

# FINANCIAL ACCOUNTING



JAMIE PRATT

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*To all my family, especially Mom and Dad*

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# Preface

≡ *Financial Accounting* is intended for a first course in financial accounting. It can be used at the undergraduate or graduate level by both majors and nonmajors and requires no previous knowledge about accounting or business. The coverage is comprehensive and flexible, allowing its use in courses of one quarter, one semester, or two quarters.

The goal of this text is to provide a balanced coverage of (1) the procedures used to prepare financial statements, (2) the measurement theories underlying the procedures, and (3) the economic environment in which accounting operates. The essential feature distinguishing this text from other introductory accounting texts is its **economic perspective**. Financial accounting statements result from a dynamic process that reflects a demand for information that is used for evaluation and control—information that affects the economic wealth of investors, creditors, managers, auditors, and consumers. The economic environment gives meaning and interest to financial accounting.

In 1980, Professor Stephen A. Zeff, then editor of *The Accounting Review*, called for more coverage of economic consequences in financial accounting textbooks.<sup>1</sup> In response to concerns over shrinking enrollments in accounting programs and reports of a decline in the quality of accounting graduates, Professor Gerhard G. Mueller, president of the American Accounting Association, made the following statement in 1989, almost ten years later:

*Our present textbooks and pedagogy haven't changed since the 1950s and are quite obsolete. There has developed a huge schism between what's taught in the classroom and what the real world is like. In most colleges, you get the bright, bushy-tailed students into the first-year accounting class, and within the first two weeks, they're totally turned off. They think that accounting is nothing but number-crunching.*<sup>2</sup>

This textbook meets these concerns by demonstrating that financial accounting is more than journals and ledgers. It is an information system that affects students' lives in significant ways, a system that can prepare them better for the challenges awaiting in the world of business.

While the text describes the economic context of financial accounting, it does not ignore important **procedural issues**. Complete chapters are devoted to the accounting cycle (including an appendix on special journals and subsidiary ledgers) and adjusting journal entries. Furthermore, journal and ledger entries throughout the text illustrate accounting methods and concepts. Teaching financial accounting from an economic perspective is meaningless unless the student understands how transactions affect the financial statements. Accounting procedures define such effects and are a necessary and important component of this text.

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1. Stephen A. Zeff, "Intermediate and Advanced Accounting: The Role of Economic Consequences," *The Accounting Review* (October, 1980), pp. 658–63.

2. Jean Evangelauf, "Accounting Educators Plan to Update Curriculum, Debate Tighter Entrance Requirements for CPAs," *The Chronicle of Higher Education* (May 10, 1989), p. A31.

### THREE LEVELS OF FINANCIAL ACCOUNTING

Figure P-1 illustrates the three interrelated levels from which to view financial accounting—economics, measurement theory, and mechanics. The **economic relationships** among investors, creditors, managers, and auditors give rise to a demand for relevant and reliable measures of earning power and solvency. This demand introduces **measurement theory**, the second level from which to view financial accounting. This level provides measures of earning power and solvency, the conceptual or theoretical foundation of financial accounting and underlies the procedures that lead to the financial statements. The **mechanical level** consists of the procedures used to prepare financial statements. These procedures maintain the basic accounting equation and specify how transactions affect a company's financial statements.

The arrow in Figure P-1 linking the mechanical level to the economic level illustrates that the financial statements, which result from the underlying theory and mechanics of accounting, fulfill an economic need. Investors and creditors use these statements to evaluate and control the actions of managers; managers use them to attract capital from investors and creditors; independent auditors, who are hired by managers, examine them to attest to their fairness. The financial accounting system cannot be understood unless all three levels of financial accounting are understood from the perspectives of investors, creditors, managers, and auditors. Introductory accounting students will pursue a wide range of careers, and it is important that they appreciate the multidimensional nature of financial accounting.

### CHAPTER COVERAGE

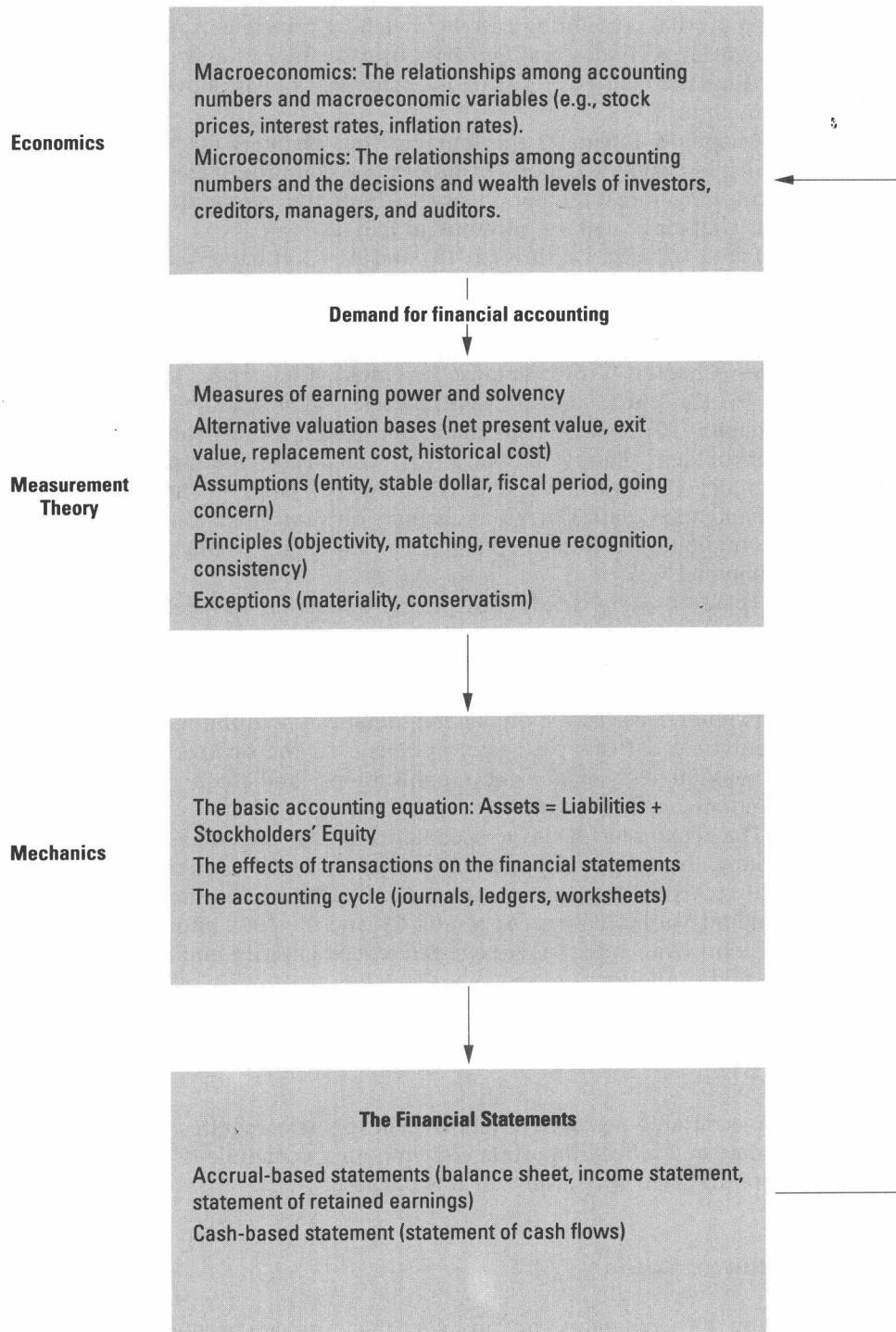
The text is divided into three parts. Part 1 (Chapters 1 through 5) establishes the foundations at the economic, measurement theory, and mechanical levels that will enable students to understand and appreciate the more detailed chapters in Parts 2 and 3. In a sense Part 1 represents a mini-course in financial accounting. Its general coverage of the financial statements provides a balance of mechanics, measurement theory, and economics.

Chapter 1 focuses primarily on the economic level, illustrating first the economic relationships among investors, creditors, managers, and auditors and then discussing the environment and institutional structure within which accounting operates.

Chapter 2 begins to link the economic, measurement theory, and mechanical levels. It introduces the basic accounting equation and the financial statements; it defines each account and discusses each statement in terms of earning power and solvency. Students see how investors and creditors use the numbers in these statements to evaluate and control management.

Chapters 3 and 4 focus on the mechanical level and its link to measurement theory. Chapter 3 is devoted exclusively to mechanics. It covers the accounting cycle (excluding adjusting journal entries) and contains additional sections on computerized accounting systems, special journals and ledgers (Appendix 3A), and internal control (Appendix 3B). Chapter 4 completes the discussion of the accounting cycle and introduces important issues of measurement theory. It begins by distinguishing cash from accrual accounting and then explains how to prepare

**Figure P-1 The three levels of financial accounting**



the statement of cash flows from the entries to the cash account in the ledger. The remainder of the chapter covers adjusting journal entries and how they implement accrual accounting and the matching principle. Appendix 4A describes how to convert revenues and expenses to cash inflows and outflows, and introduces the fundamentals of preparing the statement of cash flows from accrual-based information.

Chapter 5 integrates the four previous chapters. It explains the assumptions, principles, and exceptions of financial accounting using a framework that links accounting measurement theory to both the economic and mechanical levels. This chapter provides a capstone to Part 1.

Part 2 (Chapters 6 through 15) and Part 3 (Chapters 16 and 17) provide more in-depth coverage of the financial statement accounts in a way that balances mechanics, measurement theory, and economics. Part 2 covers the Current Asset Classification, Cash, and Marketable Securities (Chapter 6), Short-Term Receivables (Chapter 7), Merchandise Inventory (Chapter 8), Long-Lived Assets (Chapter 9), Current Liabilities, Contingencies, Pensions, and Deferred Income Taxes (Chapter 10), Long-Term Liabilities: Notes, Bonds, and Leases (Chapter 11), Stockholders' Equity (Chapter 12), Long-Term Investments (Chapter 13), the Complete Income Statement (Chapter 14), and the Statement of Cash Flows (Chapter 15). Part 3 includes chapters on Consolidated Financial Statements and International Operations (Chapter 16) and Using Financial Statement Information (Chapter 17).

These chapters clearly and precisely describe the methods of accounting and the underlying measurement theories. Easy-to-follow numerical examples support and illustrate the methods and theories. Each chapter also contains a section on economic consequences, tables containing industry and company comparisons, integrated discussions relating financial accounting to significant and timely events (e.g., "Black Monday," problems in the savings and loan industry), numerous quotes from business publications, and frequent excerpts from current corporate annual reports.

The remainder of the text contains special appendixes on the Time Value of Money, including compound interest and present value tables (Appendix A), Correcting Accounting Errors (Appendix B), Accounting for Changing Prices: Inflation and Market Values (Appendix C), and the 1989 annual report of K mart Corporation (Appendix D). A page-referenced glossary and an index are provided at the end of the text.

## **SPECIAL REAL-WORLD FEATURES**

The economic perspective followed in this text requires that the material be up-to-date and reflect important contemporary economic issues. Several text features were designed specifically for this purpose.

### **Industry Data**

Many of the chapters contain tables that compare accounting practices and show the importance of accounting numbers and ratios across different industries and well-known companies. These tables illustrate that the financial accounting issues

faced by retailers, manufacturers, service enterprises, and financial institutions are quite different. A brief explanation of the operations of companies in different industries and how these operations give rise to different financial accounting concerns follows each table.

### **Excerpts from Business Publications and Professional Journals**

Excerpts from various business publications (*The Wall Street Journal*, *Forbes*, and other professional and academic journals) are integrated throughout the text. In addition to documenting and clarifying important points, these excerpts provide a real-world flavor to the text presentation.

### **Excerpts from Current Corporate Annual Reports**

Actual disclosures and quotes from the annual reports of well known corporations are integrated throughout the text. These excerpts provide actual examples of the accounting and disclosure practices of major U.S. corporations and, in many cases, indicate the issues foremost in the minds of management when it reports to the stockholders. To impress students with the variety of disclosure and presentation practices of major U.S. corporations, these excerpts have not been modified to conform to the financial statement presentation style used throughout the text. While this approach results in certain inconsistencies, it is an unavoidable characteristic of a text designed to capture real-world accounting practices.

### **K Mart's Annual Report**

The 1989 annual report of K mart Corporation appears in Appendix D at the end of the text. Each chapter contains a section relating the report to accounting issues covered in the chapter. This feature provides students with another opportunity to relate the text material to the real world. The end of Chapter 17 presents a complete and comparative ratio analysis of K mart Corporation and Wal-mart Stores, Inc.

### **Real-World Cases**

Each chapter is followed by cases for analysis and discussion. These cases are based on current, real-world situations. Some require that the student analyze and/or interpret actual corporate disclosures, while others ask for commentaries on relevant quotes from well known business publications and business leaders. Once again, the student has the opportunity to relate the chapter material to current events in the business environment.

## **SPECIAL PEDAGOGICAL FEATURES**

The text contains a number of features designed specifically to aid the student's learning process. These features are discussed below.



## From Simple to Complex

The text develops broad and relatively simple concepts first, followed by gradually increased detail and complexity. Such a strategy helps students to understand better the fundamental concepts without getting lost in the detail that characterizes much of financial accounting. It also enables students to see more easily how relatively few concepts underlie most of financial accounting measurement. This strategy is used within and across chapters of the text.

The presentation of the statement of cash flows provides an example of gradually building from broad and simple to detailed and complex. The statement is introduced in Chapters 1 and 2 where it is discussed in general terms and where its relationship with the other financial statements in the measure of solvency is emphasized. The mechanics of preparing the statement are introduced in Chapter 3 where the statement is prepared directly from the cash account in the ledger. In Chapter 4 a more complex form of the statement of cash flows is prepared from the cash account in the ledger, and throughout the chapter, the differences between accrual and cash-basis accounting are examined. Appendix 4A demonstrates how the revenues and expenses on a relatively simple income statement can be adjusted to compute net cash flow from operating activities. The notion of accrual versus cash flow is mentioned many times in the subsequent chapters, but it is not until Chapter 15 that a comprehensive coverage of the statement of cash flows appears. This chapter covers how the statement is used and, using a relatively complex example, illustrates how it can be prepared from the information contained in two balance sheets and an income statement.

Presenting the statement of cash flows in the above manner allows the text to give balanced coverage to the three major financial statements from the beginning, highlighting the fact that no statement is more or less important than the others. At the same time, presenting the material in this way allows the student gradually to work up to the level of understanding required to prepare and appreciate the statement of cash flows in its complete form.

## Visual Frameworks

Many visual frameworks illustrate and describe complex procedural processes, measurement theories, and economic relationships. Figure P-1 is a typical example. Such frameworks aid the learning process by enabling students to see relationships that otherwise would be obscure. Instructors may also find these frameworks useful in organizing lectures and discussions.

## Simple and Relevant Examples

Numerical examples, both simple and relevant, appear throughout the text. Some illustrate basic accounting procedures, others compare the financial statement effects of alternative accounting methods, and still others demonstrate how operating decisions and accounting methods and estimates relate to the terms of contracts. The mathematical operations involved in these examples are always simple, and in each case, the example demonstrates a point developed in the text. In cases where examples are used to compare different accounting methods, the

methods are normally presented side-by-side on a single figure. This type of presentation is not only efficient, but it also enhances comparability.

### Chapter Materials and End-of-Chapter Materials

**Learning Objectives and Chapter Summaries.** Each chapter is preceded by a list of learning objectives designed to highlight the important issues in the chapter. These objectives guide the student through the material, indicating those areas needing additional attention. The chapter summary restates the learning objectives and includes a summary answer of each, providing both a concise statement of the basic issues addressed by each objective and an efficient summary of the chapter material.

**Review Problems.** Each chapter (except Chapter 1) is followed by a comprehensive review problem that tests the student on the mechanics underlying the essential accounting methods covered in the chapter. A solution follows each problem. These problems not only test a student's knowledge, but also serve as a reminder that procedural issues are at the heart of understanding important accounting concepts.

**Key Terms and Glossary.** An important objective of this course is to establish an understanding of the relevant terminology. Accordingly, several features are designed to help students learn key financial accounting terms. The important terms in each chapter are printed in bold face type when they are first defined in the text. A list of these terms appears at the end of each chapter, and a glossary of key terms is provided in the back of the text. Each term in both the end-of-chapter lists and the glossary is referenced by the page in the text where it is first defined.

**Questions, Exercises, Problems, and Cases.** The review material at the end of each chapter is comprehensive and complete. Twenty or more questions, which follow the order of topics covered in the text and provide a systematic review of the chapter material, are provided at the end of each chapter.

The procedures and concepts discussed and illustrated in a given chapter are each covered by at least one exercise and one problem. The exercises and problems have been arranged by degree of difficulty, moving from simpler to more complex within each type. Chapters typically contain ten to fifteen exercises and ten to fifteen problems. The exercises are relatively simple and require fewer and less complicated computations than do the problems. In addition, most exercises deal with only one concept, while the problems often consider several concepts simultaneously. The exercises and problems, each of which is accompanied by a brief description of the concepts or procedures being covered, can be classified into three categories requiring the student to (1) perform straightforward accounting procedures or classify various financial statement accounts, (2) determine the effects of different accounting methods on important financial statement numbers (e.g., net income, current ratio, debt/equity ratio), or (3) assess the impact of different accounting methods on contracts such as debt covenants and compensation contracts. As mentioned earlier, each chapter is also followed by at least five cases, each of which is based on a real-world situation.

## FLEXIBLE ORGANIZATION

The text can be adapted to different course formats at either the undergraduate or graduate level. A number of chapters, for example, are followed by appendixes that the instructor may choose to cover. Chapters 13 (Long-Term Investments), 14 (The Complete Income Statement), 16 (Consolidated Financial Statements and International Operations), 17 (Used Financial Accounting Information), and Appendixes A (Time Value of Money), B (Correcting Accounting Errors), and C (Accounting for Changing Prices: Inflation and Market Values) at the end of the text represent topics that, depending on time considerations and the interests of the instructor, may or may not be assigned. Many chapters are organized so that certain topics can be omitted without losing continuity. Contingencies, pensions, and deferred income taxes, for example, can easily be deleted from Chapter 10, while capital leases can be deleted from Chapter 11. As a result, instructors can develop courses to fit almost any format by selectively choosing from the available material.

The traditional one-quarter introductory accounting course at the undergraduate level, for example, could include Chapters 1 through 12, deleting contingencies, pensions, deferred income taxes, and capital leases and using Appendix 4A to cover the statement of cash flows. A more procedural approach could cover the same topics, but spend more time with Chapter 3 and Appendix 3A and less time with Chapter 5.

A one-quarter course at the graduate level might include Chapters 1 through 12 and Chapter 15 without deleting one or more of the topics mentioned above, while a one-quarter course designed for nonaccounting majors could consist of Chapters 1 through 5, 14, 15, and 17, and Appendixes A and C at the end of the text.

A semester course at either the graduate or undergraduate level could cover Chapters 1 through 12, and Chapter 15, and some combination of Chapters 14, 16, and 17, and Appendixes A, B, and C at the end of the text. Virtually the entire textbook could be covered in a two-quarter course.

These course strategies are merely suggestions designed to highlight the fact that the text can be used in a variety of circumstances. It is sufficiently comprehensive to provide the material for a conceptually oriented, two-quarter graduate level course and, at the same time, can be adapted to a one-quarter undergraduate course with an emphasis on procedures. In any case, one aspect about the text is certain—the coverage will provide an interesting balance of mechanics, measurement theory, and economics.

## ACCURATE PRESENTATION

Throughout the development and production of this book, accuracy has been a primary concern. The manuscript was extensively reviewed over several drafts by accounting faculty from a variety of universities, and was also class tested a number of times. All exercises, problems, and cases were solved completely by independent reviewers. The attention to accuracy continued as the manuscript was typeset. All chapters were reviewed once again by accounting faculty, with some concentrating on textual content, some on illustration material, and others on the exercises, problems, and cases. Extreme care has been taken to ensure that the text is consistent, accurate, and clearly written.

## STUDENT LEARNING AIDS

**Study Guide.** Prepared by S. Sam Sedki (St. Mary's University). Designed to have a procedural flavor that complements the text, this invaluable study aid includes the following elements for each chapter: chapter overview; review of key terms, including definitions; matching, fill-in-the-blank, and multiple-choice questions; and short procedure-specific exercises, all of which highlight important concepts and relationships introduced in the text.

**Working Papers.** This supplement contains a sufficient number of appropriate blank forms for all exercises and problems in the text. Each form is identified by exercise/problem number.

**Practice Set.** Created by Mark Friedman (University of Miami), "Byte of Accounting, Inc." is an effective computerized practice set that uses the general ledger component of DacEasy Accounting<sup>™</sup>, one of the most popular commercial accounting packages on the market, to demonstrate the value of the computer as a tool of the accountant. By using a real general ledger, students are able to acquire a more meaningful experience with the computer and the monthly accounting cycle of a corporation. "Byte of Accounting, Inc." gives students the opportunity to complete the accounting cycle manually prior to using the computer, an exercise that allows them to build upon work already completed. The package is available for student purchase and is intended for use with the IBM-PC and compatibles.

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## SUPPLEMENTS FOR THE INSTRUCTOR

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**Text Bank.** Prepared by Steven Reimer (University of Iowa). This bank of more than 1500 questions features chapter tests comprised of questions that are categorized by learning objectives and by question orientation (i.e., whether the question tests procedures, measurement concepts, or economic concepts). Also included are four comprehensive exams, each of which include questions over four to five chapters.

**Solutions Manual.** Developed by James R. Frederickson. This supplement provides complete solutions to all exercises, problems, and cases in the text.

**Solutions Transparencies.** This package includes over 750 acetates that illustrate the solutions for each exercise, problem, and case in the text.

**Teaching Transparencies.** Fifty carefully developed two-color acetates focus on the key concepts of the text, concepts that lend themselves to illustration and classroom discussion. Each acetate was selected by a special review panel that included the author.

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*Jamie Pratt*



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