

# Financial Accounting

Second Edition



Libby ■ Libby ■ Short

# Financial Accounting

SECOND EDITION

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## FINANCIAL ACCOUNTING

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## INTERNATIONAL EDITION

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# Preface

We wrote the first edition in the belief that the subject of financial accounting is inherently interesting but that financial accounting textbooks often are not. Furthermore, the typical texts do not demonstrate that accounting is an exciting major field or important to future careers in marketing, finance, and other areas of management. We approached the writing of the second edition as we did the first: with **career relevance** as our guide to selection of material, and the need to **engage the student** as our guide to style, pedagogy, and design. During the preparation of the second edition, we remained very attentive to the feedback that the instructors and students using the first edition have provided us. In every aspect of writing and designing this edition, we have been mindful of the challenge to capture the students' interest; based on what our reviewers and the students who have used our text have told us, we've succeeded. However, in the final analysis it is you and your students who will determine the true worth of our efforts.

This text is aimed at students with career interests in marketing, finance, banking, manufacturing, and human resources, as well as accounting, but with no prior exposure to accounting and financial statements, and often little exposure to the business world. We have carefully designed the scope and depth of the text so that most or all of it can be covered in a single term.

## Goals of the Second Edition

To truly engage and stimulate students' interest in the subject matter is an obvious, yet often overlooked, goal of a textbook. Only you can tell us if we've succeeded in motivating the reader and increasing concept retention where so many others haven't. Again, our adopters, reviewers, and students using the first edition think so, and if you and your classes are at all like them, investing the time to read a chapter, we believe, will ultimately make a big difference to you and your students! Other key goals we had in mind when writing the text were

- To convey to students the importance of financial accounting and financial statements to managers.
- To help students learn how investing, financing, and operating decisions of different **real** merchandising, manufacturing, and service businesses are reflected in their **financial statements**.
- To help students understand how these statements are used in **real business decisions**.
- To encourage and develop students' critical thinking by incorporating a strong decision-making orientation.

Besides meeting our overall objective of stimulating an interest in the subject matter to improve learning, these goals are in accordance with the recommendations of the Accounting Education Change Commission **to teach students more effectively the relevance and use of accounting information.**

## Development Story of the Second Edition

Meeting the ever-changing needs of instructors and students, many of which are driven by continuous change in the accounting profession and the dynamic business environment of the 1990s, requires input from many people. We have received tremendous feedback from instructors and students around the country who represent both users and nonusers of the first edition. This extensive development process was instrumental in making this text and package truly market-driven. In virtually every instance where preferences were at stake, we deferred to the suggestions of our colleagues and their students. In the second edition, we paid particular attention to student recommendations concerning pedagogy and design. In our acknowledgments we will attempt to thank everyone involved, but first we wanted to provide a brief overview of the market-driven process that guided the development of the second edition.

In the fall of 1995, we conducted the Libby Challenge that asked students and instructors to compare a chapter of our book with the corresponding chapter in the text they were currently using and then provide us with their comments. In 1996, we conducted extensive market research, including instructor and student reviews, surveys, seminars, and class testing. We used this feedback to craft the first draft of the second edition. Then, in the spring of 1997, we had the first draft of the second edition reviewed, chapter-by-chapter, by over 25 instructors around the country. We used the feedback from these individuals to fine-tune our presentation and ensure clarity and accuracy. In addition, we solicited and incorporated suggestions from over 200 students around the country.

The tremendous feedback provided by this process helped us develop and enhance the numerous differences and advantages we believe distinguish our text and allow us to meet our goals. The five features listed below are ones that you have told us are the most important.

## What's Different and Why: Key Features

1. *Integration of real-world business and accounting practices into the material by building each chapter around the operations and financial statements of an interesting "focus company" (e.g., Timberland; see Exhibit A).*

The major topics of each chapter are *integrated around a single focus company*, its operations, and its financial statements and related disclosures. Focus companies were selected from Forbes' Best Small Companies in America as well as the Fortune 1,000. They include well-known and exciting companies such as Timberland, Harley-Davidson, Callaway Golf, Sbarro, Inc., Boston Beer, and General Electric. Each accounting and reporting issue raised is discussed in the context of the focus company and its financial statements and other disclosures. In addition, each chapter emphasizes a different aspect of management, including marketing strategy, human resources, financing strategy, manufacturing, corporate communication, and mergers and acquisitions. (See the inside front cover for a listing of our focus and contrast companies by chapter.) This directly demonstrates the relevance of the material to a variety of future careers.

## EXHIBIT A

## THE TIMBERLAND COMPANY

## CONSOLIDATED BALANCE SHEETS

As of December 31, 1995 and 1994

(Dollars in Thousands, Except Per Share Data)

	1995	1994
<b>Assets</b>		
Current assets		
Cash and equivalents	\$ 38,389	\$ 6,381
Accounts receivable, net of allowance for doubtful accounts of \$2,658 in 1995 and \$2,704 in 1994	95,786	128,435
Inventories	180,636	218,219

## THE TIMBERLAND COMPANY

## CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 1995, 1994 and 1993

(Amounts in Thousands Except Per Share Data)

	1995	1994	1993
Revenues	\$655,138	\$638,097	\$420,062
Cost of goods sold	451,741	428,702	266,211
Gross profit	203,397	209,395	153,851

*Integration as opposed to add-on, disjointed vignettes* distinguishes our approach from that of other texts; it is also the key to demonstrating career relevance and conveying the excitement of real accounting and reporting problems. For example, in Chapters 2 through 4 typical transactions from Sbarro, Inc., a family-style Italian restaurant chain, are shown to demonstrate this firm's investing, financing, and operating decisions.

We also regularly integrate "contrast company" examples where appropriate to illustrate the variety in real-world practices, and the effect of a company's particular circumstances on its accounting and reporting practices. Our selection of focus and contrast companies provides the proper balance of merchandising, manufacturing, and service companies.

For example, Harley-Davidson is the focus company for Chapter 7, "Reporting and Interpreting Cost of Goods Sold and Inventory." We first examine the inventory accounting issues faced by Harley's motorcycle and Motorclothes™ product lines to demonstrate the effects of its growing operations where Harley faces rising costs. We then compare it to three contrast companies that face very different inventory accounting issues: Deere & Co., which is a shrinking manufacturer; Compaq Computer, which is a declining-cost manufacturer; and the housing division of Asahi Chemicals (of Japan), which produces valuable, distinguishable inventory items.

By the time students complete the semester, they have examined a wide variety of company situations and real financial disclosures. Just as important, these examples are appropriate for the introductory student. For example, in Chapter 5, where we discuss the communication of accounting information using Callaway Golf as the focus company, we take time to define acronyms such as CEO and CFO and terms like *institutional investor* to be sure that the introductory student

has an understanding of common business terminology. The reviewers of our text have unanimously endorsed our superior use of real company examples and believe as we do that they will maintain students' interest in the material. In the first edition and in this edition, we have made every effort to select focus companies that students are familiar with and find interesting. The student feedback from the first edition has been overwhelmingly positive in this regard. Acting on student suggestions, we have substituted General Electric for American Brands as the focus company in Chapter 12 and Boston Beer Company for Home Shopping Network as the focus company in Chapter 13.

2. *Material selected for its managerial significance and its relevance to understanding and using real company financial statements—a true user orientation.*

The material included in this text was selected for its relevance to understanding real companies, financial statements, and real management decisions. Unrealistic topics and practices have been eliminated. For example, LIFO applied on a perpetual basis was eliminated because it is rarely used in practice. Further, in keeping with the financial statement focus of the text, pure recordkeeping functions have been included in appendixes or reserved for future coursework. We replace these topics with often omitted material that is fundamental to understanding financial statements. By eliminating the recordkeeping emphasis, we can use basic transaction analysis, journal entries, and T-accounts to provide the structure for understanding the interplay between management decisions and financial statements and the analysis of financial statements. We demonstrate how this structure is as important to future financial statement users as it is to accountants.

An equal part of this feature is the integration of discussions of the decisions made by management and financial statement users in our focus and contrasting companies. Our financial analysis features, shown on the next page, along with the international, ethics, cash flow, and financial ratio features, relate directly to the decisions faced by managers and financial statement users at our focus and contrasting companies. For example, the focus company in Chapter 5, "The Communication of Accounting Information," is Callaway Golf. Here we trace the decisions of Ely Callaway (chairman and CEO), Carol Kerley (CFO) and her accounting staff, as well as the auditors at Price Waterhouse, bankers at First Interstate Bank of California, investment bankers at Merrill Lynch, and the managers at Sumitomo Corporation (which exports and sells Callaway's golf clubs in Japan), as Callaway develops the necessary financial statements and related reports needed to obtain both private and public financing for the growing company.

This decision-making focus encourages and develops critical thinking. At the same time, we cover the highly technical requirements for financial reporting format and content within a context that literally makes some of the most technical accounting material come alive. As a consequence, students will better remember the technical material and better understand its importance.

3. *Earlier introduction to ratio analysis and cash flow analysis.*

During the development process for the first edition and again during the development of this edition, many instructors have mentioned that they would like to introduce students to ratio analysis and cash flow analysis earlier in the course but they can't because most financial accounting textbooks wait until the last few chapters to cover this material. Many instructors feel like they give these two extremely important topics short shrift because it is difficult to cover them thoroughly in a one-semester or one-quarter course. In the second edition, we

## Increased Profitability Due to an Accounting Adjustment? Reading the Footnotes

Financial analysts are particularly interested in changes in accounting estimates because they can have a large impact on a company's before-tax operating income. In Delta's case, the changes added \$34.3 million because of reduced depreciation expense and add a similar amount each year over the remaining life of the aircraft. Analysts pay close attention to this number because it represents increased profitability due to an accounting adjustment.

As another example, in May 1996, "Japan Airlines, the country's largest carrier, reported its first operating profit since 1991. The company attributed the improvement in the 12 months to March to its extensive restructuring and strong demand in growing Asian markets. But a change in its method of accounting for depreciation also improved JAL's results." The company changed from the declining-balance method (higher depreciation expense) to the straight-line method (lower depreciation expense), and reported an increase in recurring profit compared with last year of ¥10.9 billion. "Although the move suggested the company would have recorded a large recurring loss for the year under the old principles, JAL said the change was a fairer reflection of the costs and benefits of the big outlays on new airports and other facilities recently made by JAL."

SOURCE: Gerard Baker, *Financial Times*, May 30, 1996.

have satisfied their desire to introduce these topics earlier by integrating ratio analysis and cash flow analysis throughout the text.

Although ratios were sporadically incorporated throughout the first edition, we have made a conscious effort to introduce relevant ratios in each chapter of the second edition. Most ratios are introduced in the context of the Financial Analysis sections found in each chapter throughout the text. We agree with our reviewers that an earlier introduction to ratio analysis will prove beneficial to students, especially in situations where, because of time constraints, ratio analysis and financial statement analysis are not covered in any degree of detail. Here is an example from Chapter 3:

## Analyzing Your Return on Investment

A very common ratio that investors and financial analysts use is return on investment (ROI). It measures the profitability of a company for investors who expect to earn a certain rate on their investment. ROI is computed as follows:

$$\text{Return on investment} = \frac{\text{Net income}}{\text{Average stockholders' equity}}$$

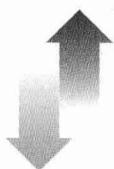
Average stockholders' equity is computed as the sum of the beginning and ending balances of stockholders' equity divided by 2. Sbarro's 1995 ROI was 11.7 percent [ $\$21,300 \div [(\$185,600 + \$179,500) \div 2]$ ]. To analyze this return, we need to compare it to the ratio for other companies in the industry for the same year:

Outback Steakhouse	25.1%
McDonald's Corporation	19.4%
Wendy's International, Inc.	14.5%

Sbarro appears to be providing a comparable return to its investors.

Beginning in Chapter 1 and continuing through Chapter 12, we have incorporated a discussion and analysis of changes in the cash flow of the focus company being discussed and the decisions that caused the changes in cash flow. The earlier introduction of cash flows is sure to encourage students to think more critically about the decisions they will be faced with as managers and the impact those decisions will have on the company's cash flow. Here's an example from Chapter 4:

## FOCUS ON CASH FLOWS



A common misconception is that positive net income is equivalent to an increase in cash. Because net income is calculated on the accrual basis, however, revenues may be recognized although the cash has not yet been received, and cash may have been paid before expenses are recognized. The Sbarro illustration in this chapter is a clear example of this. The net income for the month was determined to be a positive \$4,975,000, yet we see in the statement of cash flows that cash actually declined for the period by \$3,820,000 and cash flows from operations resulted in a negative \$4,530,000.

We must be careful in drawing any conclusions from this observation because the time period is only one month. However, over the long run, companies must have positive cash flows from operations to remain viable. In fact, Sbarro has generated approximately \$54,000 in positive cash flows from operations each year since 1994.

4. *Exposing students to the variety of accounting methods used around the world and the ethical dilemmas that arise in certain situations involving accounting.*

We feel it is important to expose students to the variety of reporting practices used throughout the world. Today's students will become tomorrow's global executives, and as a result, they need to understand and appreciate the implications of different accounting practices. International accounting sections are incorporated in each chapter and in the homework material.

## International PERSPECTIVE

### Taking a Different Strategy to Success

Singapore Airlines, formed in 1972, has recognized continued profitability as one of the world's largest operators of the most technologically advanced "jumbo jets," the Boeing 747-400. Unlike the rest of the airline industry with an average fleet age of more than 12 years, Singapore Airlines uses its aircraft for an average of just under six years. This strategy for managing the company's operational productivity has a dual effect. Depreciation expense is significantly higher due to the shorter estimated useful life, thus reducing net income. Singapore Airlines sells its used aircraft, however, an activity that has resulted in gains (entitled "Surplus on Sale of Aircraft and Spares") reported on the income statement. Both depreciation computations (through the use of estimates) and asset sales (through differences in the timing of the sales) provide management with the flexibility to manage earnings.

On October 28, 1996, *The Straits Times* (page 48) reported that Singapore Airlines' six-month earnings were up 7.2% compared to the same period in the prior year. However, the surplus on sales of aircraft was up 734.7%. "Without the surplus in the six months ended Sept. 30, the national carrier's net earnings would have declined for the first time since 1994."

In every business, decision makers are occasionally confronted with ethical dilemmas that require them to make choices that will impact various groups of people differently. We integrate accounting ethics in each chapter of the text to convey to students the importance of acting responsibly in business practice.

### Fierce Pressure to Report Smooth, Ever Higher Earnings

Corporate executives have been under intense pressure over the past decade to keep earnings rising smoothly to meet the consensus expectations of analysts. As the expectations have become more explicit, so too have the mechanisms executives use to manage earnings and hit their targets. Long-lived assets can play a significant role in the ability of companies to meet or beat the estimates, as indicated in the financial press:

...

#### How the pros do it

**Plan ahead:** Time store openings or asset sales to keep earnings rising smoothly. In most cases, this is earnings management at its least controversial. The master of it is General Electric.

...

**Capitalize it:** Usually it's pretty clear which costs you capitalize and which you expense. But there are gray areas—software R & D is one—and you can get creative about the length of time an asset should be depreciated. America Online was, until it stopped in October, a noted aggressive capitalizer.

**Write it off:** Take a "big bath" and charge a few hundred million in restructuring costs, and meeting future earnings targets will be easier. Among the biggest restructurers in the 1990s: IBM.

...

5. *Choosing examples and explaining material in a manner appropriate for the introductory student.*

The pace, depth of coverage, and level of difficulty of the material and examples are carefully matched to the needs and abilities of introductory students. To ensure accessibility of the material, we employ a building block approach; we carefully cover the basics before we address more complex issues. As the students' sophistication develops throughout the term, so does the sophistication of the focus company and contrasting company illustrations. Smaller, single industry companies with simple operations, capital structures, and disclosures are used in the early chapters. The examples increase in sophistication as a student's knowledge grows both within chapters (e.g., Chapter 7's coverage of LIFO) and between chapters (e.g., Chapter 1 versus Chapter 5 versus Chapter 14).

The technical material is conveyed with clear step-by-step presentations within the realistic examples. For example, Chapters 2, 3, and 4 follow Sbarro, Inc. (a chain of Italian fast-food restaurants) through each step of the basic accounting process, ensuring that students are prepared for the later material. The emphasis on contrasting company practices is conveyed through side-by-side illustrations that punctuate the effects of differences in financial statement presentations and accounting methods. Numerous exhibits and other visual aids are included to enhance comprehension and learning (see Exhibit B). To further increase comprehension, we define unfamiliar terminology (including terms that develop general business knowledge rather than strictly accounting terminology) within the text material, in marginal definitions, and in a glossary of key terms at the end of the book. We also list key terms with page references at the end of each chapter.

### QUESTION OF ETHICS



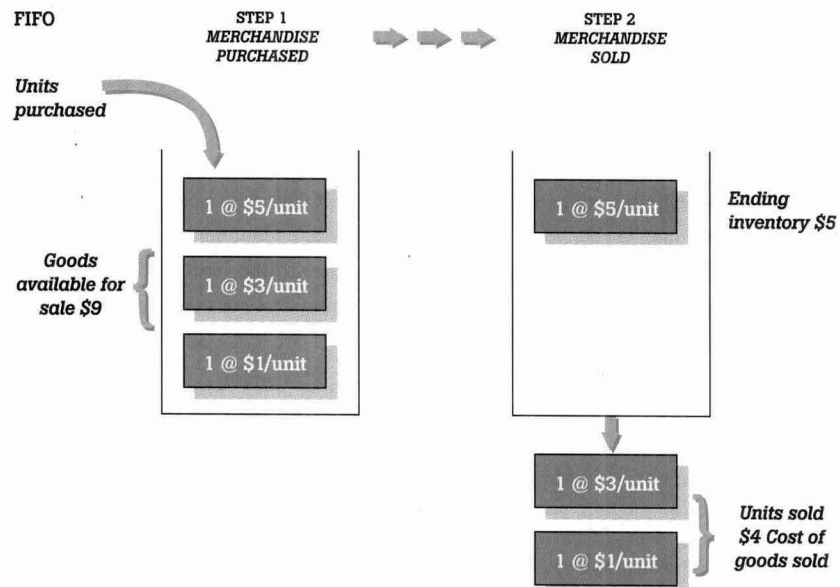
#### REAL WORLD EXCERPT

"Learn to Play the Earnings Game (and Wall Street will love you)"

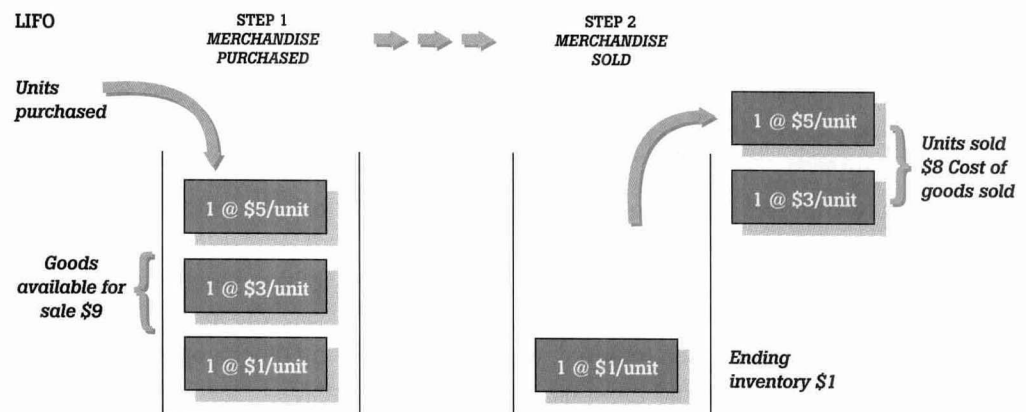


## EXHIBIT B

## FIFO



## LIFO



6. *Active-learning features engage the student, provide interactive feedback, and promote critical thinking skills.*

Active learning creates attention and promotes retention. The integration of technical material in the real-world context produces major advantages here. A unique feature, Self-Study Quizzes (see Exhibit C), stops the student at strategic points throughout each chapter to make sure that key points are well understood. These quizzes help students avoid reading the text in the same fashion as they do a novel; to understand accounting, students must be able to work with the numbers. Students who used the first edition commented that in anticipation of a quiz, they think about what they are reading, which improves learning. The quizzes often require that students prepare or use financial statement disclosures based on actual companies to reinforce the usefulness of what they are learning. For example, in Chapter 5 students actually determine whether Callaway's senior management had earned their bonuses. The quizzes are part of our integrative approach. These are followed by Demonstration Cases presented at the end of the chapter. Students who have carefully worked with these two types of learning aids are ready to work the end-of-chapter homework assignments.

## EXHIBIT C

## SELF-STUDY QUIZ

Callaway executives receive maximum bonuses if pretax earnings growth meets or exceeds the target of 30 percent. Use Exhibit 5.5 to see whether Callaway executives earned their maximum bonuses in the most recent year.

## COMPUTATIONS

Discuss why Callaway might choose to pay executives based on performance and why they use the same accounting numbers used in reports to shareholders to measure the executives' performance.

Now check your answers to those in the footnote at the bottom of the page.\*

The material within chapters is followed by an extensive selection of end-of-chapter questions, exercises, problems, cases, and projects that examine single concepts or integrate multiple concepts presented in the chapter. To maintain the real-world flavor of the chapter material, they are often based on other real domestic and international companies, and require analysis, conceptual thought, calculation, and written communication. Assignments suitable for individual or group written projects and oral presentations are included in strategic locations. In addition, we have included a considerable number of assignments that require students to use the Internet. In this edition, we have included a new section at the end of the homework material called Projects. These projects can be used as group or individual assignments, and they ask students to analyze and compare financial statements, consider ethical dilemmas, perform financial analysis using ratios, and use the Internet to locate information.

## Treatment of Difficult Topics

Among the myriad topics that are covered in an introductory financial accounting course, a number were identified by our reviewers as difficult for students to comprehend. A listing of some of these follows along with a brief discussion of some strengths of our approach to these areas.

**Bonds.** Our primary coverage of bonds (in Chapter 10) begins with a strong discussion of the uses and nature of bonds, presented in context with the Showboat, Inc., focus company example. This allows students to understand the relevance of this material better. At one point in the chapter, KC Southern's amortization policy is contrasted with Showboat's to point out a financial analyst's potential interpretation of the two policies.

\*Pretax earnings growth % =  $(195,595 - 158,401) \div 158,401 = 23.5\%$  versus 30% target.

They did not earn their maximum bonuses. (In reality, they received 64.2 percent of their maximum bonuses.) The company believes that higher pretax earnings growth will result in higher prices for Callaway stock. Paying Callaway executives a bonus for increasing earnings growth thus helps align the interests of the executives with those of the shareholders. In addition, companies often pay shareholders bonuses based on the numbers in the annual report because they have been independently verified by the auditors.

**Time Value of Money.** Our reviewers clearly feel that a key strength of our discussion of the time value of money (Chapter 9) is a practical illustration of its applications to accounting through short cases with General Mills, Inc., as the focus company.

**Inventory.** We clearly took a user-oriented approach to the discussion of this material in Chapter 7 with a goal of providing an understanding of what accountants do with inventory and why. Throughout the entire chapter the focus is on the key concepts of inventory valuation and their effects on financial statements without placing undue emphasis on recordkeeping.

**Adjusting Entries.** Again, we start with the premise that students will better understand the *how* behind this concept if we first illustrate through a real-company example *why* adjusting entries are necessary. To an introductory student, the process of adjusting entries is often not intuitive, and so our reviewers unanimously endorsed our walk-through of the Sbarro, Inc., analysis as an effective tool for presenting this hard-to-grasp concept.

## Changes in the Second Edition

### Body of Chapter

- All financial statements have been updated to reflect 1995 and 1996 annual reports.
- A new section focusing on cash flows entitled "Focus on Cash Flows" has been incorporated into each chapter, beginning in Chapter 2 and ending in Chapter 12.
- Financial ratios are introduced in each chapter where appropriate and a summary of key ratios is presented at the end of each chapter.

### Homework

- We have incorporated a new Projects section in the end-of-chapter material. These projects require students to work either in groups or individually. Students will need to use the Internet, ratio analysis, and cash flow analysis, consider ethical dilemmas, and much more. They are located at the end of the Cases section.
- We have added a Team Project at the end of each chapter's critical writing homework. A semester-long team project can be created by assigning each chapter's Team Project. This allows students a more in-depth review of financial statements and uses by company and industry. This type of project also may be created from the Toys "R" Us Cases at the end of each chapter.
- We have incorporated twice the amount of real world companies used in the assignment material of the previous edition. Companies such as Mercury Finance, Fruit of the Loom, Apple, and Federal Express are utilized in the assignment material to reinforce the real world company focus of the text.
- We have increased the emphasis on using accounting information as opposed to preparing financial statements by increasing the number of homework assignments that require students to analyze financial data and interpret the economic impact of management decisions.
- We have incorporated more information- and technology-related assignments to reflect the ever-increasing use and value of such systems in the business world. These assignments require students to utilize the Internet among other sources.

## Key Features in Each Chapter and Changes in the Second Edition

### Chapter 1: Financial Statements and Business Decisions (Maxidrive)

- Students are introduced immediately to an overview of the four basic financial statements through an interesting company example based on an exciting case. At the same time, inter-industry differences in financial reporting are illustrated to begin building critical thinking skills for the student.
- Financial Analysis discussions are introduced throughout this chapter (and then carried through all chapters) to show students how useful accounting knowledge can be in making economic decisions.

#### Changes in the Second Edition

- The price/earnings ratio is introduced in the context of the introduction to financial statement analysis. Ratio analysis and related homework assignments are incorporated in each chapter leading up to Chapter 14, "Analyzing Financial Statements," which integrates the earlier discussion.
- New project assignments, which require students to access information sources from outside the textbook and to work on team-based financial analysis tasks, are located in each chapter of the book, starting in Chapter 1.

### Chapter 2: Investing and Financing Decisions and the Balance Sheet (Sbarro)

- Exhibit 2.1 illustrates a unique presentation of the conceptual framework that becomes the building block for the transaction analysis approach to follow.
- Balance sheet concepts are examined and reinforced before the income statement concepts are presented in Chapter 3.
- As an active learning feature for better comprehension, students must complete the transaction analysis illustration following the process discussed in the chapter.
- Debit-credit and T-account concepts are presented clearly and are shown in addition to transaction analysis. Students thus see the relevance and use of these often confusing procedural topics.
- Financial Analysis discussions emphasize financing and investing decisions.

#### Changes in the Second Edition

- The debt-to-equity ratio is introduced in the context of the Sbarro, Inc., focus company case for analyzing the financing strategies that companies employ. It is then reinforced in related homework assignments.
- The effects of transactions on the accounting equations are emphasized in context with the ongoing Sbarro, Inc., focus company case.
- The new Focus on Cash Flows discussion with related homework assignments is continued and then carried through each chapter, culminating in Chapter 13, where the complete statement is reviewed.

### Chapter 3: Operating Decisions and the Income Statement (Sbarro)

- Income statement concepts and their relationships to balance sheet concepts are examined and reinforced in their own separate chapter.
- The transaction analysis model as illustrated through the Sbarro, Inc., example is continued to allow students to build upon concepts presented in Chapter 2.
- Financial Analysis discussions emphasize operating decisions.

- Strong development of the principles related to revenue recognition and the matching concepts are introduced in this chapter, including a conceptual discussion of accruals and deferrals. Timelines are presented as useful analytical tools for providing visual representations of transactions or series of transactions.

#### Changes in the Second Edition

- Chapters 3 and 4 have been thoroughly revised to improve clarity of presentation.
- We have increased the use of visuals to help explain the flow of events when accounting for transactions.
- The transaction analysis presentation has been streamlined to increase efficacy, and the presentation of adjustments has also been streamlined for greater clarity.
- The return on investment ratio is introduced as a common measure utilized by investors and financial analysts. It is computed for Sbarro and its competitor to provide a framework for analysis.
- The Focus on Cash Flows discussion illustrates the difference between net income and cash from operations.

#### Chapter 4: The Adjustment Process and Financial Statements (Sbarro)

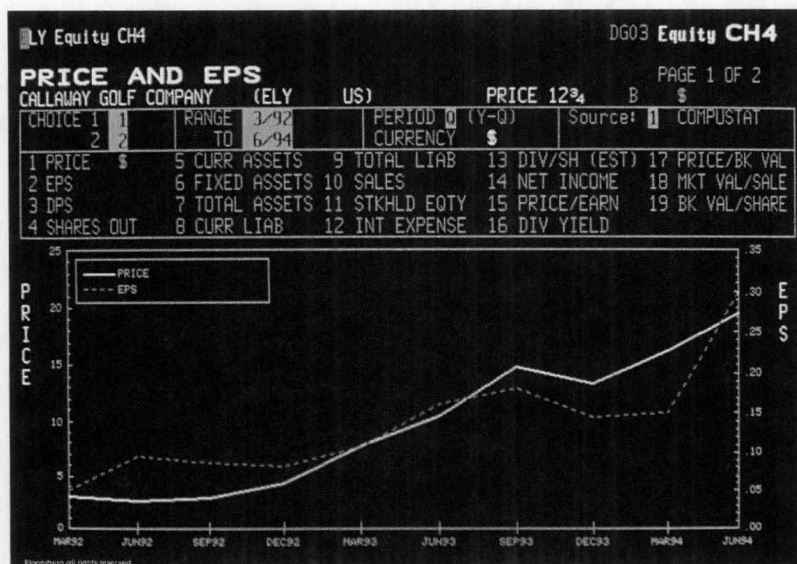
- After first showing students the *why* behind adjusting entries, we show them the *how* through a consistent three-step process that can be applied to analyze any situation requiring an adjusting journal entry. The focus is on understanding versus rote memorization.
- The discussion of the statement of cash flows, its importance, and its origin is continued here so that students can keep cash effects in mind through later chapters without being overburdened with technical details.
- Formal recordkeeping formats and reversing entries can be found in Appendix C of the text.

#### Changes in the Second Edition

- Earnings per share is introduced as a required disclosure item.
- The adjusting entries have been simplified to focus on the effects of adjustments.
- The chapter supplements found at the end of Chapter 4 are now located in Appendix C at the end of the book.
- The closing process has been streamlined for greater clarity and to focus on the effects of closing the records.

#### Chapter 5: The Communication of Accounting Information (Callaway Golf)

- This unique chapter clearly and concisely presents how financial statements are disseminated and used, emphasizing not just the output but the people and process involved. Exhibits 5.1 and 5.2 are truly innovative (Exhibit 5.2 is shown on the next page.)
- Through a presentation of financial information sources, electronic information services, and actual reports used by companies, we help students redefine the uses behind the process presented in the previous three chapters. We have expanded the discussion of electronic information services and the benefits of such services now and in the future.
- An often overlooked item, notes to financial statements, which were first presented in Chapter 1, are discussed in greater detail here with actual corporate examples used to illustrate these important components of the reporting process.



### Changes in the Second Edition

- We have dramatically expanded the discussion of effective uses of the Internet as a tool for distributing and researching financial data with examples that the students can immediately use. This presentation is coupled with an overall increase in Internet awareness across chapters and across homework assignments.
- New standards on EPS and comprehensive income are incorporated.

### Chapter 6: Reporting and Interpreting Sales Revenue, Receivables, and Cash (Timberland)

- To improve student understanding, receivable issues are linked with revenue recognition.
- Issues related to discounts, returns, and bad debts are presented as part of marketing strategy and financial management at Timberland not as pure record-keeping functions.
- The concept of bad debt expense is presented clearly with an emphasis on analyzing the effects of this expense on actual financial statements; students work with actual statements and footnotes.
- Recognizing revenue in unusual circumstances is covered at a level appropriate for the introductory student.

### Changes in the Second Edition

- The end-of-chapter supplement on bank reconciliations has been incorporated into the chapter.
- The petty cash supplement has been eliminated.
- The section on special circumstances of the application of the revenue principle has been removed from the chapter and placed in a chapter supplement.

### Chapter 7: Reporting and Interpreting Cost of Goods Sold and Inventory (Harley-Davidson)

- The influence of choice of inventory method on financial statement information is presented through examples of choices facing Harley-Davidson, Inc., a company with which most students can readily identify.

- Harley-Davidson's inventory method choices are compared to those of other companies in different circumstances.
- In the discussion of periodic versus perpetual inventory systems, the focus is on the usefulness of perpetual inventory systems for managerial decisions rather than heavy coverage of recordkeeping.

#### Changes in the Second Edition

- The discussion of the periodic inventory system has been abbreviated and the discussion of the perpetual inventory system has been expanded.
- The discussion of LIFO liquidations has been placed in a chapter supplement.

#### **Chapter 8:** Reporting and Interpreting Property, Plant, and Equipment; Natural Resources; and Intangibles (Delta Air Lines)

- The depreciation methods are presented in a decision-making framework that minimizes procedure and emphasizes how methods are chosen.
- The discussion of residual value and estimated useful life is strengthened by the continued use of examples from Delta Air Lines, Inc.
- The chapter develops student interest in a potentially dry topic by showing how planning productive capacity is an essential management responsibility.

#### Changes in the Second Edition

- The discussion of the use of property, plant, and equipment has been moved to precede the discussion of depreciation methods for property, plant, and equipment to make the topical presentation more logical to students.
- The sum of the year's digits depreciation method has been eliminated since it is not often used in practice.
- The impairment of assets is discussed along with its effects on financial analysis.
- The fixed asset turnover ratio is illustrated for Delta Air Lines and its competitors to provide a framework for analysis.
- The discussion of trade-ins has been eliminated.

#### **Chapter 9:** Reporting and Interpreting Liabilities (General Mills)

- As in other chapters, ratios (e.g., current ratio) are discussed as the accounts used in computations are covered, allowing students to more clearly see the linkages and understand the importance of ratio analysis.
- Topics were selected based on a review of hundreds of financial statements. To provide relevance, students are exposed to liabilities that they will see on most statements. Complex issues are introduced without excessive details.

#### Changes in the Second Edition

- A brief discussion of leases has been added to the chapter.

#### **Chapter 10:** Reporting and Interpreting Bonds (Showboat)

- Student interest is maintained by following an actual bond issuance for Showboat, Inc., from the prospectus stage through sale, concluding with a vote by bondholders to amend bond covenants.
- Based on reviewer feedback, material was added on bond investments held to maturity, which briefly illustrates why certain companies choose this as an investment strategy and how they report it in their financial statements. By combining bond liabilities and bond investments, students develop a better understanding of these instruments.