

SIXTH EDITION

INTRODUCTION TO  
**FINANCIAL  
ACCOUNTING**

**HORNGREN ♦ SUNDEM ♦ ELLIOTT**

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# Introduction to Financial Accounting

*Sixth Edition*

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To Joan, Scott, Mary, Susie,  
Cathy, Liz, Garth, Jens,  
Laura, and Dawn

■ **Charles T. Horngren** is the Edmund W. Littlefield Professor of Accounting at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his Ph.D. from the University of Chicago. He is also the recipient of honorary doctorates from Marquette University and De Paul University.

A Certified Public Accountant, Horngren has served on the Accounting Principles Board, the Financial Accounting Standards Board Advisory Council, the Council of the American Institute of Certified Public Accountants, and as a trustee of the Financial Accounting Foundation.

A member of the American Accounting Association, Horngren has been its President and its Director of Research. He received the Outstanding Accounting Educator Award in 1973. The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award in 1975 and its Distinguished Professor Award in 1983. In 1985 the American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren. In 1990 he was elected to the Accounting Hall of Fame.

Professor Horngren is also a member of the National Association of Accountants. He was a member of the Board of Regents, Institute of Certified Management Accountants, which administers the CMA examinations.

Horngren is the co-author of six other books published by Prentice Hall including: *Cost Accounting: A Managerial Emphasis*, Eighth Edition (with George Foster and Srikant M. Datar); *Introduction to Management Accounting*, Tenth Edition (with Gary L. Sundem and William O. Stratton); *Accounting*, Third Edition (with Walter T. Harrison, Jr., and Michael A. Robinson), and *Financial Accounting*, Second Edition (also with Harrison). In addition he is the Consulting Editor for the Prentice Hall Series in Accounting.

■ **Gary L. Sundem** is Professor of Accounting at the University of Washington, Seattle. He received his B.A. degree from Carleton College and his MBA and Ph.D. degrees from Stanford University.

Professor Sundem was the 1992–93 President of the American Accounting Association, served as Executive Director of the Accounting Education Change Commission, 1989–91, and as Editor of *The Accounting Review*, 1982–86.

A member of the National Association of Accountants, Sundem is past-president of the Seattle chapter. He has served on NAA's national Board of Directors, Committee on Academic Relations, and the Research Committee.

Professor Sundem has numerous publications in accounting and finance journals, including *Issues in Accounting Education*, *The Accounting Review*, *Journal of Accounting Research*, and *The Journal of Finance*. He received an award for the most notable contribution to accounting literature in 1978. He was selected as the Outstanding Accounting Educator by the Washington Society of CPAs in 1987. He has made more than 100 presentations at universities in the United States and abroad.

■ **John A. Elliott** is an Associate Professor of Accounting at the Johnson Graduate School of Management at Cornell University. He received his B.S. and MBA degrees from the University of Maryland and his Ph.D. degree from Cornell University. He is currently Director of the Ph.D. program at the Johnson School and has acted as associate dean for academic affairs.

A certified public accountant, Elliott worked for Arthur Anderson & Co. and for Westinghouse before returning for his advanced degrees. He currently teaches financial accounting and international accounting at the Johnson School. Prior teaching has included auditing and taxation as well as intermediate accounting and financial statement analysis. Over 25 years as an educator, Professor Elliott has taught at the University of Maryland, St. Lawrence University, Central Washington State College, and the University of Chicago. In addition to executive teaching for Cornell, he has conducted various corporate training programs in the United States and internationally.

As a member of the American Accounting Association, he was the founding president of the Financial Accounting and Reporting Section. As a member of the Financial Accounting Standards Committee he has frequently responded to FASB exposure drafts and worked to integrate academic study with practice. His research has been published in accounting and economics journals and deals primarily with the use of accounting information to assess the financial condition of an enterprise.

Professor Elliott served on the Hangar Theatre Board of Trustees for nine years, and was president for four of those years. He currently serves as Treasurer of the Board of the Cayuga Medical Center at Ithaca.

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# Preface

**I**ntroduction to Financial Accounting is the first member of a matched pair of books that provides full coverage of the essentials of financial and managerial accounting. The second book is *Introduction to Management Accounting*. In combination, the pair can be used throughout two semesters or three quarters of introductory accounting.

This book takes the view that business is an exciting process and that accounting is the perfect window through which to understand how economic events affect businesses. Since we believe accounting is an aid to understanding economic events, and that accounting builds on simple principles, this book introduces a number of concepts earlier than other textbooks do. However, the early introductions are at the simplest level and are illustrated with carefully chosen examples from real companies that emphasize the basics. Thus, in Chapter 2 we introduce the concept of earnings per share and how the share price of a company may change when an earnings announcement occurs. But it is not until Chapter 15 that details of calculation of earnings per share under complex conditions are addressed. In Chapter 2 we introduce the price-earnings ratio and dividend yield as ratios that are used by investors. Throughout the book we add ratios in each chapter that enhance students' understanding of the accounting topics addressed. Finally, in Chapter 15, the prior coverage is enriched and integrated to provide a complete coverage of financial statement analysis that includes management's discussion and segment reporting. In Chapter 2 we introduce the simplest possible statement of cash flow to emphasize the role of this statement in the family of accounting reports. The statement is revisited periodically throughout the remainder of the text. Chapter 11 provides an integrated exploration of the cash flow consequences of material covered to that point, and subsequent chapters explore new issues.

These examples illustrate our philosophy: Introduce the simple concepts early. Revisit the concepts at more complex levels as the reader gains sophistication and understanding. Provide real world examples at every stage that illustrate the topics consistent with the theoretical treatment in the chapter. Always view accounting as a tool that enhances our understanding of economic events. After this transaction, are we better off or worse off? One of our colleagues, Hal Bierman, often focuses on an economic event by asking, "are you happy or are you sad?" We believe that accounting provides a way to understand what is happening and to answer that question. You might think of the basic financial statements as scorecards in the most fundamental economic game of all. Each year the financial statements help you answer the most important questions:



Are you happy or are you sad? Did you make money or lose money? Are you prospering, or are you just surviving, or are you failing?

President Carter's financial statements, the Golden Gate Bridge District's loss of \$26.20 of ferry tickets, and the 1985 financial implications of a baseball players strike are all classic examples that we decided to retain in the current problem material. While the baseball strike of 1985 is ancient history, the 1994–95 version has just ended and the next one is probably right around the corner. We believe there is great value in extensive current examples, and we provide them. Accounting changes constantly, and we stay on top of those changes. But the reality is that "...the more things change the more they stay the same..." and our mix of constructed problems and old and new real world examples is intended to find the right balance.

*Introduction to Financial Accounting* is a textbook for introductory accounting courses that presupposes no prior knowledge of accounting. It deals with important topics that all students of management should study. Our goals have been to choose *relevant* subject matter, including many examples drawn from actual companies, and to present it *clearly* and *flexibly*. Although the focus is on U.S. accounting methods, numerous references to international practices and standards are found throughout the text. The book is oriented to the user of financial statements, but it gives ample attention to the needs of potential accounting practitioners.

Because financial accounting is so pervasive, an understanding of its uses and limitations is valuable whether the student eventually becomes a company president, a sales manager, a professional accountant, a hospital administrator, or a politician. In particular, knowledge of accounting for business is worthwhile because all of us relate to companies in one or more of the following ways: investors, managers, customers, creditors, government regulators, observers, or critics.

A philosopher once said, "You have to know what something *is* before you know what it *is used for*. When you know what it is used for, then you can decide what changes deserve serious thought." *Introduction to Financial Accounting* describes the most widely used accounting theory and practice. Emphasis is on *what accounting is* rather than *what it should be*. After all, beginning students must know what accounting today is really like before they can make judgments as to what changes in practice are desirable. Ample consideration is given to proposed changes in accounting throughout the book (especially in Chapter 16), but the thrust is toward understanding generally accepted theory and practice.

This text stresses underlying concepts, but it makes them concrete with profuse illustrations, many taken from corporate annual reports. Moreover, accounting procedures such as transaction analysis, journalizing, and posting are given abundant consideration. For example, see the sections on transaction analysis in Chapter 1. In this way, the reader obtains a thorough grasp of the fundamentals of accounting. The study of concepts develops understanding of procedures, and the study of procedures enriches understanding of concepts. A major objective is to equip students with enough fundamental concepts and terminology so that they can comprehend a typical corporate annual report.



Flexibility has been a driving force in writing this book. Are you among the many instructors who favor solidifying the fundamentals by using many journal entries, T-accounts, work sheets, and special journals? Then see Chapters 3, 4, and 5, including its appendixes, and the appendixes to Chapters 10 and 11. Are you among the other instructors who favor downplaying the details and emphasizing concepts? Then consider skipping some of the material just cited, in whole or in part (especially Chapter 5).

The flexibility of the book is illustrated by the use of chapter appendixes. They give the instructor latitude in picking and choosing among various topics. In short, greater depth and breadth are available, depending on the preferences of the teacher. Moreover, parts of the bodies of some chapters can be omitted if desired. Numerous candidates for exclusion can be found in Chapters 6–16. Examples include materials in Chapter 6 other than the valuation of accounts receivable, and the presentation of consolidated statements in Chapter 13.

A major feature is the use of the fundamental accounting equation as a central thread throughout the book for explaining new concepts and analyzing transactions. For example, consider the presentations in Chapter 10 on bonds, Chapter 11 on the statement of cash flows, Chapter 13 on intercompany investments, and Chapter 14 on interperiod income tax allocation. Such presentations give instructors immense latitude. They can use journal entries, or T-accounts, or the balance sheet equation format *exclusively*, if desired.

Additional features of this book include attempts to spark the reader's curiosity from the outset by:

1. Introducing financial statements of *actual companies* throughout the text beginning in Chapter 1.
2. Using published financial information as a basis for much of the assignment material in each chapter.
3. Showcasing interesting illustrations of chapter topics in boxed-off features in each chapter.
4. Including references to international accounting standards and practices throughout the text, rather than relegating them to the end.
5. Including a complete set of financial statements for Wal-Mart, the largest retailer in the United States, and having one problem in each chapter's assignment materials based on these statements. One problem in each chapter allows students to use the Compact D™/SEC Academic Edition from Disclosure®, a computerized database of financial statements. We have also added a new ethics problem in each chapter.
6. Integrating a few financial ratios in Chapter 2, a few more in Chapter 4, a few more in Chapter 6, and so on. The goal is to make financial statement analysis a natural element of the process. We do not relegate the interpretation of financial statements to the rear of the book.
7. Using a minimum of technical detail to introduce relatively complicated subjects, and examining the subjects in more depth in chapter appendixes. For example, we treat the details of the statement of cash flows in an appendix to Chapter 11, and pooling of interests is relegated to the appendix in Chapter 13.

8. Providing a solid conceptual foundation in the first two chapters before covering the mechanics of journals, ledgers, and related procedural matters in Chapter 3.
9. Introducing simple income tax aspects in Chapter 4 rather than later. Income taxes are not only important, they stimulate reader interest.
10. Listing learning objectives at the start of each chapter, and highlighting each objective again in the margin as it is discussed, which is a key student review tool.
11. Emphasizing key terms by offering marginal glossary definitions.

### ***Alternative Ways of Using This Book***

Texts are fundamentally teaching instruments. Teaching is highly personal and heavily influenced by the backgrounds and interests of assorted students and faculty in various settings. To satisfy this audience, a book must be a pliable tool, not a straitjacket.

In our opinion, the first twelve chapters provide the foundation for the field of financial accounting. These twelve chapters may be amplified by assigning other chapters in a variety of sequences that do not disrupt the readers' flow of thought. The most obvious candidates for alternate order and selective inclusion are:

Chapters 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11 and any of 12–16.	
↑	↑
11	13
16	16

Chapter 8 deals with internal controls. Often this topic is omitted in introductory financial accounting courses. It is placed in Chapter 8 because the authors believe the topic is extremely important. Further, it is less technical than other chapters, so it provides a change of pace for students in the midst of heavily technical material. However, it can be delayed until anytime later in the course without loss of continuity.

Chapter 11 on cash flows may be assigned after Chapter 7 (or even pages 487–504 after Chapter 5); it is placed as Chapter 11 because the statement of cash flows is an excellent vehicle for reviewing all the fundamentals of financial accounting.

### ***Assignment Material***

Careful choices among the wide variety of assignment material in each chapter will slant the course toward various combinations of breadth and depth, theory and procedures, simplicity and complexity. Many exercises and problems marked with an icon use information presented in actual corporate annual reports or news stories. In this way, some major points in the chapter can be underscored by “real world” illustrations. Most of the annual reports used are relatively recent but some classics are retained. One complete annual report, that of Wal-Mart Stores, Inc., is included as Appendix A at the end of the text. It is the basis for the next-to-last problem in each chapter. Using these problems will assure students that they can cope with real financial statements.



Special review assignment material is contained in Chapters 5 and 16. In addition, some assignments in Chapters 13-16 tend to crystallize previous work. The review assignment material for Chapter 16 is especially noteworthy. It uses corporate annual reports as a basis for review of all parts of the course. These cases or problems provide a splendid test of the student's overall comprehension. Their successful solution enhances a student's confidence enormously, especially because he or she is dealing with real companies' financial statements.

The front of the solutions manual contains several alternate detailed assignment schedules and ample additional suggestions to teachers regarding how best to use this book.

### **Features of This Edition**

Users of the fifth edition gave the assignment material high marks regarding quality, quantity, and range. They especially liked the references in the text and the assignment materials to actual companies. The sixth edition enhances the latter feature because it spurs student interest and enthusiasm.

We have expanded and revised the "boxed" items that highlight real-world issues related to the chapter coverage. For example, in the inventory chapter, one box deals with why some firms do not use LIFO, and another box describes the classic salad oil fraud, in which management used complex deceptions to substantially overstate their inventory and earnings. In the first chapter a box discusses how *The New York Times* grades annual reports and the letter to shareholders, while nearby text relates earnings announcements to changes in share prices on an April day in 1995. A later box details how internal control failures permitted thieves to steal over \$300,000 from an unsuspecting woman's bank account. Such real-world examples heighten student interest.

We have devoted enormous attention to the assignment material for each chapter. The beginning of the Chapter 1 Assignment Material explains the format and the various ways of using the material. If they desire, instructors may select materials exclusively from those "real-world" exercises and problems identified with the logo and cover all the essentials of financial accounting.

Of special note is Chapter 11, "Statement of Cash Flows." This chapter provides an especially easy-to-learn explanation of the statement. In particular, the readers need not contend with either a long series of "things to do" or awkward work sheets. Instead, the chapter employs the familiar balance sheet equation that threads throughout the entire book. Thus readers can quickly understand why as well as how the statement dovetails with balance sheets and income statements. A chapter appendix covers the T-account approach for those instructors who favor such a technique.

Another valuable feature of this edition is the series of Wal-Mart problems at the end of each chapter's assignment material. These problems directly link the chapter's subject matter to the actual financial statements of Wal-Mart, which are reproduced in Appendix A at the end of the book. As students

progress through the course, they will grow increasingly comfortable with the real-world report of a publicly-held company.

All chapters were updated. Consider the following distinguishing features:

- Learning objectives and accounting vocabulary definitions placed in chapter margins for emphasis.
- New ethics problem in each chapter.
- Examples of the use of accounting information for decision making in Chapter 1.
- Brief introduction to Statement of Cash Flows and simple ratios in Chapter 2.
- Introduction to formats found on non-U.S. balance sheets in Chapter 4.
- Expanded discussion of auditing in Chapter 5.
- Emphasis on what expenditures should be capitalized in Chapter 9.
- Examples woven throughout Chapter 13 on intercorporate investments to illustrate the extent and nature of intercorporate relations and motivate the need for diverse accounting practice.
- Clarified and expanded discussion of permanent and timing differences between the reporting to tax authorities and the reporting to shareholders in Chapter 14.
- More integrated coverage of the use of historical results to predict future results in Chapter 15, together with brief coverage of foreign currency translation.
- Expanded section on non-U.S. financial statements in Chapter 16, focusing on Japan, Germany, and France.

### **Supplements for Instructors**

*Instructor's Manual*—includes learning objectives, chapter overviews, chapter outlines, quizzes, transparency masters, and selected readings.

*Solutions Manual*—provides solutions for all end-of-chapter assignment material. All solutions were prepared by the authors.

*Solutions Transparencies*—provides selected solutions on acetates.

*Test Item File*—consists of approximately 15 true/false questions, 50 multiple-choice questions, and 10 exercises per chapter. The learning objective and level of difficulty are indicated for each question.

*ABC News/Prentice Hall Video Library*—offers high-quality feature and documentary-style videos with carefully researched selections from award-winning ABC news shows. The accompanying video guide provides a synopsis, learning objectives, and discussion questions for each video segment.

*Prentice Hall Custom Test*—offers a computerized testing package in both DOS and Windows formats.

### **Supplements for Students**

*Study Guide*—includes a detailed review of key ideas for each chapter plus practice test questions and problems along with the worked-out solutions.

*Working Papers*—include tear-out forms, organized by chapter, for solving the problem assignments.

*The New York Times Dodger*—a complimentary “mini-newspaper” supplement for students that consists of recent articles pertaining to the field of accounting. This supplement is updated annually for timeliness.



*Compact D™ from Disclosure®*—software database that contains detailed profiles and financial data for 100 publicly traded companies. Each chapter of the text includes a generic financial statement problem that can be assigned in conjunction with this software package. Compact D/SEC™ Academic Edition 30 contains the profiles and financial data of 30 companies. Compact D/SEC™ Academic Edition 100 contains profiles and financial data of 100 companies.

*Lotus (R) Templates*—provides pre-prepared templates for selected problems from the text.

Practice Sets: *Runners Corporation* (Manual & Computerized)

*Reading and Applications in Financial Accounting, Third Edition*, by Rankine/Stice—available shrinkwrapped with the text.

## **Acknowledgments**

Our appreciation extends to our present and former colleagues and students. This book and our enthusiasm for accounting grow out of their collective contributions to our knowledge and experience. We particularly appreciate the following individuals who supplied helpful comments and reviews of the previous edition or of drafts of this edition: Schlomi Benartzi, University of Southern California; James Bond, Winthrop College; Averil Brent, Columbia University; Alice Cooperstein, Central Connecticut State University; William Colye, Babson College; Patricia Dougherty, Boston University; Julia D'Souza, Cornell University; Pete Dukes, University of Washington; Anita Feller, University of Illinois; Richard Frankel, University of Michigan; Al Hartgraves, Emory University; Yuji Ijiri, Carnegie Mellon University; Dale Janouski, State University of New York at Buffalo; Donna Kilpatrick, University of Washington; Robert Libby, Cornell University; Barbara Lougee, Cornell University; Don Lucy; Joan Luft, Michigan State University; Carol Marquardt, Cornell University; Maureen McNichols, Stanford University; W. Timothy O'Keefe; Mohamed Onsi, Syracuse University; Joseph Paperman, University of Washington; Moses Pava, Yeshiva University; Laura Philips, White House Office of Science and Technology; Morton Pincus, University of Iowa; James Sander, Butler University; Rudolph Schattke, University of Colorado at Boulder; Bob Swieringa, Financial Accounting Standards Boards; and Christine Wiedman, College of William and Mary. Graeme W. Rankin and Earl K. Stice co-authored some of the boxes in the text. Donna Phoenix skillfully typed the solutions manual.

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Comments from users are welcome.

Charles T. Horngren  
Gary L. Sundem  
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