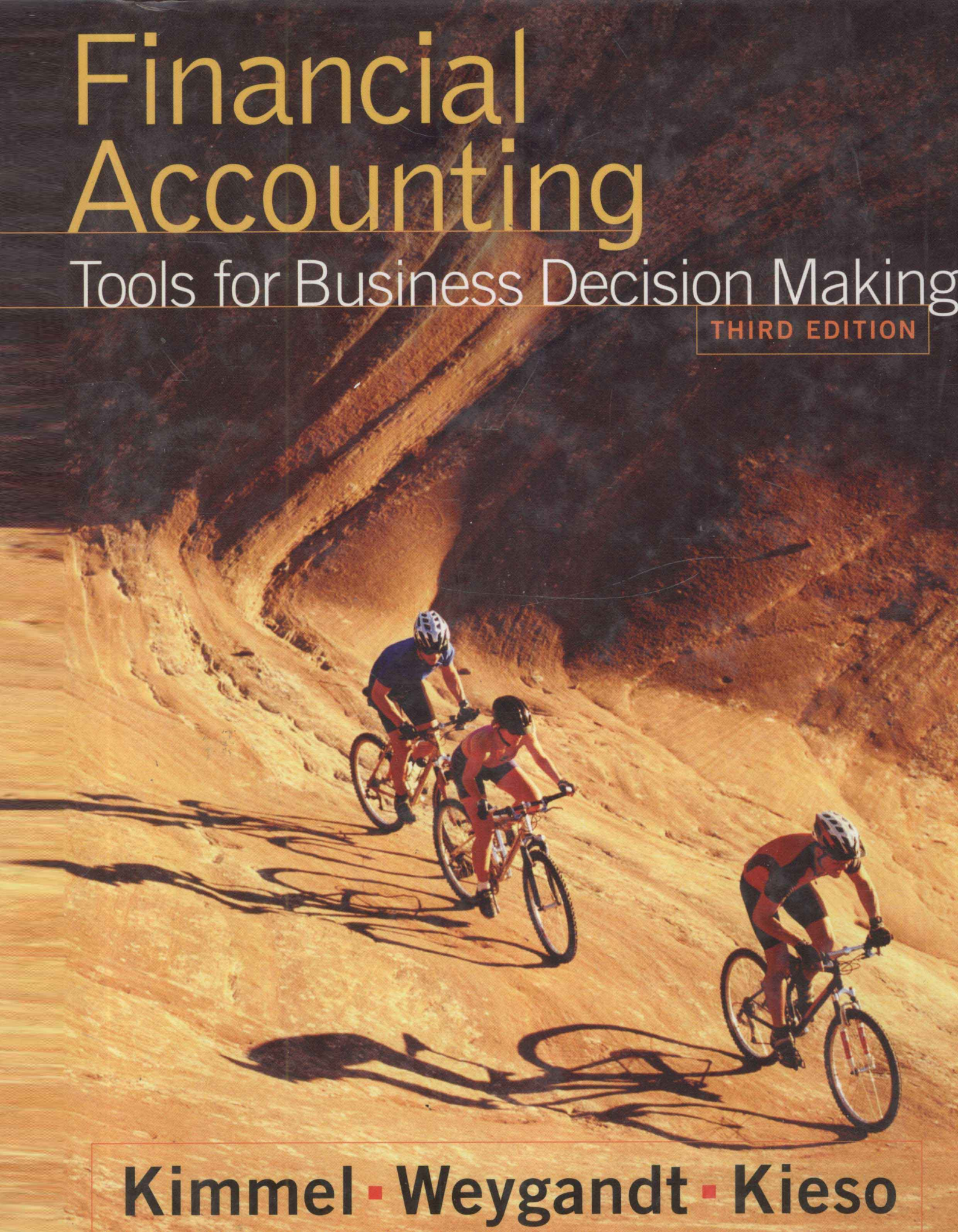


Financial Accounting

Tools for Business Decision Making

THIRD EDITION



Kimmel ■ Weygandt ■ Kieso

Dedicated to
our parents and our in-laws,
and to our families,
most especially our spouses,
Merlynn
Enid
Donna

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he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and is presently a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin and the Dean Foundation. He is the recipient of the Wisconsin Institute of CPAs' Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Accounting Educator Award.

Donald E. Kieso, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Peat Marwick Emeritus Professor of Accounting at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of

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PREFACE

Our efforts to continually improve this text are driven by a few key beliefs:

“It really matters.”

The recent economic turbulence caused by the lack of credible financial information demonstrates the importance of accounting to society. The collapse of Enron, Global Crossing, Arthur Andersen, and others has had devastating consequences for the lives of tens of thousands of people. Our Business Insight—Ethics Perspective boxes, Ethics cases, video clips on the CD, and a number of our Feature Stories and Research Cases are designed to reveal accounting’s critical role. In short, it has never been more clear that accounting really matters.

“Less is more.”

Our instructional objective is to provide students with an understanding of those concepts that are fundamental to the use of accounting. Most students will forget procedural details within a short period of time. On the other hand, concepts, if well taught, should be remembered for a lifetime. Concepts are especially important in a world where the details are constantly changing.

“Don’t just sit there—do something.”

Students learn best when they are actively engaged. The overriding pedagogical objective of this book is to provide students with continual opportunities for active learning. One of the best tools for active learning is strategically placed questions. Our discussions are framed by questions, often beginning with rhetorical questions and ending with review questions. Even our selection of analytical devices, called Decision Toolkits, uses key questions to demonstrate the purpose of each.

“I’ll believe it when I see it.”

Students will be most willing to commit time and energy to a topic when they believe that it is relevant to their future career. There is no better way to demonstrate relevance than to ground discussion in the real world. By using high-profile companies such as **Tootsie Roll**, **Microsoft**, **Nike**, and **Intel** to frame our discussion of accounting issues, we demonstrate the relevance of accounting while teaching students about companies with which they have daily contact. As they become acquainted with the financial successes and failures of these companies, many students will begin to follow business news more closely, making their learning a dynamic, ongoing process.

“You need to make a decision.”

All business people must make decisions. Decision making involves critical evaluation and analysis of the information at hand, and this takes practice. We have integrated important analytical tools throughout the book. After each new decision tool is presented, we summarize the key features of that tool in a Decision Toolkit. At the end of each chapter we provide a comprehensive demonstration of an analysis of a real company using the decision tools presented in the chapter. The presentation of these tools throughout the book is logically sequenced to take full advantage of the tools presented in earlier chapters, culminating in a capstone analysis chapter.

“It’s a small world.”

Rapid improvements to both information technology and transportation are resulting in a single global economy. The Internet has made it possible for even small businesses to sell their products virtually anywhere in the world. Few business decisions can be made without consideration of international factors. To heighten student awareness of international issues, we have increased references to international companies and issues and provided A Global Focus exercise in each chapter.

KEY FEATURES OF EACH CHAPTER

Chapter 1, Introduction to Financial Statements

- Explains the purpose of each financial statement.
- Uses financial statements of a hypothetical company (to keep it simple), followed by those for a real company, **Tootsie Roll Industries** (to make it relevant).
- Presents accounting assumptions and principles.

Chapter 2, A Further Look at Financial Statements

- Discusses revenues, expenses, assets, and liabilities.
- Presents the classified balance sheet.
- Applies ratio analysis to real companies—**Best Buy** and **Circuit City** (current ratio, debt to total assets, earnings per share, price-earnings ratio, current cash debt coverage, and cash debt coverage).

Chapter 3, The Accounting Information System

- Covers transaction analysis—emphasizes fundamentals while avoiding unnecessary detail.

Chapter 4, Accrual Accounting Concepts

- Emphasizes difference between cash and accrual accounting.
- Discusses how some companies manage earnings through accrual practices.
- Presents minimal discussion of closing and work sheets; provides additional detail in an appendix.

Chapter 5, Merchandising Operations and the Multiple-Step Income Statement

- Introduces merchandising concepts using perpetual inventory approach.
- Presents the multiple-step income statement.
- Applies ratio analysis to real companies—**Target** and **Wal-Mart** (gross profit rate and profit margin ratio).
- In an appendix, introduces the periodic inventory approach and compares it to perpetual.

Chapter 6, Reporting and Analyzing Inventory

- Covers cost flow assumptions and their implications for financial reporting. For simplification, emphasizes the periodic approach. Cost flow assumptions under perpetual inventory systems covered in an appendix.
- Applies ratio analysis to real companies—**Target** and **Wal-Mart** (inventory turnover).
- Discusses implications of LIFO reserve for real company—**Caterpillar Inc.**

Chapter 7, Internal Control and Cash

- Covers internal control concepts and implications of control failures.
- Presents bank reconciliation as a control device.
- Discusses cash management, including operating cycle and cash budgeting.

Chapter 8, Reporting and Analyzing Receivables

- Presents the basics of accounts and notes receivable, bad debt estimation, and interest calculations.

- Discusses receivables management, including determining to whom to extend credit; establishing payment period; monitoring collections; evaluating the receivables balance; and accelerating receipts.
- Applies ratio analysis to a real company—**McKesson** (receivables turnover).

Chapter 9, Reporting and Analyzing Long-Lived Assets

- Covers the basics of plant assets and intangible assets.
- Discusses basics of buy or lease decision.
- Covers the implications of depreciation method choice; shows details of accelerated methods in appendix.
- Applies ratio analysis to real companies—**Southwest Airlines** and **AirTran** (asset turnover and return on assets).
- Demonstrates implications of estimated useful life for intangible amortization.
- Includes a discussion of statement of cash flows presentation of fixed-asset transactions.

Chapter 10, Reporting and Analyzing Liabilities

- Covers current liabilities: notes payable, sales taxes, payroll, unearned revenues, and current maturities of long-term debt.
- Covers long-term liabilities, bond pricing, and various types of bonds.
- Straight-line amortization and effective interest method covered in an appendix.
- Includes present value discussion in an appendix at the back of the book.
- Discusses basics of contingent liabilities, lease obligations, and off-balance-sheet financing.
- Applies ratio analysis to real companies—**Ford** and **General Motors** (current ratio, debt to total assets ratio, and times interest earned).
- Includes a discussion of statement of cash flows presentation of debt transactions.

Chapter 11, Reporting and Analyzing Stockholders' Equity

- Presents pros and cons of corporate form of organization.
- Covers issues related to common and preferred stock, and reasons companies purchase treasury stock.
- Explains reasons for cash dividends, stock dividends, and stock splits and implications for analysis.
- Discusses debt versus equity choice.
- Applies ratio analysis to real companies—**Nike** and **Reebok** (return on common stockholders' equity, payout ratio).
- Includes a discussion of statement of cash flows presentation of equity transactions.

Chapter 12, Statement of Cash Flows

- Explains purpose and usefulness of statement of cash flows.
- Splits chapter into two sections, allowing instructor to use either the indirect approach, the direct approach, or both.

- Employs two-year progression in examples, with first year looking at most basic items affecting cash flows, and second year looking at additional items.
- Applies ratio analysis to real companies—**Microsoft**, **Oracle**, **AMD**, and **Intel** (free cash flow, current cash debt coverage ratio, and cash debt coverage ratio).

Chapter 13, Performance Measurement

- Capstone chapter—reinforces previous analytical tools and demonstrates their interrelationships, as well as presents new tools.
- Discusses “sustainable income” and implications of discontinued operations, extraordinary items, accounting changes, nonrecurring charges, and comprehensive earnings.
- Demonstrates horizontal and vertical analysis of **Kellogg**.
- Discusses factors that affect the quality of earnings.
- In an appendix, applies comprehensive ratio analysis to real companies—**Kellogg** and **General Mills**.

Appendix A, Specimen Financial Statements: Tootsie Roll Industries, Inc.

Appendix B, Specimen Financial Statements: Hershey Foods Corporation

Appendix C, Time Value of Money

- Provides coverage of present value and future value of single sums and annuities.

Appendix D, Reporting and Analyzing Investments

- Provides a comprehensive discussion of reporting and analyzing investments.
- Includes a discussion of statement of cash flows presentation of investments.

NEW IN THIS EDITION

The second edition was a tremendous success. In the spirit of continuous improvement, we have made many changes in this edition. These changes come in response to suggestions made by reviewers and focus group participants and comments from users. We sincerely appreciate your input.

- In this edition our “focus companies” are again **Tootsie Roll Industries** and **Hershey Foods**. They were chosen because they have high name recognition with students, they operate primarily in a single industry, and they have relatively simple financial statements. Most importantly, the idea of evaluating candy companies seemed fun. We updated to the *2001 Annual Reports*.
- In order to more closely tie the topic of each chapter to the real world, *Review It* questions relating to Tootsie Roll Industries have been updated in every chapter.
- We have added several Business Insight—Ethics Perspective boxes throughout the book and have included many new Ethics Cases.
- To enhance students’ conceptual understanding of the impact of transactions, accounting equation analyses in

the margins next to each journal entry (beginning in Chapter 5) now provide classification of all items affecting stockholders’ equity.

- Capstone chapter now discusses earnings quality, sustainable earnings, pro forma income, and implications for analysis.
- We have expanded the use of the cash flow statement as an analytical tool in two ways: (1) The effect of transactions on cash flow is now shown throughout the book as part of the marginal accounting equation graphic. (2) Cash flow statement analysis has been integrated in the chapters on debt equity and plant assets.
- To better reflect current practice as well as to reduce procedural detail, we have moved the journal entries for periodic inventory out of Chapter 6 and into an appendix to Chapter 5.
- For greater flexibility of use, we moved straight-line amortization of discounts and premiums into an appendix to the debt chapter (Chapter 10).
- We changed the order in which ratios are presented in the book in order to enhance usefulness for analysis.
- Financial Reporting Problems and Comparative Analysis Problems in the Broadening Your Perspective section use the 2001 annual reports of Tootsie Roll Industries and Hershey Foods.
- Added many new references to real companies and many new brief exercises, exercises, and problems that use real-company data.
- To ensure complete coverage of concepts, we have included 34 new Exercises and 51 new Problems.
- To help students know if they are on the right track as they work homework Problems, we added check figures in the margins.

Chapter 1, Introduction to Financial Statements

- New feature story discussing role of accounting and introducing Tootsie Roll Industries.
- Updated financial statements throughout the chapter.
- New section on ethics in financial reporting.
- New Business Insight boxes on scrutiny of energy company profits and importance of accounting credibility.
- New Interpreting Financial Statements problem.

Chapter 2, A Further Look at Financial Statements

- Updated data for Best Buy, Circuit City, and Tweeter.
- Expanded coverage of complete balance sheet to include more items.
- Moved return on assets ratio and profit margin ratio to later chapters and replaced with earnings per share and price-earnings ratio.
- New Business Insight boxes on the SEC and on earnings announcements.
- New Ethics Case.
- New Global Focus problem.

Chapter 3, The Accounting Information System

- Revised Do It activity.
- Simplified summary of transactions in Illustration 3-2.
- New Financial Analysis on the Web problem.

Chapter 4, Accrual Accounting Concepts

- New Feature Story on revenue recognition and earnings management.
- New Business Insight on Microsoft's "reserve" accounts.
- New illustration to provide visual explanation of closing process.
- New Research Case.
- New Global Focus problem.

Chapter 5, Merchandising Operations and the Multiple-Step Income Statement

- Updated data for Wal-Mart and replaced Kmart with Target.
- New T-account illustration summarizing the effect of purchasing transactions.
- Transactions analysis box in this and subsequent chapters was expanded to provide classification of items affecting stockholders' equity and description of effect of transaction on cash flows.
- New Business Insights on accounting transparency and on Kmart's bankruptcy.
- New section on determining cost of goods sold under a periodic system.
- Replaced operating expense to sales ratio with profit margin ratio.
- Moved presentation of journal entries for periodic inventory system from Chapter 6 into a new appendix to Chapter 5.
- New Research Case.
- New Interpreting Financial Statements problem.

Chapter 6, Reporting and Analyzing Inventory

- Updated data for Caterpillar Corporation and Manitowoc Company.
- Moved section on periodic inventory system to Chapter 5 appendix.
- Simplified discussion of LIFO reserve.
- New Business Insights on inventory management problems at Palm, cases of inventory fraud, and lower of cost or market adjustment at Ford.
- New Interpreting Financial Statements problem.
- New Financial Analysis on the Web problem.
- New Research Case.

Chapter 7, Internal Control and Cash

- New Business Insight on history of internal control.
- New Research Case.
- New Ethics Case.
- Deleted discussion of ratio of cash to daily cash expenses and moved free cash flow to later chapter.

Chapter 8, Reporting and Analyzing Receivables

- Updated data for McKesson and Del Laboratories.
- New Business Insights on online time-keeping and billing for service companies, collecting a bill owed by Russian government, and actions taken by Kmart's creditors.
- Removed credit risk ratio.
- New Research Case.
- New Interpreting Financial Statements problem.
- New Financial Analysis on the Web problem.

Chapter 9, Reporting and Analyzing Long-Lived Assets

- Updated data on Southwest Airlines and AirTran.
- New Business Insights on improper capitalization of expenses by WorldCom and discussion of intangible nature of some Internet domain names.
- Revised discussion on land improvements.
- Replaced average useful life ratio and average age of plant assets with return on assets ratio and a discussion on effect of return on assets and asset turnover on the profit margin ratio.
- New section about fixed asset presentation on statement of cash flows.
- Intangible assets discussion updated to reflect new standard.
- New Research Case.
- New Interpreting Financial Statements problem.

Chapter 10, Reporting and Analyzing Liabilities

- Updated data on General Motors and Ford.
- Simplified discussion on types of bonds.
- Moved discussion of the debt versus equity decision to Chapter 11 and expanded that discussion.
- Added two graphics showing amortization of bond discounts and premiums.
- Moved procedures for amortization of bond discounts and premiums under straight-line method to appendix.
- New Business Insight on choice to issue short- or long-term debt.
- New section about debt presentation on statement of cash flows.
- Revised discussion about off-balance-sheet items and created appendix for more advanced topics on this subject.
- New Research Case.
- New Interpreting Financial Statement problem.
- New Ethics Case.

Chapter 11, Reporting and Analyzing Stockholders' Equity

- Updated data on Nike and Reebok.
- Five new Business Insight boxes on Enron's board of directors, shareholder resolutions, shareholder activism in Japan, dividend payment practices, and reverse stock splits.
- Simplified discussion about par value.
- Moved journal entries for stock dividends to an appendix.
- New section about equity presentation on statement of cash flows.
- Moved earnings per share and price-earnings ratio to earlier chapters.
- New Research Case.
- New Interpreting Financial Statements problem.
- New Global Focus problem.

Chapter 12, Statement of Cash Flows

- Updated data for Microsoft, Oracle, Intel, and AMD.
- New Business Insight on improper manipulation of statement of cash flow data.

- Removed capital expenditure ratio and cash return on sales ratio.
- New Research Case.
- New Global Focus problem.

Chapter 13, Performance Measurement

- New feature story about earnings management.
- Simplified financial statement presentation of irregular items.
- Expanded discussion of comprehensive income.
- New example of a complete income statement and statement of comprehensive income.
- New summary discussion of ratio analysis. Moved comprehensive analysis of Kellogg to appendix.
- New Business Insight on restructuring charges.
- Updated all ratios and financial measures to reflect Kellogg's 2000 and 2001 data.
- New section on quality of earnings, including discussion of pro forma income and improper revenue recognition.

Appendix D, Reporting and Analyzing Investments

- Moved presentation on investments to end-of-book appendix and simplified coverage.
- Added section on statement of cash flows presentation of investments.

PROVEN PEDAGOGICAL FRAMEWORK

In this book we have used many proven pedagogical tools to help students learn accounting concepts and apply them to decision making in the business world. This pedagogical framework emphasizes the *processes* students undergo as they learn.

Learning How to Use the Text

- The text begins with a **Student Owner's Manual**, which helps students understand the value of the text's learning aids and how to use them. After becoming familiar with the pedagogy, students can take a **Learning Styles Quiz** (p. xxvi) to help them identify how they learn best—visually, aurally, through reading and writing, kinesthetically, or through a combination of these styles. They then will find tips on in-class and at-home learning strategies, as well as help in identifying the text features that would be most useful to them based on their learning style.
- Additionally, Chapter 1 contains notes (printed in red) that explain each learning aid the first time it appears.
- **The Navigator** pulls all the learning aids together into a learning system. It is designed to guide students through each chapter and help them succeed in learning the material. The Navigator consists of (1) a checklist at the beginning of the chapter, which outlines text features and study aids students will need in order to master the topics, and (2) a series of check boxes that prompt students to use the learning aids and set priorities as they study. At the end of the chapter, students are reminded to return to The Navigator to check off their completed work.

THE NAVIGATOR ✓	
■ Scan <i>Study Objectives</i>	☐
■ Read <i>Feature Story</i>	☐
■ Read <i>Preview</i>	☐
■ Read text and answer <i>Before You Go On</i>	
p. 58 ☐	p. 63 ☐
p. 72 ☐	p. 75 ☐
■ Work <i>Using the Decision Toolkit</i>	☐
■ Review <i>Summary of Study Objectives</i>	☐
■ Work <i>Demonstration Problem</i>	☐
■ Answer <i>Self-Study Questions</i>	☐
■ Complete <i>Assignments</i>	☐

Understanding the Context

- **Study Objectives**, listed at the beginning of each chapter, form a learning framework throughout the text. Each objective is repeated in the margin at the appropriate place in the main body of the chapter and again in the **Summary of Study Objectives**. Also, end-of-chapter assignment materials are linked to the Study Objectives.
- A chapter-opening **Feature Story** presents a scenario that helps students picture how the chapter topic relates to the real world of accounting and business situations. It also serves as a recurrent example in the chapter. Each story that focuses on a well-known company ends with the company's Web address to encourage students to go online for more information about these companies.
- A chapter **Preview** links the chapter-opening Feature Story to the major topics of the chapter. First, an introductory paragraph explains how the story relates to the topics to be discussed, and then a graphic outline of the chapter provides a "road map," useful for seeing the big picture as well as the connections between subtopics.

Learning the Material

- This book emphasizes the accounting experiences of **real companies and business situations throughout**, from chapter-opening Feature Stories to the chapter's last item of homework material. Details on these many features follow. In addition, every chapter uses accounting practices of real companies. Names of real companies are highlighted in red, and many of these real-world examples and illustrations are identified by a company logo.
- Continuing the real-world flavor of the book, **Business Insight** boxes in each chapter give students glimpses into how real companies make decisions using accounting information. The boxes, highlighted with striking photographs, focus on four different accounting perspectives—those of managers, investors, international business, and ethics.

- Color **illustrations** support and reinforce the concepts of the text. **Infographics** help students visualize and apply accounting concepts to the real world. These infographics often portray important concepts in entertaining and memorable ways. When illustrations present financial statements or computations, numbers or categories are highlighted in colored type to draw students' attention to key information.
- **Before You Go On** sections occur at the end of each key topic and consist of two parts: **Review It** serves as a learning check within the chapter by asking students to stop and answer knowledge and comprehension questions about the material just covered. **Review It** questions marked with the Tootsie Roll icon send students to find information in Tootsie Roll Industries' 2001 annual report, which is packaged with new copies of the book and printed in Appendix A at the back of the book. These exercises help cement students' understanding of how topics covered in the chapter are reported in real-world financial statements. Answers appear at the end of the chapter. **Do It** is a brief demonstration problem that gives immediate practice using the material just covered. An **Action Plan** lists the steps necessary to complete the task, and a **Solution** is provided to help students understand the reasoning involved in reaching an answer.
- **Accounting Equation analyses** are found in the margin next to key journal entries. They reinforce students' understanding of the impact of an accounting transaction on the financial statements. In this edition, we have expanded these analyses in two ways: Each analysis now provides more explanation of the nature of transactions affecting equity. Second, each analysis now reports the cash effect of each transaction, to reinforce the student's understanding of the difference between cash effects versus accrual accounting.
- **Helpful Hints** in the margins expand upon or help clarify concepts under discussion in the nearby text. This feature actually makes the book an Annotated *Student Edition*.
- **Key terms** and concepts are printed in blue where they are first explained in the text and are defined again in the end-of-chapter glossary. **Alternative Terminology**



notes in the margins present synonymous terms that students may come across in subsequent accounting courses and in business.

- Marginal **International Notes** provide a helpful and convenient way for instructors to begin to expose students to international issues in accounting, reporting, and decision making.
- Each chapter presents **decision tools** that are useful for analyzing and solving the business problems discussed in that chapter. At the end of the text discussion relating to the decision tool, a **Decision Toolkit** summarizes the key features of that decision tool and reinforces its purpose. For example, Chapter 8 presents the receivables turnover ratio and average collection period as tools for use in analyzing receivables. At the end of that discussion is the Toolkit you see below.
- A **Using the Decision Toolkit** exercise, which follows the final Before You Go On section in the chapter, asks students to use the decision tools presented in that chapter. Students evaluate the financial situation of a real-world company, often using ratio analysis to do so. In most cases the company used in this analysis is a competitor of the example company in the chapter. For example, in Chapter 11, Nike was analyzed as the example company in the chapter discussion, so Reebok is analyzed in the Using the Decision Toolkit at the end of the chapter. Such comparisons expand and enrich the analysis and help focus student attention on comparative situations that flavor real-world decision making.

Putting It Together

At the end of each chapter, between the body of the text material and the homework materials, are several features useful for review and reference:

- A **Summary of Study Objectives** reviews the main points of the chapter; the **Decision Toolkit—A Summary** presents in one place the decision tools used throughout the chapter; and a **Glossary** of important terms gives definitions with page references to the text. A **CD icon** tells students that there is a Key Term Matching Activity on the *Financial Accounting* CD-ROM that can help them master the material.
- Next, a **Demonstration Problem** gives students another opportunity to refer to a detailed solution to a

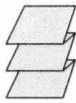
DECISION TOOLKIT

Decision Checkpoints 	Info Needed for Decision 	Tool to Use for Decision 	How to Evaluate Results 
Are collections being made in a timely fashion?	Net credit sales and average receivables balance	$\text{Receivables turnover ratio} = \frac{\text{Net credit sales}}{\text{Average gross receivables}}$ $\text{Average collection period} = \frac{365 \text{ days}}{\text{Receivables turnover ratio}}$	Average collection period should be consistent with corporate credit policy. An increase may suggest a decline in financial health of customers.

representative problem before they do homework assignments. An **Action Plan** presented in the margin lists strategies to assist students in understanding the solution and help establish a logic for approaching similar problems.

Developing Skills Through Practice

Throughout the homework material, certain questions, exercises, and problems make use of the decision tools presented in the chapter. These are marked with the icon . Others can be solved using the new **General Ledger Software**, available with this edition of the text. These are marked with the icon shown at left. The financial results of real companies are included in many  exercises and problems; these are indicated by the company name shown in red.

- **Self-Study Questions** comprise a practice test to enable students to check their understanding of important concepts. These questions are keyed to the Study Objectives, so students can go back and review sections of the chapter in which they find they need further work. Answers appear on the last page of the chapter. A **Web icon** and a **CD icon** tell students that they can answer the Self-Study Questions in an interactive format on the text's CD-ROM or Web site. They can also take an additional Self-Test on the Web site to further help them master the material.
- **Questions** provide a full review of chapter content and help students prepare for class discussions and testing situations.
- **Brief Exercises** build students' confidence and test their basic skills. Each exercise focuses on a single **Study Objective**.
- Each of the **Exercises** focuses on one or more of the **Study Objectives**. These tend to take a little longer to complete and present more of a challenge to students than Brief Exercises. The Exercises help instructors and students make a manageable transition to more challenging problems. Certain exercises, marked with a , help students practice business writing skills. The **Web icon** indicates that students can complete certain exercises in an interactive format on the text's Web site.
- **Problems** stress the application of the concepts presented in the chapter. Two sets of problems—A and B—have corresponding problems keyed to the same **Study Objectives**, thus giving instructors greater flexibility in assigning homework. **Check figures** in the margin next to select Problems provide key numbers to let students know they are on the right track. Certain problems, marked with an icon , help build business writing skills.
- Each Brief Exercise, Exercise, and Problem has a **description of the concept** covered and is keyed to the Study Objectives.
- **Spreadsheet Exercises and Problems**, identified by an icon, can be solved using *Solving Financial Accounting Problems Using Excel*. 
- Problems marked with the **Peachtree** icon can be worked using *Peachtree Complete Accounting to Ac-*

company Financial Accounting, Third Edition. A separate student workbook that includes the software is available for purchase.



Expanding and Applying Knowledge

Broadening Your Perspective is a unique section at the end of each chapter that offers a wealth of resources to help instructors and students pull together the learning for the chapter. This section offers problems and projects for those instructors who want to broaden the learning experience by bringing in more real-world decision making, analysis, and critical thinking activities. The elements of the **Broadening Your Perspective** section are as follows.

- **Financial Reporting and Analysis** problems use financial statements of real-world companies for further practice in understanding and interpreting financial reporting. A **Financial Reporting Problem** in each chapter directs students to study various aspects of the financial statements of Tootsie Roll Industries, Inc., which are printed in Chapter 1 (in simplified form) and in Appendix A (in full). A **Comparative Analysis Problem** offers the opportunity to compare and contrast the financial reporting of Tootsie Roll Industries, Inc., with a competitor, Hershey Foods Corporation. Since the ability to read and understand business publications is an asset over the span of one's career, **Research Cases** direct students to the *Wall Street Journal* and other business periodicals and references for further study and analysis of key topics. The **Interpreting Financial Statements** problems offer one or more minicases per chapter that ask students to read parts of financial statements of actual companies and use the decision tools presented in the chapter to interpret this information. A **Global Focus** problem asks students to apply concepts presented in the chapter to specific situations faced by actual international companies. **Financial Analysis on the Web** problems guide students to Web sites from which they can mine and analyze information related to the chapter topic.
- **Critical Thinking** problems offer additional opportunities and activities. The **Group Decision Cases** help promote group collaboration and build decision-making skills by analyzing accounting information in a less structured situation. These cases require teams of students to evaluate a manager's decision or they lead to a decision among alternative courses of action. They also give practice in building business communication skills. **Communication Activities** provide practice in written communication—a skill much in demand among employers. **Ethics Cases** describe typical ethical dilemmas and ask students to analyze the situation, identify the ethical issues involved, and decide on an appropriate course of action.

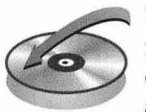
ACTIVE TEACHING AND LEARNING SUPPLEMENTARY MATERIAL

Financial Accounting, Third Edition, features a full line of teaching and learning resources. Driven by the same basic beliefs as the textbook, these supplements provide a consistent and well-integrated active learning system.

This hands-on, real-world package guides *instructors* through the process of active learning and gives them the tools to create an interactive learning environment. With its emphasis on activities, exercises, and the Internet, the package encourages *students* to take an active role in the course and prepares them for decision making in a real-world context.



Financial Accounting Web Site at www.wiley.com/college/kimmel As a resource and learning tool for both instructors and students, the *Kimmel Financial Accounting* Web Site serves as a launching pad to numerous activities, resources, and related sites. On the Web site, instructors will find electronic versions of all instructor resources including the *Solutions Manual*, *Instructor's Manual*, *Test Bank*, *Computerized Test Bank*, and *PowerPoint* presentations. Students will find *interactive quizzing*, *PowerPoint*, *Interactive Homework Exercises*, *Business Extra*, *company links*, *annual reports*, and much more. Visit the site often for updates and new materials.



Take Action! CD-ROM A very exciting element that is available for purchase with this edition of *Financial Accounting* is the interactive *Take Action!* CD-ROM. The CD has three main sections that address the needs and interests of today's student:

- **Learning Techniques** contains resources to improve student study skills. It includes a *Learning Styles Quiz*, a *Writing Handbook*, and a *walkthrough* detailing how to effectively use the financial accounting text.
- **Course Materials** contains resources that reinforce and supplement concepts discussed in the main text. An exciting feature in this section of the CD are the *interactive tutorials* aimed at strengthening a student's basic understanding of important elements of the course. Employing audio and graphics, the many tutorials parallel the text's coverage of topics such as analyzing and recording business transactions, making adjusting entries, preparing financial statements, depreciation, bad debt, and inventory cost flow. An annual report walkthrough and instructions on how to use a work sheet are discussed in other tutorials. To provide additional practice, the CD also contains interactive *Self-Tests* with feedback and a *Key Terms Matching Activity*. Also included are features such as *video clips*, a *Database of Real Companies*, and *Interpreting the Financial Statement Activities*.
- **Career Paths** contains resources such as *Why Accounting Is Important*, a feature illustrating career opportunities and demonstrating that accounting knowledge is important to people in all lines of business. The *Careers in Accounting* section discusses the role of accounting in society. The *Professional Profiles* section includes interviews with accounting and nonaccounting professionals.

Instructor's Active Teaching Aids

Instructor's Resource CD-ROM. The Instructor's Resource CD (**IR CD**) provides all instructor support mate-

rial in an electronic format that is easy to navigate and use. The IR CD contains an electronic version of instructor print supplements that can be used in the classroom, for printing out material, for uploading to your own Web site, or for downloading and modifying. The IR CD gives you the flexibility to access and prepare instructional material based on your individual needs.

Solutions Manual. The Solutions Manual contains detailed solutions to all exercises and problems in the textbook and suggested answers to the questions and cases. Each chapter includes an *assignment classification table*, an *assignment characteristics table*, and a *Bloom's taxonomy table*. The Solutions Manual has been carefully verified by a team of independent accuracy checkers. (Also available at www.wiley.com/college/kimmel and on the IR CD.)

Solutions Transparencies. Packaged in an organizer box with chapter file folders, these transparencies feature detailed solutions to all exercises and problems in the textbook as well as suggested answers to the Broadening Your Perspective activities. They feature large, bold type for better projection and easy readability in large classroom settings.

Instructor's Manual. The Instructor's Manual is a comprehensive set of resources for preparing and presenting an active learning course. The manual includes information on group and active learning, and has sample syllabi for use with the textbook. The Instructor's Manual also includes a series of discussions on how to incorporate ethics material and communication activities in the classroom.

In addition to *comprehension checks* and *short vocabulary and multiple-choice quizzes*, each chapter also includes a number of activities and exercises designed to engage students in the learning process. Some of these activities include *Research and Communication exercises*, *International and Social Responsibility exercises*, and *Ethics exercises*. (Also available at www.wiley.com/college/kimmel and on the IR CD.)

PowerPoint Presentation Material. This PowerPoint lecture aid contains a combination of key concepts, images, and problems from the textbook for use in the classroom. Designed according to the organization of the material in the textbook, this series of electronic transparencies can be used to visually reinforce financial accounting principles. (Available at www.wiley.com/college/kimmel and on the IR CD.)

Test Bank. The Test Bank is a comprehensive testing package that allows instructors to tailor examinations according to study objectives, learning skills, and content. It features over 3,000 examination questions, with an emphasis on concepts, decision-making, and the real-world environment. Actual financial statements are used throughout to provide a relevant context for questions.

In addition to a *final exam*, the Test Bank provides an *achievement test for every two chapters* in the textbook and a *comprehensive exam for every four chapters* of the text.

The tests, easy to photocopy and distribute to students, consist of problems and exercises as well as multiple-choice, matching, and true/false questions. (Also available at www.wiley.com/college/kimmel and on the IR CD.)

Computerized Test Bank. This software allows instructors to create and print multiple versions of the same test by scrambling the order of all questions found in the print Test Bank. The computerized test bank also allows users to customize exams by altering or adding new problems. (Available at www.wiley.com/college/kimmel and on the IR CD.)

Wiley Nightly Business Report Video. This video contains a series of video clips from the *Nightly Business Report* that are related to some of the actual companies discussed in the text. Each of the segments is approximately 3 to 5 minutes long and can be used to introduce topics to students, enhance lecture material, and provide a real-world context for important financial accounting concepts. Suggestions for integrating the material into the classroom are included in the Video Instructor's Manual.

WebCT and Blackboard. WebCT or Blackboard offers an integrated set of course management tools that enable instructors to easily design, develop, and manage Web-based and Web-enhanced courses.

The Wiley *Financial Accounting*, Third Edition, WebCT and Blackboard courses contain the basic course management shell with all on line resources for students. It allows the professor to present all or part of a course online and helps the student organize the course material, understand key concepts, and access additional tools. Your Wiley WebCT and Blackboard course can be customized to fit individual, professor needs. Contact your Wiley representative for more information.

Interactive Homework Management System. A wide variety of end-of-chapter materials are available online in Wiley's new homework management environment. This interactive environment allows instructors the ability to monitor and assess students' grasp of end-of-chapter materials. Please contact your local Wiley sales representative for more details.

Students' Active Learning Aids

Student Workbook. The Student Workbook is a comprehensive review of financial accounting and is a powerful tool when used in the classroom and in preparation for exams. The workbook guides students through chapter content while focusing on study objectives and the decision-making process.

Each chapter contains *objectives, reviews, exercises, a demonstration problem, and true/false, multiple-choice, and matching questions.* Solutions to exercises and questions are written with detail in order to effectively provide immediate feedback. A *chapter outline* and *blank working papers* allow students space to take lecture notes and record problems worked in class.

Working Papers. Working Papers are accounting forms for all end-of-chapter exercises, problems, and cases. A convenient resource for organizing and completing homework assignments, they demonstrate how to correctly set up solution formats and are directly tied to textbook assignments.

Annual Report Project. This practice set is designed to provide students the opportunity to analyze a corporate annual report. The practice set provides hands-on exposure to financial statements of actual companies, emphasizes the importance of the notes to financial statements, and provides an opportunity to examine the application of procedures and methods discussed in the main text.

Beacon Lumber Practice Set. This practice set introduces students to many of the most common business events and shows how to record them in standard accounting format through a series of classroom discussions, role playing, and homework assignments. By getting involved in the ongoing activity of a typical small company, students begin to draw connections between the everyday work of ordinary business and the rules of accounting.

Excel Working Papers. Available on CD-ROM, these Excel-formatted forms can be used for end-of-chapter exercises, problems, and cases. An electronic version of the print Working Papers, the Excel Working Papers provide students with the option of printing forms and completing them manually, or entering data electronically and then printing out a completed form. By entering data electronically, students can paste homework to a new file and e-mail the work sheet to the instructor.

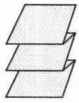
General Ledger Software. The General Ledger Software program allows students to solve select end-of-chapter text problems or customized problems using a computerized accounting system. Easy to use, GLS demonstrates the immediate effects of each transaction and enables students to enter and post journal entries and generate trial balances and financial statements. This upgraded 32-bit software contains a voice-guided tour of GLS and allows students to create their own data diskette.



Peachtree Complete® Accounting Software, Problems, & Workbook. This workbook teaches students how to effectively use Peachtree Complete® Accounting Software, a valuable accounting tool, and also reviews basic accounting concepts. The Peachtree Software provided on a CD attached to the workbook, allows students to see the effects of journal entries on balance sheets, income statements, and other accounting forms. Many of the problems in the workbook are derived from select problems found in the main text.



Solving Financial Accounting Problems Using Excel for Windows. This workbook contains Excel templates that allow students to complete select end-of-chapter exercise



and problems identified by a spreadsheet icon in the margin of the main text. A useful introduction to computers, this package details how to work with preprogrammed spreadsheets and it instructs on how to design a spreadsheet.

Interactive Homework Quizzing. The *Kimmel Financial Accounting*, Third Edition, Web site links students to interactive financial accounting exercises. These exercises, derived from end-of-chapter Exercises in the text, provide students with immediate feedback on their work. Many of the exercises contain an algorithmic function that allows students to work through the same exercise with different data every time the exercise file is opened. Students can keep practicing until they reach the level of success they desire.

Financial Accounting Tutor (FAcT). FAcT is a self-paced CD-ROM tutorial designed to review financial accounting concepts. It uses simple examples that have been carefully crafted to introduce concepts gradually. Throughout, the program emphasizes the logic underlying the accounting process. FAcT uses interactive and graphical tools to enhance the learning process. Intuitive navigation and a

powerful search mechanism allow students to easily follow the tutorial from start to finish or skip to the topics they want to complete. The discussions and examples are followed by brief, interactive problems that provide immediate feedback. Built-in tools, such as an on-line financial calculator, help solve the problems.

Business Extra Web Site at www.wiley.com/college/businessextra. The Business Extra Web Site gives you instant access to a wealth of current articles dealing with all aspects of accounting. The articles are organized to correspond to the chapters of this textbook, and discussion questions follow each article. Articles referred to in the end-of-chapter Research Cases are available at the Business Extra site. To access Business Extra, you will need to purchase the "Doing Business in Turbulent Times" booklet.

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Suggestions and comments from users are encouraged and appreciated. Please feel free to e-mail any one of us at account@wiley.com.

Paul D. Kimmel
 Jerry J. Weygandt
 Donald E. Kieso

STUDENT OWNER'S MANUAL

HOW TO USE THE STUDY AIDS IN THIS BOOK

CHAPTER

2

A Further Look at Financial Statements

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Explain the meaning of generally accepted accounting principles and describe the basic objective of financial reporting.
- 2 Discuss the qualitative characteristics of accounting information.
- 3 Identify two constraints in accounting.
- 4 Identify the sections of a classified balance sheet.
- 5 Identify and compute ratios for analyzing a company's profitability.
- 6 Explain the relationship between a retained earnings statement and a statement of stockholders' equity.
- 7 Identify and compute ratios for analyzing a company's liquidity and solvency using a balance sheet.
- 8 Identify and compute ratios for analyzing a company's liquidity and solvency using a statement of cash flows.



THE NAVIGATOR

- Scan Study Objectives ☐
- Read Feature Story ☐
- Read Preview ☐
- Read text and answer Before You Go On
p. 58 ☐ p. 63 ☐ p. 69 ☐
p. 72 ☐ p. 75 ☐
- Work Using the Decision Toolkit ☐
- Review Summary of Study Objectives ☐
- Work Demonstration Problem ☐
- Answer Self-Study Questions ☐
- Complete Assignments ☐

The **Navigator** is a learning system designed to guide you through each chapter and help you succeed in learning the material. It consists of (1) a checklist at the beginning of the chapter, which outlines text features and study aids you will need; and (2) a series of check boxes that prompt you to use the learning aids in the chapter and set priorities as you study.

FEATURE STORY

Just Fooling Around?

Few people could have predicted how dramatically the Internet would change the investment world. One of the most interesting results is how it has changed the way ordinary people invest their savings. More and more people are spurning investment professionals and instead are striking out on their own, making their own investment decisions.

Two early pioneers in providing investment information to the masses were Tom and David Gardner, brothers who created an online investor bulletin board called the Motley Fool. The name comes from

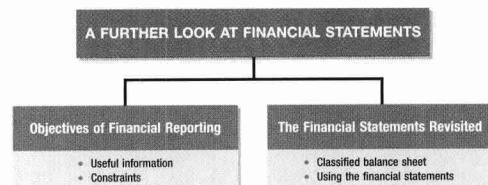
The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business. References to the Feature Story throughout the chapter will help you put new ideas in context, organize them, and remember them. Each one ends with the Internet addresses of the companies cited in the story.

Study Objectives at the beginning of each chapter give you a framework for learning the specific concepts covered in the chapter. Each study objective reappears in the margin where the concept is discussed. Finally, you can review the study objectives in the **Summary** at the end of the chapter text.

The **Preview** links the Feature Story with the major topics of the chapter and describes the purpose of the chapter. It then outlines the topics that are discussed. This narrative and visual preview helps you organize the information you are learning.

If you are thinking of purchasing Best Buy stock, or any stock, how can you decide what the stock is worth? If you own a stock, how can you determine whether it is time to buy more stock—or time to bail out? Your decision will be influenced by a variety of considerations; one should be your careful analysis of a company's financial statements. The reason: Financial statements offer relevant and reliable information, which will help you in your stock purchase decisions.

In this chapter we begin by looking at the objectives of financial reporting. We then take a closer look at the balance sheet and introduce some useful ways for evaluating the information provided by the statements.



SECTION 1

OBJECTIVES OF FINANCIAL REPORTING

Financial reporting is the term used to describe all of the financial information presented by a company—both in its financial statements and in additional disclosures provided in the annual report. For example, if you are deciding whether to invest in Best Buy stock, you need financial information to help make your decision. Such information should help you understand Best Buy's past financial performance and its current financial picture, and give you some idea of its future prospects. Although information found on electronic bulletin boards like the Motley Fool is useful, it is no substitute for careful study of financial reports. The primary objective of financial reports is to provide information that is useful for decision making.

A company *can* change to a new method of accounting if management can justify that the new method produces more useful financial information. In the year in which the change occurs, the change must be disclosed in the notes to the financial statements so that users of the statements are aware of the lack of consistency.

The characteristics that make accounting information useful are summarized in Illustration 2-1.

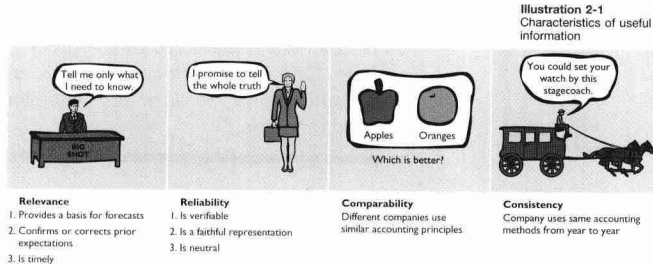


Illustration 2-1
Characteristics of useful information

Color illustrations, such as this **infographic**, help you visualize and apply information as you study. They reinforce important concepts and therefore often contain material that may appear on exams.

CONSTRAINTS IN ACCOUNTING

The characteristics we have discussed are intended to provide users of financial statements with the most useful information. Taken to the extreme, however, efforts to provide useful financial information could be far too costly to the company. Therefore, constraints have been agreed upon to ensure that accounting rules are applied in a reasonable fashion, from the perspectives of both the company and the user. **Constraints** permit a company to apply generally accepted accounting principles without jeopardizing the usefulness of the reported information. The constraints are materiality and conservatism.

MATERIALITY

Materiality relates to a financial statement item's impact on a company's overall financial condition and operations. An item is **material** when its size makes it likely to influence the decision of an investor or creditor. It is **immaterial** if it is too small to impact a decision maker. In short, if the item does not make a difference, GAAP does not have to be followed. To determine the materiality of an amount—that is, to determine its financial significance—the item is compared with such items as total assets, sales revenue, and net income.

To illustrate how the constraint of materiality is applied, assume that Best Buy made a \$100 error in recording revenue. Best Buy's total revenue is \$10 billion; thus a \$100 error is not material.

CONSERVATISM

Conservatism in accounting means that when preparing financial statements, a company should choose the accounting method that will be least likely to overstate assets and income. It **does not mean, however, that one should intentionally understate assets or income.**

STUDY OBJECTIVE
1
Identify two constraints in accounting.

Study Objectives reappear in the margins where the related topic is discussed. End-of-chapter assignments are keyed to study objectives.

Helpful Hints in the margins are like having an instructor with you as you read. They further clarify concepts being discussed.

Helpful Hint In late 1999, the SEC issued stricter rules on materiality because it felt that too often companies were using materiality as an excuse not to report certain losses.

ferred to as generally accepted accounting principles (GAAP). They are determined by standard-setting bodies in consultation with the accounting profession and the business community.

The Securities and Exchange Commission (SEC) is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB). The FASB's overriding criterion is that the accounting rules should generate the most **useful** financial information for making business decisions. To be useful, information should possess these qualitative characteristics: relevance, reliability, comparability, and consistency.



BUSINESS INSIGHT Investor Perspective

In the aftermath of Enron, much attention has turned toward the Securities and Exchange Commission (SEC). In 2000, companies filed 98,000 reports with the SEC, 14,000 of which were annual reports. But budget shortfalls and staffing limitations meant that the SEC was able to review only 2,280 of these annual reports. As a result of SEC reviews, companies are often required to improve the disclosures in their annual report. Enron's report had not been reviewed since 1997.



RELEVANCE

Information of any sort is relevant if it would influence a decision. Accounting information is relevant if it would make a difference in a business decision. For example, when Best Buy issues financial statements, the information in the statements is considered relevant because it provides a basis for forecasting Best Buy's future earnings. Accounting information is also relevant to business decisions because it confirms or corrects prior expectations. Thus, Best Buy's financial statements help **predict** future events and **provide feedback** about prior expectations for the financial health of the company.

In addition, for accounting information to be relevant it must be **timely**. That is, it must be available to decision makers before it loses its capacity to influence decisions. In order to increase the timeliness of financial reports, the SEC recently required that companies provide their annual report to investors within 60 days of their year-end. They had previously been allowed up to 90 days.

STUDY OBJECTIVE
2
Discuss the qualitative characteristics of accounting information.

Business Insight examples give you more glimpses into how actual companies make decisions using accounting information. These high-interest boxes are classified by four different points of view—ethics, investor, international, and management.

Key terms and concepts are printed in blue where they are first explained in the text. They are listed and defined again in the end-of-chapter **Glossary**.