FINANCIAL ACCOUNTING

REPORTING AND ANALYSIS

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Financial Accounting: Reporting and Analysis

Fifth Edition

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Preface

We have worked hard to make *Financial Accounting: Reporting and Analysis*, fifth edition, the most interesting, relevant, and understandable financial accounting text available. The objective of *Financial Accounting: Reporting and Analysis* is to prepare students to succeed as future business managers. Therefore, the important themes of the text are the business context of accounting, the interaction between accounting and business, and financial statement analysis. The target audience for the book is first-year MBA students. We believe that the book will also be attractive for use in high-quality undergraduate programs. We have consciously written the text for future business managers, not for future accountants.

"The analysis material is strong. I like the use of real-world situations that require higher order thinking skills. Many of the questions require the student to assume a businessperson role and respond appropriately."
Mary Lea McAnally
University of Texas—Austin

Through this textbook, we attempt to convince students that financial statements are a useful and interesting tool for diagnosing a company's problems (or strengths) and for making loan, investment, acquisition, employment, political decisions, and so on. We also hope to convince students that the economic and political forces operating on practicing accountants, Big 5 auditors, and accounting standard setters (both in the U.S. and internationally) make the field of financial accounting an intellectually fascinating one.

Along with many other instructors, we have learned through experience that the way to teach financial accounting is to repeatedly hammer home the business relevance of accounting. The beautiful thing about teaching financial accounting is that actual examples from real companies are available daily through the business press and through public disclosure of financial reports (increasingly made over the Web). We take advantage of this wealth of material by building each chapter around the most recent financial statements of a well-known company. Using actual financial statements in this way has at least two benefits. First, just the mention of a real company name (McDonald's, Microsoft, DuPont, Sears) creates an image in the student's mind and increases attentiveness. Second, we can take advantage of students' everyday consumer experiences to link accounting terminology and practice with actual events that they already understand very well. For example, the concept of unearned revenue is easy for students to understand when they remember the last time they bought air tickets from Delta or United and consider the practical accounting implications of the delay between the ticket purchase and the actual flight.

"I was very impressed with the clarity of the writing. Many students feel intimidated as they begin a course in accounting, and I believe that the authors' straightforward presentation will help them relax and learn."
Keith E. Smith
The George Washington University

We have attempted to make our writing intuitive and lively. Our objective (or dream) is that students will actually enjoy reading the chapters. We have found in teaching that our excitement and enthusiasm about accounting motivates students to listen more carefully, to study a little harder, and to retain a little better. We have tried to accomplish the same thing in writing this book.

Text Features

Early Coverage of Financial Statement Analysis. We believe that MBA students should be exposed to financial statement analysis in the early chapters of an introductory financial accounting text. We introduce students to some simple analysis in chapters 1 and 2. Chapter 3 (Introduction to Financial Statement Analysis) provides a simple, yet effective, framework for analyzing financial statements. Each subsequent chapter contains analytical techniques related to the chapter concepts. Finally, chapter 16 highlights the impact that accounting assumptions have on the values of financial ratios.

Financial Analysis Cases. After each major part of the text, a Financial Analysis Case reinforces and emphasizes the accounting issues covered in that part. Each case is based on current data for real companies. The cases are one to two pages long and include questions for students and three or four additional pages of accounting information. The five companies examined in the cases are:

IBM   Procter & Gamble   Intel   AT&T   Coca-Cola

Increased Coverage of Statement of Cash Flows. We introduce the statement of cash flows in chapter 2, cover it in detail in chapter 6, and include relevant cash flow material in each of the later chapters. We believe that our coverage of the statement of cash flows is more complete and pervasive than in any other financial accounting textbook.

Integrated International Topics. We integrate international topics into each chapter. Examples of the type of topics we include are:

Interpreting foreign financial statements
Harmonization of international accounting standards
Accounting issues faced by U.S. multinationals
Cross-border transactions

Less Emphasis on Journal Entries and the Accounting Cycle. Journal entries are not covered or used in the text discussion until chapter 7. After that, they are used sparingly. We emphasize the journal entry as a Tool of Analysis.

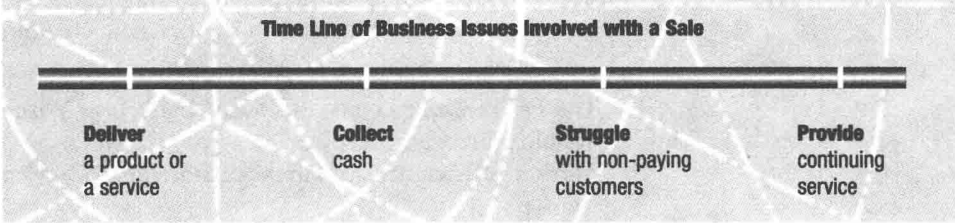
Key Points. The Key Points are a small but, we think, significant twist on the standard "Learning Objectives" found at the beginning of chapters. The purpose of the Key Points is twofold: to outline what is covered in the chapter and also to briefly teach some of the main points to be covered. For example, a Key Point not only notifies the student that something called the "balance sheet" is covered in the chapter, but also very briefly explains what a "balance sheet" is.

"I enjoyed reading the business profiles—they provide context that is often lacking from accounting texts."
George Sanders
Western Washington University

Business Profile. These profiles are thumbnail sketches of the history and current operations of prominent real companies. The business environment of the company profiled is tied into one or more of the accounting issues to be covered in the chapter. Companies spotlighted in these profiles include:

Berkshire Hathaway	DuPont	McDonald's
Circle K	Exxon	Safeway
DaimlerChrysler	General Electric	Sears
Disney	General Motors	Wal-Mart
Dow Jones	Home Depot	

Activity Timeline. Each timeline illustrates the sequence of the primary business events underlying the accounting issues explained in a chapter. An example for the Revenue Cycle (chapter 8) is given below.



The timeline is then used to explain how these business issues naturally require accountants to develop accounting procedures and estimates in order to properly represent the business activities of the company in the financial statements. For example, the accounting issues associated with the Revenue Cycle Timeline are as follows:

- When should revenue be recognized: when the good or service is provided, when the cash is collected, or later, when there is no longer any chance that the customer will return the product or demand a refund because of faulty service?
- What accounting procedures are used to manage and safeguard cash as it is collected?
- How do you account for bad debts, that is, customers who don't pay their bills?
- How do you account for the possibility that sales this year may obligate you to make warranty repairs and provide continuing customer service for many years to come?

"I really like the vignettes starting each chapter. They are engaging and informative."
Matthew J. Anderson
Michigan State University

Relationship Among the Financial Statements. This graphical exhibit is a schematic representation of the three primary financial statements (balance sheet, income statement, and statement of cash flows). This exhibit highlights the specific financial statement items to be covered in the chapter. For example, in the inventory chapter (chapter 9), the items highlighted are Inventory (on the balance sheet), Cost of Goods Sold (on the income statement), and Cash Paid for Purchases (on the statement of cash flows). The exhibit also reiterates the relationships among the three primary financial statements: the statement of cash flows explains the balance sheet change in cash, the income statement (along with dividends) explains the balance sheet change in retained earnings, and operating cash flow and net income are related by the accrual adjustments that accountants make to the raw cash flow data.

FYI. The FYI items are interesting little tidbits of information to be boxed into margin notes.

Test Your Intuition. The Test Your Intuition items are short questions requiring students to ponder the economic and business implications of the accounting material just discussed. These items will require the student to use intuition to extrapolate beyond the text material. Solutions are provided in the instructor's solutions manual.

Caution. The Caution items are warnings about common student misunderstandings. We develop these items based on experience we have had with our own students.

Business Context. The Business Context items provide interesting supplemental material, related to the text but outside the flow of the text discussion. Each Business Context item is an original essay between a half page and a page in length. Business Context items in the first few chapters include:

- How to Get Your Own Copy of McDonald's Financial Statements
- The FASB: Can't Live With It and Can't Live Without It
- Should I Incorporate?
- Market Efficiency: Can Financial Statement Analysis Help You Win in the Stock Market?
- Why Does Corporate America Oppose Market Values in the Balance Sheet?
- Do Accountants Record the Most Important Events?

Data Mining. The Data Mining items contain summary financial statement information for a selection of famous companies, along with brief assignments requiring students to analyze the data. These are simple but informative and fun. For example, in chapter 2 (Introduction to the Financial Statements), the students are given a list of the ten U.S. companies with the highest net incomes in 1997 (according to the Fortune 500 list). The students are also given the total market value for each of these companies. The varying relationship between net income and market value for the ten companies illustrates that investors are willing to pay more for the earnings of some companies than for the earnings of others—they will pay $50 for each dollar of current earnings for Microsoft but only $10 for each dollar of current earnings for Ford. Students are asked to go beyond the numbers and think about why this might be. Other Data Mining items from the first few chapters include:

- The Accounting Equation, as applied to the ten U.S. companies with the highest asset totals
- Book-to-Market Ratios for the ten U.S. companies with the highest market values
- Margin and Turnover for five companies from differing industries
- Identifying LBO Targets using cash flow data
- Paid-in Capital, Retained Earnings, and Treasury Stock, computing relative amounts for the five largest companies in the U.S.
- Efficient Use of Working Capital, a comparison of 1993 and 1997 numbers for five large retailers

Web Search. Each Web Search is a short in-text exercise that takes students to an Internet site related to some point in the text discussion.

Review of Key Points. The Key Points from the beginning of the chapter are repeated, along with a short summary of the text discussion related to that Key Point.

Key Terms. All new terms are boldfaced in the text and listed with page references at the end of each chapter. A glossary of all key terms is provided in Appendix C.

End-of-Chapter Material

We are extremely proud of our end-of-chapter material. In addition to high quality exercises and problems, we provide analysis, research, writing, and presentation assignments that are ideal for MBAs.

Questions. These are short questions, usually with no numerical content, that lead students on a sequential review of the text material.

Exercises. The Exercises are usually numerical and cover one specific topic introduced in the chapter.

Problems. The Problems are more involved than are the Exercises and often include coverage of two or more topics introduced in the chapter. In addition, almost all of the Problems include one sub-part labeled "Analysis" that requires students to use the data given in the Problem to make a business decision. A sample of "Analysis" questions associated with the Problems in chapter 2 (Overview of the Financial Statements) is given below:

- ANALYSIS On October 31, 2001, it is announced that Superior Computer Corporation has declared bankruptcy. The assets of Superior will be liquidated, and all debts will be repaid within 60 days. Discuss how the numbers in the balance sheet prepared on October 31, 2001, will be affected by this bankruptcy news.
- ANALYSIS You looked at the income statement of Anasonic's chief competitor and found that the competitor's cost of goods sold is 48% of sales. Compute this percentage for Anasonic, and discuss what might be causing the difference between Anasonic and its competitor.
- ANALYSIS Item (f) states that Ocra paid $15,000 in cash dividends in its first six months of operations. How else might Ocra have used this $15,000? Do you think it was a good idea to pay this cash dividend so soon after Ocra began business? Explain your answer.

Applications & Extensions

Deciphering Actual Financial Statements. These Deciphering problems use actual data (from the most recent year available) for real companies. The problems have students apply the concepts learned in the chapter to real data. Students are also asked to think about how the reported financial numbers, and the relationships among them, relate to the underlying business of the real company. Financial statements examined in the Deciphering problems of the first four chapters include those from the following companies:

A&P	Disney	McDonald's
Boston Celtics	DuPont	Microsoft
Coca-Cola	Ford	PepsiCo
Consolidated Edison	General Motors	Safeway

"I believe the authors have made a significant improvement over other books in including real company disclosures with the introduction of the primary financial statements."
Wayne H. Shaw
Southern Methodist University

International Financial Statements. These problems are very similar to the Deciphering problems, with the added twist that the data are from non-U.S. companies. These problems allow students to see statement formats and terminology that are different from those illustrated in the chapter. In addition, these problems are excellent vehicles through which to discuss the difference between U.S. GAAP and the accounting principles used in other countries. In our opinion, by considering the rationale behind the accounting practices in other countries, students will better understand U.S. practice. In the first few chapters, the reporting practices of DaimlerChrysler, Swire Pacific, and British Telecommunications are the subject of end-of-chapter problems.

Business Memo. These exercises establish some sort of business scenario and then ask students to write a brief (one-page) memo explaining an accounting principle and suggesting a course of action.

Research. The research projects require students (either individually or in groups) to gather data (press releases, financial statements, news articles), perform some kind of analysis, and then report their results, either orally or in writing.

Ethics Dilemma. The Ethics Dilemmas give students a role in a hypothetical scenario involving questionable judgment on an accounting issue. These Dilemmas are good learning exercises on many dimensions—they provide an interesting setting to review accounting concepts, they illustrate that real business people will go to great lengths to manage their financial statements, and they provide a realistic setting in which students can consider their personal ethics.

The Debate. The Debates are based on a polarizing accounting issue covered in the chapter, often reflecting actual debates that have occurred as part of the accounting standard-setting process. This is a group project, with the group being divided into two teams. The teams are instructed as follows: Your teams are NOT to make even-handed, reasonable arguments. Each team is an advocate for a position and should do everything possible (short of lying, of course) to present a convincing case.

Cumulative Spreadsheet. The spreadsheet exercise builds in each chapter. It is based on cash flow difficulties faced by Home Depot at the end of 1985, but a fictitious name (Handyman) is used—we reveal the Home Depot connection in the last chapter. The early assignments simply have the students construct a spreadsheet balance sheet and do a couple of simple manipulations, ratio calculations, and so on. By the end of the text, the spreadsheet will have grown to a five-year forecast of operating cash flow that depends on assumptions about different operating parameters (speed of receivables collection, inventory efficiency, interest rates, sales growth, profitability).

Internet Search. In most cases, the Internet Search asks students to go to the Web to find current financial information about the company featured in the Business Profile at the beginning of the chapter.

Chapter-by-Chapter Changes

Chapter 1, The Nature and Purpose of Financial Accounting, includes a new emphasis on using accounting information to evaluate the performance and health of a business. It also introduces the three primary financial statements (using simple excerpts from the financial statements of McDonald's) and discusses how rapid advancements in information technology and global business are making accounting an important subject to study.

Chapter 2, Overview of the Financial Statements, uses Safeway financial statements to illustrate key concepts. New coverage of financial statements highlights their usefulness and describes the supplemental information found in the accompanying notes. The role of the auditor is described.

Chapter 3, Introduction to Financial Statement Analysis, is a new chapter that introduces financial statement analysis and illustrates key concepts using financial statements from the E.I. DuPont Company. New coverage includes how to use financial ratios, how to prepare and analyze common-size financial statements, and how to apply the DuPont framework. In addition, the power of cash flow ratios is reviewed along with common pitfalls in financial statement analysis.

Chapter 4, The Balance Sheet, is a significantly new chapter that covers the balance sheet with emphasis on understanding the underlying business activities associated with individual asset, liability, and equity accounts. The format of the balance sheet is presented, and the concepts of recognition and valuation are discussed. The balance sheet of Sears is used to discuss individual balance sheet items, and the concepts of asset and financing mix are introduced by comparing Sears with Wal-Mart and J.C. Penney.

Chapter 5, The Income Statement, is a new chapter that provides in-depth coverage of the income statement and uses the income statement of General Motors as the focus of the discussion. In addition, the expanded balance sheet equation is used to analyze operating transactions.

Chapter 6, The Statement of Cash Flows, provides thorough, detailed coverage of the cash flow statement with the use of actual cash flow data from Circle K. An innovative pedagogical approach intuitively links the direct and the indirect methods.

Chapter 7, The Accounting Information System, streamlines the coverage of bookkeeping by combining fourth edition chapters 5, 6, and the bookkeeping module into one chapter with the intent of teaching students to use journal entries and T-accounts as tools of analysis.

Chapter 8, Revenue Cycle, builds on the fourth edition (chapter 7) by adding a new section on the key issue of revenue recognition. Use of the revenue recognition criteria is illustrated with a variety of real examples.

Chapter 9, Expenditure Cycle—Inventory, contains an expanded discussion of the cost accounting issues associated with inventory. The fifth edition also contains more discussion of the use of financial ratios in assessing a company's management of its inventory.

Chapter 10, Expenditure Cycle—Other Operating Items, focuses on the following areas: employee compensation, deferred income taxes, estimated liabilities such as environmental liabilities, and the capitalize versus expense decision.

Chapter 11, Investments in Operating Assets, has significantly increased coverage of the accounting for intangible assets. In addition, the topics of impairment and of fixed asset revaluation (acceptable in many foreign countries) are discussed.

Chapter 12, Investments in Securities, includes a new section on derivatives. The derivatives material explains what a derivative is, how derivatives are used to hedge risk, and the basics of the accounting for derivatives.

Chapter 13, Financing with Debt, has much less reliance on journal entries. In addition, the chapter has extended coverage of leases, with emphasis on the off-balance-sheet aspects of operating leases.

Chapter 14, Financing with Equity, includes more discussion of issues of importance to MBAs such as IPOs, stock picking, and stock buybacks. In addition, the fifth edition includes updated coverage of comprehensive income in the equity section as well as discussion of the equity section of foreign company balance sheets.

Chapter 15, Accounting in a Global Market, continues the innovative coverage in chapter 15 of the fourth edition. The discussion is updated for revisions in the International Accounting Standards, and further coverage is given to the issue of international harmonization of accounting standards.

Chapter 16, Issues in Financial Statement Interpretation: Changing Prices and Alternative Accounting Methods, illustrates the impact accounting assumptions can have on computed financial ratios. In addition, this chapter includes coverage of the impact of inflation on the financial statements.

Ancillary Materials

Instructor's Manual. The instructor's manual contains detailed solutions, including the intermediate calculations, to questions, exercises, problems, and other end-of-chapter materials. The solutions manual has been verified by an independent accounting professor for accuracy.

Test Bank. Prepared by Keith E. Smith, the Test Bank contains over 1,000 test items, including fill-in-the blank, multiple choice, matching, short problems, and short essay questions. Detailed solutions to all questions are included, along with explanations and computations where applicable.

Thomson Learning Testing Tools. All items from the printed test bank are available on disk through Thomson Learning Tools, an automated testing program that allows instructors to create exams by selecting provided questions, modifying existing questions, and adding questions. It is available in Windows and MS-DOS versions and is provided free of charge to instructors at educational institutions who adopt *Financial Accounting: Reporting and Analysis* by Diamond, Stice, and Stice.

PowerPoint™ Lecture System. With over 500 text-specific slides, this comprehensive lecture resource developed by Joseph L. Morris offers summaries and explanations of key chapter concepts.

***Financial Accounting: Reporting and Analysis* Web Site** (http://www.diamond.swcollege.com) A variety of instructor and student resources are available at the text Web site. PowerPoint™ slides are immediately viewable to help students review chapter concepts. In addition, Data Mining Activities and Web search activities build Internet research skills and support key chapter concepts.

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Appreciation is extended to those friends and colleagues who contributed to the Fifth Edition of *Financial Accounting: Reporting and Analysis*. We wish to thank Keven W. Cole for editorial assistance and Melissa Ruff for help with the solutions. We also extend a special thanks to Joseph L. Morris for his conscientious development of the PowerPoint™ Lecture System and to Keith E. Smith for his comprehensive test bank. We would also like to thank Sheila Viel for her continuing role checking the accuracy of the solutions to the problems.

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Michael A. Diamond

Michael A. Diamond serves as Executive Vice Provost of the University of Southern California after being appointed Vice Provost for Planning and Budget, effective July 1, 1995. Prior to that he served as dean of the Leventhal School of Accounting and director of the school's SEC and Financial Reporting Institute from July 1987 through March 31, 1994. During that time period, the Leventhal School of Accounting was consistently ranked as one of the top five accounting programs in the country. He holds a bachelor's degree from the University of California, Berkeley, and master's and Ph.D. degrees from the University of California, Los Angeles. Dr. Diamond is a leader in the accounting education reform movement. He has lectured throughout the United States and in Europe and in China on accounting curriculum revision. His articles have appeared in *Accounting Horizons*, *Journal of Accounting*, and *Harvard Business Review.*

Dr. Diamond is currently (1998–99) president of the American Accounting Association. He has been active for over twenty years in that organization having served as president of the Administrators of Accounting Programs, chair of the New Faculty Consortium committee, and Director of Education in addition to participating on several other association committees. He is also active in the American Institute of CPAs and the California Society of CPAs.

He has taught at California State University, Los Angeles, and has been a visiting professor at the University of California, Berkeley, and the University of California, Los Angeles, prior to becoming dean at the University of Southern California. He also has taught in executive education programs for a number of international accounting firms as well as Fortune 500 companies. Dr. Diamond is the recipient of the California Society of CPAs Faculty Excellence Award for 1993 and was named as one of the "Top 100 Most Influential People in Accounting," in the 1997 issue of *Accounting Today* and again in the Fall 1998 issue.

He and his wife, Elaine, have one son, Jacob.

Earl K. Stice

Earl K. Stice is the PricewaterhouseCoopers Professor of Accounting in the School of Accountancy and Information Systems at Brigham Young University. He holds bachelor's and master's degrees from Brigham Young University and a Ph.D. from Cornell University. Dr. Stice has taught at Rice University, the University of Arizona, and Cornell University, as well as a three-year term at the Hong Kong University of Science and Technology (HKUST). He won the Phi Beta Kappa teaching award at Rice University and was twice selected at HKUST as one of the ten best lecturers on campus. He has published papers in the *Journal of Financial and Quantitative Analysis, The Accounting Review,* and *Issues in Accounting Education,* and his research on stock splits has been cited in *Business Week, Money,* and *Forbes*. Dr. Stice has presented his research results at seminars in the United States, Finland, Taiwan, Australia, and Hong Kong. He is co-author of *Intermediate Accounting*, 13th edition, and *Accounting: Concepts and Applications,* 7th edition. Dr. Stice and his wife, Ramona, are the parents of five children: Derrald, Han, Ryan Marie, Lorien, and Lily.

James D. Stice

James D. Stice is the Distinguished Teaching Professor in the School of Accountancy and Information Systems at Brigham Young University. He holds bachelor's and master's degrees from BYU and a Ph.D. from the University of Washington, all in accounting. Dr. Stice has been on the faculty at BYU since 1988. During that time, he has been selected by graduating accounting students as "Teacher of the Year" on numerous occasions, and he was selected by his peers in the Marriott School of Management at BYU to receive the "Outstanding Teaching Award" in 1995. In 1996, he was selected by BYU to receive a "University Young Scholar" fellowship. Dr. Stice has published articles in *The Accounting Review, Decision Sciences, Issues in Accounting Education, The CPA Journal,* and other academic and professional journals. He is also co-author of *Intermediate Accounting,* 13th edition, and *Accounting: Concepts and Applications,* 7th edition. Dr. Stice and his wife, Kaye, have seven children: Crystal, J.D., Ashley, Whitney, Kara, Skyler, and Cierra.

Brief Contents

Contents

Part 1 Introduction to Financial Statements