason that European banks were having such severe difficulties in the third quarter of 2008 was that U.S. accounting rules were giving an advantage to U.S. banks.

[1] René Ricol, “Report to the President of the French Republic on the Financial Crisis,” September 2008.

Mr. Sarkozy passed Mr. Ricol's report along to the assembled EU Finance Ministers, who happened to be meeting in Paris. These ministers were shocked—shocked to learn that U.S. accounting rules were creating an "unlevel playing field" to the advantage of U.S. banks. The Finance Ministers issued a communiqué on October 7, 2008, calling for: "[T]he necessity of avoiding any distortion of treatment between U.S. and European banks due to differences in accounting rules . . . We also consider that the issue of asset reclassification must be resolved quickly . . . We expect this issue to be solved by the end of the month, with the objective to implement as of the third quarter."[2]

So, to whom was the call to arms addressed? To the International Accounting Standards Board (IASB), based in London and designated by the European Union as the approved source of accounting standards for all EU nations. IASB standards, collectively known as International Financial Reporting Standards (IFRS), are also recognized as the source of generally accepted accounting principles in every sizeable economy in the world . . . every sizeable economy except one, the United States.

Attention turned to Sir David Tweedie, chairman of the IASB. Sir David was told that the IASB had three days to revise IFRS. Three *days*? The due process requirements of both the IASB and its U.S. counterpart, the FASB, typically result in proposed accounting standards being circulated and discussed for *years*, not days. However, Sir David was told that without an immediate rule change, the EU would go around the IASB and unilaterally change the accounting rules for companies in its constituent countries. It is reported that Sir David considered resigning.[3] However, in order to live to fight another day, he succumbed to the EU pressure and rushed through the accounting change.

So, what was this accounting rule that was viewed as threatening the very survival of European banks? The accountants call it "fair value accounting," and in the business press it is often called "mark-to-market accounting." For companies, such as banks, that actively trade stocks and bonds, the mark-to-market rule says that the investments must be reported on the company's books at current market value, with any paper gains or losses (called "unrealized" gains or losses by the accountants) being reported in the company's income statement. Well, during the third quarter of 2008 (from July 2008 through September 2008), there had been HUGE paper losses for banks and other investors all over the world. These losses reduced the recorded capital of banks and threatened to put many banks in violation of their regulatory capital requirements. So, you can see why banks in particular were upset at "mark-to-market accounting." Note: No one seemed to complain much about mark-to-market accounting in the years when the market was up.

Back to Mr. Ricol. He claimed to have found a provision in the U.S. accounting rules that allowed U.S. banks to reclassify their investment securities into a category that accountants call "held to maturity." The important thing about held-to-maturity securities is that they are reported in the balance sheet at their original cost, not their current market value, with any changes in value being ignored. Thus, this appears to be a loophole that U.S. banks could use to sidestep the harsh impact of mark-to-market accounting. At least that is the way this U.S. rule was explained to the EU Finance Ministers. What the Finance Ministers were not told is that this reclassification is so rare that no one can think of an example of a U.S. company ever actually doing it. In addition, the U.S. rule requires the reclassification to "held-to-maturity" to be done at the prevailing market value on the date of the reclassification, so any paper gains or losses must be recorded in full on that day. This doesn't seem like much of a loophole. But remember, the EU Finance Ministers probably weren't given a full briefing on all the aspects of the U.S. rule; they were only told that this U.S. loophole allowed U.S. banks to avoid mark-to-market accounting, thus appearing to create an unlevel international playing field with European banks being the losers.

Now the story gets really interesting. In drafting the hasty revision to its rules, someone in the IASB (no one is saying who) made the IASB version of this reclassification rule applicable retroactively to July 1, 2008. Very clever. The IASB rule was approved on October 13, 2008, two weeks AFTER the end of the fiscal third quarter of the year.[4] By

[2] Ecofin Council of 7 October 2008, "Immediate responses to financial turmoil."
[3] David Jetuah, "Tweedie nearly quit after fair value change," *Accountancy Age*, November 12, 2008.
[4] "Reclassification of Financial Assets—Amendments to *IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures*," International Accounting Standards Board, London, October 2008.

that time, European banks were able to see which of their investments had gone up and which had gone down during the third quarter. This new IASB rule allowed the European banks to roll back the clock to July 1, 2008, and, with the benefit of hindsight, designate some investments to be accounted for using mark-to-market accounting (probably the ones that they now knew went up during the third quarter) and some investments to be reclassified as "held to maturity" at the value existing as of July 1 (probably the ones that they knew, with hindsight, went down during the third quarter).

So, this IASB rule revision, intended to "level" the international playing field, substantially tilted the playing field in favor of those European banks that chose to use it. Some European banks quickly backed away from this blatant manipulation of the accounting rules for their benefit. For example, in its third quarter 2008 financial report, **BNP Paribas** specifically stated that: "BNP Paribas did not use, in the third quarter 2008, the amendment to the *IAS 39* accounting standard authorising the transfer of certain assets . . . from the trading book to other portfolios."[5] On the other hand, **Deutsche Bank** gratefully used the retroactive provision to turn a loss into a profit. Without the retroactive reclassifications, Deutsche Bank would have reported a pre-tax loss of €732 million for the third quarter. With the reclassifications, Deutsche Bank was able report a pre-tax profit of €93 million, which it proudly hailed in its third quarter report.[6]

There are certainly historical examples of U.S. politicians putting pressure on the FASB to revise its rules for some perceived benefit or another. But in the United States the FASB is somewhat shielded from these pressures by the Securities and Exchange Commission (SEC). Internationally, there is no global SEC, so the IASB was left on its own to experience the full force of the European Union's political pressure. Predictably, when faced with an EU ultimatum, the IASB buckled.

Across the Atlantic, U.S. regulators and the U.S. business community could only stand back and watch this political power play with a mixture of amazement and disgust. As of October 2008, the SEC had an announced policy, a "time line," for shifting all U.S. accounting rulemaking responsibility to the IASB by 2014. This policy stemmed from two incontrovertible facts: (1) global capital markets demand a uniform set of accounting rules, and (2) the world will never accept "Yankee" control of this one-world standard. So, the SEC had the choice of either watching the international harmonization parade go by or getting in line behind the IASB banner. However, the October 2008 IASB debacle caused both the SEC and the U.S. business community to reevaluate the benefits of ceding standard-setting power to the IASB, an organization that had now revealed itself as being subject to powers more interested in the well being of European banks than in any abstract notion of global accounting harmony. It was time to rethink the "time line."

SEC Chairman Mary Shapiro was never as enthusiastic about international accounting convergence as was her predecessor, Christopher Cox. She was fearful of "convergence" really being a "race to the bottom" in terms of a degradation in the quality of the U.S. financial reporting environment. During 2009, Chairman Shapiro said cautiously that the "time line" was on hold until the SEC determined exactly how it wanted to proceed.

The SEC's new international accounting convergence "work plan" was announced on February 24, 2010.[7] The SEC is still convinced that "a single set of high-quality globally accepted accounting standards would benefit U.S. investors." However, the SEC has expressed concern about both the quality of the international standards and the process by which those standards are set. Specifically, before ceding standard-making authority to the IASB (or any other international body, for that matter), the SEC wants to ensure that "accounting standards are set by an independent standard-setter and for the benefit of investors." The implication is that the SEC wants to be convinced that the IASB won't again cave in to EU pressure to twist an accounting rule to the benefit of European banks or some other powerful EU constituency. The SEC's "work plan" also states that the SEC will not switch over to IFRS until 2015, at the earliest.

So, what has been the result of that report written by René Ricol? The primary result has been to bring home, dramatically, the remaining barriers to

[5] BNP Paribas Press Release, "Results as at 30 September 2008," November 5, 2008, Paris.
[6] Deutsche Bank, "Interim Report as of September 30, 2008," October 2008, Frankfurt am Main, pages 2 and 53.
[7] SEC Press Release 2010-27, "SEC Approves Statement on Global Accounting Standards," U.S. Securities and Exchange Commission, February 24, 2010, Washington, D.C.

international convergence in financial reporting. The U.S. business community was forced to face the reality that it really doesn't want its reporting rules set by a London-based group that is essentially controlled by the European Union. In addition, all interested parties, both in the United States and overseas, have seen that the IASB differs from the FASB in one extremely important way—the pronouncements of the FASB have the force of law because the regulatory power of the SEC is behind them. But who will enforce the pronouncements of the IASB? Who will ensure that the provisions are applied in a consistent way in each country around the world? Will it ever really be possible to have one truly global set of accounting standards, uniformly interpreted, implemented, and audited? For now, it looks like the answer may be: No.

QUESTIONS

1. What is "mark-to-market accounting"?
2. When the IASB adopted its amended rule in October 2008, what was significant about the fact that the rule was written so that companies could apply the rule retroactively to July 1, 2008?
3. What impact did the October 2008 IASB debacle have in the United States?

Answers to these questions can be found on page 1-37.

In this text you will learn about many of the key accounting issues integral to an understanding of the October 2008 IASB case described above: the accounting for investment securities in Chapter 14, fair value accounting in the Fair Value Module, and the ongoing effort by the IASB and the FASB to achieve convergence on a globally accepted set of high-quality accounting standards. In fact, this IASB-FASB convergence is such an important issue that it is discussed in every chapter in this book, starting with this one.

As the October 2008 IASB case illustrates, the intricacies of accounting often result in differences of opinion as to what accounting methods are appropriate and the level of disclosure that should be required of companies. Arguments over appropriate accounting are facts of life because accounting involves judgment. Even in cases that don't involve financial statement scandal or political intrigue, the management of a company is likely to have some accounting disagreements with the independent auditor before the company's financial statements are released. If a company falters, outside analysts are sure to find accounting judgments with which, in retrospect, they disagree. If the FASB or IASB propose a new accounting rule, it is certain that some business executives will proclaim the rule to be utterly absurd. This is not because managers are sleazy, conniving, and self-serving (although such managers certainly exist); it is because the business world is a complex place filled with complex transactions, and reasonable people can disagree about how to account for those transactions. As the chapters in this book will explain in detail, accounting for the complex transactions that are commonplace today is much more than the simple "bean-counting" image portrayed of accounting in the popular press.

Your introductory accounting course gave you an overview of the primary financial statements and touched briefly on such topics as revenue recognition, depreciation, leases, pensions, deferred taxes, LIFO, and financial instruments. In intermediate accounting, all these topics are back, bigger and better than ever. Now, instead of getting an overview, you will actually get the nuts and bolts. Yes, some of these topics are complex—they are complex because the business world is a complex place. However, when you complete your course in intermediate accounting, you will be quite comfortable with a set of financial statements. In fact, you will probably find yourself skipping the statements themselves and turning directly to the really interesting reading—the notes.

Now is an exciting time to be studying accounting. Students have been learning double-entry bookkeeping for more than 500 years. Now it will be your privilege to witness the transformation of financial reporting via the twin forces of internationalization and information technology. Over the next five years, the increased integration of the worldwide market for capital will finally force diverse national accounting practices to converge to one global standard, with the United States being one of the last countries to accept that global standard. This text will help you understand the "how and why" of this process. In the longer term, the power of computers to create and analyze huge databases will change the very nature of accounting. Users will not learn about companies through a few pages of financial statements and notes but, ultimately, through online access to the raw financial data. It isn't clear what "accounting" will entail in the technological future, but it is certain that those professionals trained in the underlying concepts of accounting and in the importance of accounting judgment and accounting estimates will be best able to make the transition. This book is intended to prepare you for the future.

Accounting and Financial Reporting

1 **Describe the purpose of financial reporting and identify the primary financial statements.**

WHY **The purpose of financial reporting is to aid interested parties in evaluating a company's past performance and in forecasting its future performance. The information about past events is intended to improve future operations and forecasts of future cash flows.**

HOW **Internal users have the ability to receive custom-designed accounting reports. External users must rely on the general-purpose financial statements. The five major components of the financial statements are:**

- Balance sheet
- Income statement
- Statement of cash flows
- Explanatory notes
- Auditor's opinion

The overall objective of accounting is to provide information that can be used in making economic decisions.

> Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action.[8]

Several key features of this definition should be noted.

- Accounting provides a vital service in today's business environment. The study of accounting should not be viewed as a theoretical exercise—accounting is meant to be a practical tool.
- Accounting is concerned primarily with quantitative financial information that is used in conjunction with qualitative evaluations in making judgments.

[8] *Statement of the Accounting Principles Board No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: American Institute of Certified Public Accountants, 1970), par. 40.

- Accounting information is used in making decisions about how to allocate scarce resources. Economists and environmentalists remind us constantly that we live in a world with limited resources. The better the accounting system that measures and reports the costs of using these resources, the better decisions can be made for allocating them.
- Although accountants place much emphasis on reporting what has already occurred, this past information is intended to be useful in making economic decisions about the future.

CAUTION

Remember that accounting information is only one type of information used in decision making. In many cases, qualitative data are more useful than quantitative data.

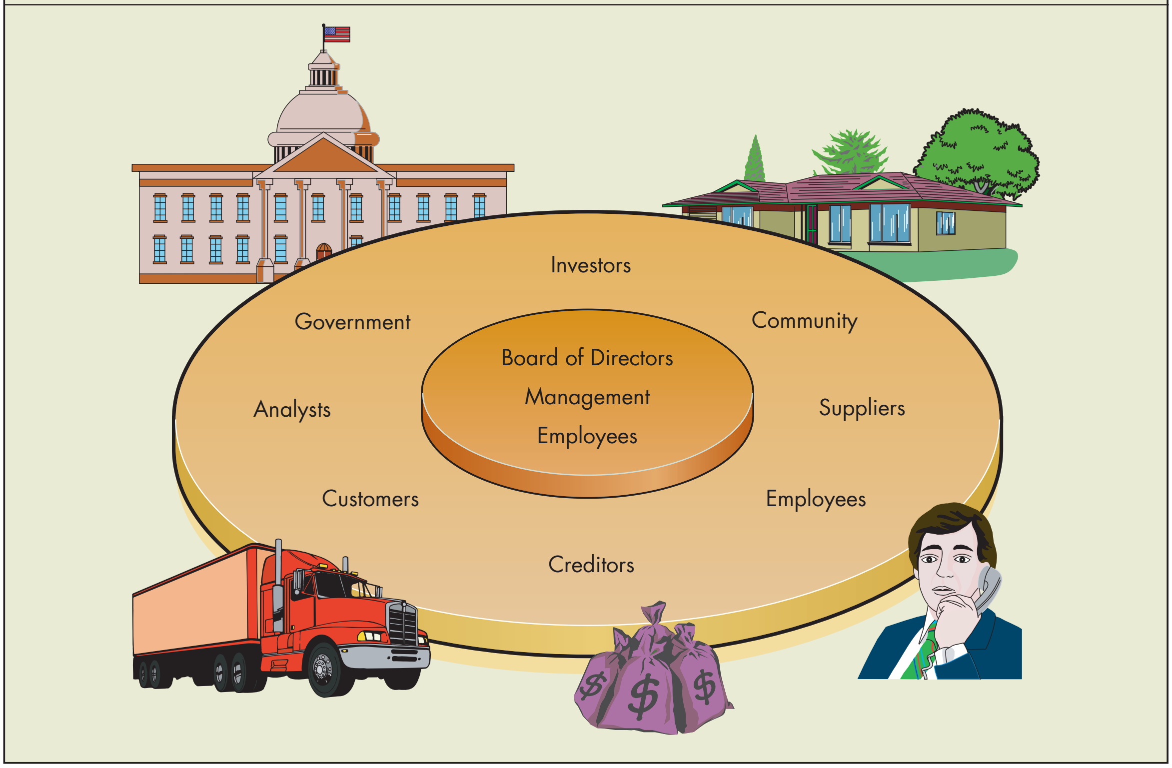
Users of Accounting Information

Who uses accounting information and what information do they require to meet their decision-making needs? In general, all parties interested in the financial health of a company are called stakeholders. Stakeholder users of accounting information are normally divided into two major classifications:

- Internal users, who make decisions directly affecting the internal operations of the enterprise
- External users, who make decisions concerning their relationship to the enterprise

Major internal and external stakeholder groups are listed in Exhibit 1-1.

EX 1-1 MAJOR INTERNAL AND EXTERNAL STAKEHOLDER GROUPS



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Internal users need information to assist in planning and controlling company operations and managing company resources. The accounting system must provide timely information needed to control day-to-day operations and to make major planning decisions such as:

- Do we make this product or another one?
- Do we build a new production plant or expand existing facilities?

Management accounting (sometimes referred to as *managerial* or *cost accounting*) is concerned primarily with financial reporting for internal users. Internal users, especially management, have control over the accounting system and can specify precisely what information is needed and how the information is to be reported.

Financial accounting focuses on the development and communication of financial information for external users. As a company grows and expands, it often finds its need for cash to be greater than that provided from profitable operations. In this situation, it will turn to people or organizations external to the company for funding. These external users need assurances that they will receive a return on their investment. Thus, they require information about the company's past performance because this information will allow them to forecast how the company can be expected to perform in the future.

Companies compete for external funding because external users have a variety of investment alternatives. The accounting information provided to external users aids in determining (1) whether a company's operations are profitable enough to justify additional funding and (2) how risky a company's operations are in order to determine what rate of return is necessary to compensate capital providers for the investment risk.

The types of decisions made by external users vary widely; therefore, their information needs are highly diverse. As a result, two groups of external users, creditors and investors, have been identified as the principal external users of financial information. Creditors need information about the profitability and stability of the company to decide whether to lend money to the company and, if so, what interest rate to charge. Investors (both existing stockholders and potential investors) need information concerning the safety and profitability of their investment.

Incentives

As mentioned, companies often need external funding if they are to compete in the marketplace. Thus, the managers of these companies have an incentive to provide information that will attract external funding. They want to present information to external users that will make it appear as though their companies will be profitable in the future.

In their pursuit of external funding, management may not be as objective in evaluating and presenting accounting information as external users would like. As a result, care must be taken to ensure that accounting information is neutral. Standards have been established and safeguards have been implemented in an attempt to ensure that accounting information is neutral and objective.

Financial Reporting

Most accounting systems are designed to generate information for both internal and external reporting. The external information is much more highly summarized than the information reported internally. Understandably, a company does not want to disclose every detail of its internal financial dealings to outsiders. For this reason, external financial reporting is governed by an established body of standards or principles that are designed to carefully define what information a firm must disclose to outsiders. Financial accounting standards also establish a uniform method of presenting information so that financial reports for different companies can be more easily compared. The development of these standards is discussed in some detail later in this chapter.

This textbook focuses on financial accounting and external reporting. The general-purpose financial statements are the centerpiece of financial accounting. These financial statements include the balance sheet, income statement, and statement of cash flows.

The three major financial statements, along with the explanatory notes and the auditor's opinion, are briefly described here.

- The balance sheet reports, as of a certain point in time, the resources of a company (the assets), the company's obligations (the liabilities), and the net difference between its assets and liabilities, which represents the equity of the owners. The balance sheet addresses these fundamental questions: What does a company own? What does it owe?
- The income statement reports, for a certain interval, the net assets generated through business operations (revenues), the net assets consumed (expenses), and the difference, which is called *net income*. The income statement is the accountant's best effort at measuring the economic performance of a company for the given period.
- The statement of cash flows reports, for a certain interval, the amount of cash generated and consumed by a company through the following three types of activities: operating, investing, and financing. The statement of cash flows is the most objective of the financial statements because it is somewhat insulated from the accounting estimates and judgments needed to prepare a balance sheet and an income statement.
- Accounting estimates and judgments are outlined in the notes to the financial statements. In addition, the notes contain supplemental information as well as information about items not included in the financial statements. Using financial statements without reading the notes is like preparing for an intermediate accounting exam by just reading the table of contents of the textbook—you get the general picture, but you miss all of the important details. Each financial statement routinely carries the following warning printed at the bottom of the statement: "The notes to the financial statements are an integral part of this statement."
- Auditors, working independently of a company's management and internal accountants, examine the financial statements and issue an auditor's opinion about the fairness of the statements and their adherence to proper accounting principles. The opinion is based on evidence gathered by the auditor from

FYI

The cash flow statement is the most recent of the primary financial statements. It has been required only since 1988.

STOP&THINK

In addition to the financial statements, the management of a company has a variety of other methods of communicating financial information to external users. Which ONE of the following is NOT one of those methods?

a) Press releases
b) Postings on the Internet
c) Interviews with financial reporters
d) Paid advertisements in the financial press
e) Preparation and dissemination of detailed operating budgets
f) Public meetings with analysts, institutional investors, and other interested parties

EX 1-2 RELATIVE FREQUENCY OF AUDIT OPINIONS

Types of Audit Opinions **Relative Frequency** **For the Year 2006**	**Companies**
UNQUALIFIED: Financial statements are in accordance with generally accepted accounting principles. They are consistent, and all material information has been disclosed.	2,369
UNQUALIFIED, WITH EXPLANATORY LANGUAGE: The opinion is unqualified, but the auditor has felt it necessary to emphasize some item with further language.	3,624
QUALIFIED: Either the audit firm was somehow constrained from performing all the desired tests, or some item is accounted for in a way with which the auditor disagrees.	5
NO OPINION: The auditor refuses to express an opinion, usually because there is great uncertainty about whether the audited firm will be able to remain in business.	0
ADVERSE: The financial statements are not in accordance with generally accepted accounting principles.	1
Total	5,999

Source: Standard and Poor's COMPUSTAT. The database includes firms traded on the New York, American, and NASDAQ exchanges.

the detailed records and documents maintained by the company and from a review of the controls over the accounting system. Obviously, there is a motivation on the part of management to present the financial information in the most favorable manner possible. It is the responsibility of the auditors to review management's reports and to independently decide whether the reports are indeed representative of the actual conditions existing within the enterprise. The auditor's opinion adds credibility to the financial statements. The types of opinions issued by auditors, along with their relative frequencies, are outlined in Exhibit 1-2. As you can see, the audit opinion is almost always "unqualified."

The financial statements and accompanying notes (certified by the auditor's opinion) have historically been the primary mode of communicating financial information to external users.

Development of Accounting Standards

2 **Explain the function of accounting standards and describe the role of the FASB in setting those standards in the United States.**

WHY **By defining which accounting methods to use and how much information to disclose, accounting standards save time and money for accountants. Users also benefit because they can learn one set of accounting rules to apply to all companies.**

HOW **The Financial Accounting Standards Board (FASB) sets accounting standards in the United States. The FASB is a private-sector body and has no legal authority. Accordingly, the FASB must carefully balance theory and practice in order to maintain credibility in the business community. The issuance of a new accounting standard is preceded by a lengthy public discussion. The Emerging Issues Task Force (EITF) works under the direction of the FASB and formulates a timely expert consensus on how to handle new issues not yet covered in FASB pronouncements.**

Consider this situation. A company decides to pay its managers partly in cash and partly in the form of options to buy the company's stock. The options would be very valuable if the company's stock price were to increase but would be worthless if the company's stock price were to decline. Because the company gives these potentially valuable options to employees, cash salaries don't need to be as high.

Should the value of the options be reported as salary expense or not? (You'll learn the answer to this surprisingly explosive question in Chapter 13.) One alternative is to let each company decide for itself. Users then must be careful about comparing the financial statements of two companies that have accounted for the same thing differently. Another alternative is to have one standard accounting treatment. Who sets the standard?

Accounting principles and procedures have evolved over hundreds of years in response to changes in business practices. The formal standard-setting process that exists today in the United States, however, has developed in just the past 75 years. The triggering event was the Stock Market Crash of 1929. In the aftermath of the crash, many market observers claimed that stock prices had been artificially inflated through questionable accounting practices. The Securities and Exchange Commission (SEC) was created to protect the interests of investors by ensuring full and fair disclosure. The SEC was also given specific legal authority to establish accounting standards for companies desiring to publicly issue shares in the United States. The emergence of the SEC forced the U.S. accounting profession to unite and to become more diligent in developing accounting principles. This led over time to the formation of a series of different private-sector organizations, each having the responsibility of issuing accounting standards. These organizations, their publications, and the time they were in existence are identified in Exhibit 1-3. The SEC has generally allowed these private-sector organizations to make the accounting standards in the United States. These standards are commonly referred to as generally accepted accounting principles (GAAP). Remember, however, that the SEC retains the legal authority to establish U.S. accounting standards if it so chooses.

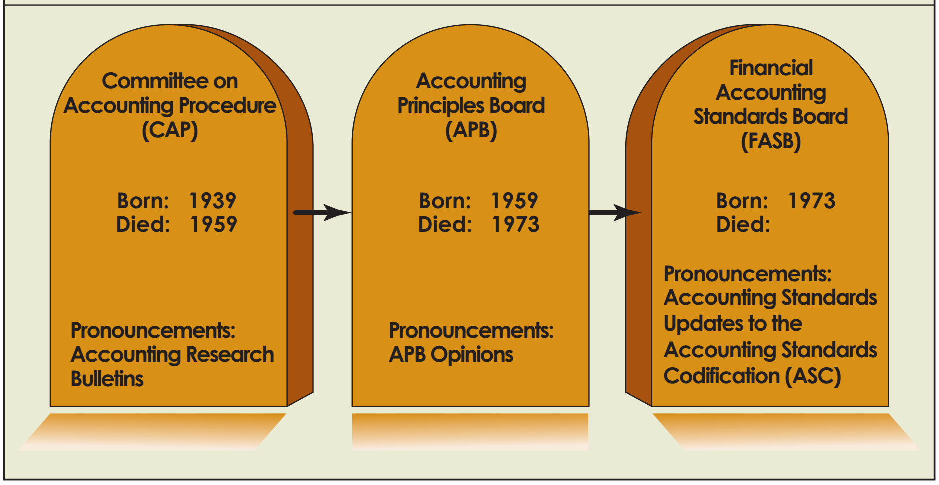
Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB) is currently recognized as the private-sector body responsible for the establishment of U.S. accounting standards. The FASB was organized in 1973, replacing the Accounting Principles Board (APB). The APB was replaced because it had lost credibility in the business community and was seen as being too heavily influenced by accountants. As a result, the five full-time members of the FASB are drawn from a variety of backgrounds—auditing, corporate accounting, financial services, and academia.[9] The members are required to sever all connections with their firms or institutions prior to assuming membership on the Board. Members are appointed for 5-year terms and are eligible for reappointment to one additional term. Headquartered in Norwalk, Connecticut, the Board has its own research staff and a 2009 operating budget of $29.1 million, much of which comes from fees levied under the Sarbanes-Oxley Act on companies publicly traded in the United States.

Appointment of new Board members is done by the Financial Accounting Foundation (FAF). The FAF is an independent, self-perpetuating body that, like the FASB, is made up of representatives from the accounting profession, the business world, government, and academia. However, the FAF has no standard-setting power, and its members are not full time. The FAF serves somewhat like a board of directors, overseeing the operations of the FASB.

[9] When it was initially established, the FASB was structured to have seven Board members. This number was reduced to five on July 1, 2008. In August 2010, it was announced that the FASB would return to seven board members in 2011.

EX 1-3 U.S. ACCOUNTING STANDARD-SETTING BODIES



In addition to overseeing the FASB, the FAF is also responsible for selecting and supporting members of the Governmental Accounting Standards Board (GASB). The GASB was established in 1984 and sets financial accounting standards for state and local government entities.

The Standard-Setting Process

The major functions of the FASB are to study accounting issues and to establish accounting standards. These standards are published as Accounting Standards Updates. The FASB has also issued Statements of Financial Accounting Concepts that provide a framework within which specific accounting standards can be developed. The conceptual framework of the FASB is detailed later in the chapter.

The hallmark of the FASB's standard-setting process is openness. Because so many companies and individuals are impacted by the FASB's standards, the Board is meticulous about holding open meetings and inviting public comment. At any given time, the Board has a number of major projects under way. For example, as of May 10, 2010, the FASB was engaged in 23 agenda projects, 17 of which are joint projects with the International Accounting Standards Board (IASB), which is described later in this chapter. These FASB projects address fundamental issues such as revenue recognition and the distinction between liabilities and equity as well as technical issues relating to very complex business transactions such as insurance contracts.

Each major project undertaken by the Board involves a lengthy process. The FASB staff assembles background information and the Board holds public meetings before a decision is made to even add a project to the FASB's formal agenda. After more study and further hearings, the Board often issues a report summarizing its *Preliminary Views*, which identifies the principal issues involved with the topic. This document includes a discussion of the various points of view as to the resolution of the issues, as well as an extensive bibliography, but it does not include specific conclusions. Interested parties are invited to comment either in writing or orally at a public hearing.

After comments from interested parties have been evaluated, the Board meets as many times as necessary to resolve the issues. These meetings are open to the public, and the agenda is published in advance. From these meetings, the Board develops an Exposure Draft of a statement that includes specific recommendations for financial accounting and reporting.

FYI

The FASB is quite scrupulous about holding all of its deliberations in public. In fact, since three (of five) votes are required to pass a FASB proposal, Board members are even careful not to discuss accounting issues at social occasions when three or more Board members are present.

After the Exposure Draft has been issued, reaction to the new document is again requested from the accounting and business communities. At the end of the exposure period, 60 days or longer if the topic is a major one, all comments are reviewed by the staff and the Board. Further deliberation by the Board leads to either the issuance of an *Accounting Standards Update* (if at least three of the FASB members approve), a revised Exposure Draft, or, in some cases, abandonment of the project. As you can see, the standard-setting process is a political one, full of consensus building, feedback, and compromise.

CAUTION

This description makes the standard-setting process seem orderly and serene. It is not. Fierce disagreements over accounting standards are common, and some people hate the FASB.

The final statement not only sets forth the actual standards but also establishes the effective date and method of transition. It also gives pertinent background information and the basis for the Board's conclusions, including reasons for rejecting significant alternative solutions. If any members dissent from the majority view, they may include the reasons for their dissent as part of the document. These dissents are interesting reading. For example, the dissent to the standard on the statement of cash flows (released in 1987) reveals that the Board members disagreed about a fundamental issue—whether payment of interest is an operating activity or a financing activity.[10]

Emerging Issues Task Force The methodical, sometimes slow, nature of the standard-setting process has been one of the principal points of criticism of the FASB. There seems to be no alternative to the lengthy process, however, given the philosophy that arriving at a consensus among members of the accounting profession and other interested parties is important to the Board's credibility.

In an effort to overcome this criticism and provide more timely guidance on issues, in 1984 the FASB established the Emerging Issues Task Force (EITF). The EITF assists the FASB in the early identification of emerging issues that affect financial reporting. Members of the EITF include the senior technical partners of the major national CPA firms plus representatives from major associations of preparers of financial statements. In addition, observers from the SEC, the AICPA, and the IASB (three organizations discussed later in this chapter) are invited to participate in the EITF discussions. The EITF meets periodically, typically at least once every quarter.

As an emerging issue is discussed, an attempt is made to arrive at a consensus treatment for the issue. If a consensus is reached by the EITF, that consensus must then be

[10] Three of the seven members of the FASB dissented to the issuance of the standard on the statement of cash flows. Prior to 1991, a majority of the seven-member board (four members) was the minimum requirement for approval of an Exposure Draft or a final statement of standards. This requirement was changed to a minimum approval of five members, or to what has been referred to as a "super-majority." A number of close, 4–3, votes that resulted in standards not favored by many businesspeople led to strong pressure on the Financial Accounting Foundation to change the voting requirements. Although not favored by members of the FASB, the change was made in 1990. In April 2002, the voting requirement was changed back to 4–3 as an attempt to increase the efficiency and speed of the Board's deliberations. When the number of Board members was reduced from seven to five on July 1, 2008, the simple majority rule (three out of five) was retained.

approved by a majority of the FASB members. That consensus opinion then defines the generally accepted accounting treatment unless and until the FASB decides to reconsider the issue. The EITF not only helps the FASB and its staff to better understand emerging issues but also in many cases determines that no immediate FASB action is necessary.

The consensus opinions of the EITF are published as Accounting Standards Updates. These updates are identified by a two-part number; the first part represents the year the issue was discussed, and the second part identifies the update number for that year. For example, among the consensuses reached in 2010 was Update No. 2010-17, "Milestone Method of Revenue Recognition," which deals with the timing of the reporting of revenue in long-term projects involving significant performance milestones such as the completion of certain regulatory requirements in a pharmaceutical study. [Note: We will talk about revenue recognition at length in Chapter 8.] Although many of the issues are very specialized by topic and industry, the importance of the EITF to the standard-setting process cannot be overemphasized. Because discussions rarely last more than a day or two and a consensus is reached on a majority of the issues discussed, timely guidance is provided to the accounting profession without the lengthy due process of the FASB.

FASB Accounting Standards Codification™ As you saw in the discussion above, both the FASB standards and the EITF consensus opinions are published as Accounting Standards Updates. These Updates serve as formal notification that the official body of generally accepted accounting standards (GAAP) has been updated. This official source of U.S. GAAP is called the FASB Accounting Standards Codification (ASC) and is found on the FASB's Web site at **asc.fasb.org**.

Prior to the launching of the FASB ASC in July 2009, the FASB standards and the EITF consensus opinions were made available as numbered lists of items. So, if you wanted to know about the accounting for research and development costs, for example, you had to know that the accounting for normal R&D costs was contained in FASB Statement of Financial Accounting Standards No. 2 (released in 1974), unless the R&D cost was for software development, in which case the accounting was described in Statement No. 86 (released in 1985). In other words, for everyone except the experienced practitioners and the old accounting professors who had been around for a thousand years, finding a specific accounting rule on a specific topic involved a primitive hunt-and-peck strategy.

The FASB ASC employs a topical menu structure. Accounting topics are grouped under nine broad categories. Each category contains a collection of topics. For example, under the Presentation group of topics, you can find Topic 210 on the balance sheet, Topic 230 on the statement of cash flows, Topic 260 on earnings per share, and more. Under the Broad Transactions group of topics, you can find Topic 805 on business combinations, Topic 840 on leases, and more. A list of topic groupings and individual topics is given in Exhibit 1-4.[11]

Within each Topic, the accounting standard content is organized in additional menus leading eventually down to the paragraph level. A paragraph in the FASB ASC is identified with a four-part address: Topic-Subtopic-Section-Paragraph. For example, the paragraph that explains that cash paid for interest is to be classified in the statement of cash flows as an operating activity is FASB ASC 230-10-45-17.

[11] For those who have a subscription to the "Professional View" of the FASB ASC, key word searches are also possible. The "Basic View" is free, and instructions for registering for the "Basic View" are given in this chapter. The "Professional View" costs about $800 per year. However, your college or university accounting department may have registered for free student access to the "Professional View." Ask your instructor.