

INTERMEDIATE ACCOUNTING

Edition

*Volume I
Chapters 1-14*



Dyckman



Dukes



Davis

INTERMEDIATE ACCOUNTING

Third Edition

Volume I
Chapters 1–14

Thomas R. Dyckman

Ann Whitney Olin Professor of Accounting
Cornell University

Roland E. Dukes

University of Washington

Charles J. Davis

California State University—Sacramento

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VOLUME I CHAPTERS 1–14

INTERMEDIATE ACCOUNTING

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To our wives and families:
Ann, Daniel, James, Linda, David
Phyllis, Peter, Anna
Susan, Nicole, Michael

[ABOUT THE AUTHORS

Thomas R. Dyckman, Ph.D., is Ann Whitney Olin Professor of Accounting and Quantitative Analysis and Associate Dean for Academic Affairs at Cornell University's Johnson Graduate School of Management. In addition to teaching accounting and quantitative analysis, he teaches in Cornell's Executive Development Program. He earned his doctorate degree from the University of Michigan.

He is a former member of the Financial Accounting Standards Board Advisory Committee, and the Financial Accounting Foundation which oversees the FASB. He was president of the American Accounting Association in 1982 and received the association's *Outstanding Educator Award* for the year 1987. He also received the AICPA's *Notable Contributions to Accounting Literature Award* in 1966 and 1977.

Professor Dyckman has extensive industrial experience that includes work with the U.S. Navy and IBM. He has conducted seminars for the University of California Management Development Program and the Credit Bureau Executives' Program, as well as for Ocean Spray, Goodyear, Morgan Guaranty, GTE, Southern New England Telephone, and Goulds Pumps.

Professor Dyckman has coauthored several books and written over 50 journal articles on topics from financial markets to the application of quantitative and behavioral theory to administrative decision making. He has been a member of the editorial boards of *The Accounting Review*, *The Journal of Finance and Quantitative Analysis*, *The Journal of Accounting and Economics* and *The Journal of Management Accounting Research*.

Roland E. (Pete) Dukes, Ph.D., is professor of accounting at the University of Washington where he teaches intermediate and advanced financial accounting at the undergraduate and graduate levels. He has served as chairman of the department of accounting from 1983 to 1992. He received his doctorate from Stanford University.

A member of the American Accounting Association, Professor Dukes has chaired the Annual Meeting Technical Program Planning Committee, the Doctoral Consortium Committee, the Notable Contribution to Accounting Literature Committee, and the Corporate Accounting Policy Seminar Com-

mittee. He has also served as a Distinguished Visiting Faculty for the Doctoral Consortium, as Director of the Doctoral Consortium, and as the Puget Power Affiliate Program Professor of Accounting at the University of Washington from 1986 to 1990. In 1993, Professor Dukes was named the William R. Gregory Accounting Faculty Fellow at the University of Washington.

Professor Dukes has published numerous articles in accounting journals, including *The Accounting Review*, *Journal of Accounting Research*, and the *Journal of Accountancy*. He has served on the editorial boards of *The Accounting Review*, *Journal of Accounting Research*, and *Journal of Accounting Literature*. He has been a consultant to the Financial Accounting Standards Board, and authored the *FASB Research Report* which investigated the effect of SFAS No. 8 on security return behavior. Professor Dukes also has served as a consultant to the Securities and Exchange Commission and to industry and government.

Charles J. Davis, Ph.D., C.P.A., is professor of accounting at California State University, Sacramento and has served as Department Chair. He received his doctorate in accounting from the University of Illinois at Urbana.

Professor Davis has taught in the areas of financial and managerial accounting and auditing at both the intermediate and advanced levels. He has also been active in CPA review programs and has taught internationally. Professor Davis received excellence in teaching awards from both the University of Illinois at Urbana and California State University, Sacramento. In addition, he has been active in student accounting groups on campus.

Professor Davis has written journal articles in accounting and related business fields that appear in *Advances in Accounting*, *Issues in Accounting Education*, and *Journal of Accounting and Public Policy*, and in several health-care fiscal management journals. He serves on the editorial review board of *Advances in Accounting*. He worked as a staff auditor for Peat, Marwick, Mitchell and Company and has served as a consultant to industry and government. Professor Davis is a member of the American Accounting Association.

| PREFACE

| INTRODUCTION

Many current users have responded to our requests to tell us what they liked about the revised edition and what changes they would recommend for this, the *third*, edition. Additionally, our readers note changes in the economic environment that require us to address the new accounting issues raised. The user feedback tells us you appreciated the:

1. Comprehensiveness of the previous edition
2. Real-world chapter introductions
3. Thoroughness of the end-of-chapter materials
4. Emphasis on critical thinking
5. Concept reviews
6. End-of-chapter review problems with accompanying solutions
7. Clear and concise writing style
8. Flexible topic organizational structure

However, you have also told us we need to incorporate more real-world illustrations woven into the text; focus attention on what is happening on the international scene and what new reporting issues are likely to arise; include end-of-chapter material stressing real-world analysis, with writing assignments and the same critical thinking stressed in the chapters; and not increase (and preferably decrease) the length of the text. Your feedback and requests have formed the basis of our revision.

Objectives of the Third Edition

Financial reporting plays a unique role in the allocation of resources in our economy by providing information necessary for informed investment and credit decisions. Because of the importance of the financial reporting process, it is imperative that preparers and users of the information presented in financial statements understand what the data represent and how data are determined. Only then can financial reports be used as a basis for good business decisions. Thus our main goal in writing this text is to help students learn how to determine what information should be reported and how it should be quantified according to generally accepted accounting principles.

An essential element of this goal is to explain *how* and *why* the principles currently governing the financial reporting process have developed. This integra-

tion of theory and practice is the most effective way to impart lasting knowledge, as it gives the student a reason for the existence of an accounting principle rather than merely isolated facts to memorize. We emphasize that accounting principles are decided after considering the diverse views of the parties most affected by financial reporting principles: reporting firms and the investing public. This process results in a continually evolving set of accounting principles, based on a conceptual framework, often reflecting significant compromises.

Another important goal of this edition is to maintain up-to-date and comprehensive coverage of GAAP relating to financial reporting, while reducing the overall size of the text. This text is current as of the date of publication. It includes discussion of recent FASB exposure drafts and coverage of all the relevant new *SFASs* that have been approved since the previous edition. However, while recognizing the necessity of maintaining comprehensive coverage, the realities of the marketplace and the ever-increasing number of professional standards have caused us to reevaluate the relative importance of certain topics, resulting in deletions and reductions in coverage that have enabled us to produce a somewhat shorter text.

Each of us has taught intermediate accounting for many years. In so doing, we have developed an awareness of the issues and applications most difficult for the student to master. We have exercised special care when covering those areas to make the presentation as clear, understandable, and stimulating as possible. We involve the student in the learning process by integrating into the discussion current examples of financial reporting by actual companies. We facilitate the learning process by developing the ideas within the framework of a relatively straightforward example, and then proceeding step-by-step through the more difficult and controversial material. For many topics, there is a progression to the more complex and realistic case only after the student is introduced to the basic idea and the reason for its importance.

Curriculum Concerns

This edition is responsive to the concerns of the Accounting Education Change Commission (AECC). These concerns suggest a new direction in

accounting education that encourages students to “learn how to learn.” Curricula should emphasize the importance of the underlying concepts rather than the memorization of rules and regulations. The focus is on the process of inquiry in which the student learns to: identify problem situations, search for relevant information, analyze and interpret the information, and reach a well-reasoned conclusion.

With these goals in mind, the third edition frequently asks questions and presents important contemporary issues in a manner that compels the student to think about the appropriate solution to a reporting problem. For example, the impact of lobbying and the need for compromise by the FASB is discussed in several chapters affected by the more controversial pronouncements. One aim of this emphasis is to develop the student’s ability to critically

evaluate particular reporting standards. We would like the student to be able to decide whether a particular accounting principle successfully fulfills the primary objective of financial statements, namely to provide information useful for decision making. A second aim is to acquaint the student with the political nature of the standard-setting process.

We view current GAAP solutions to reporting problems as one step in the continuing evolutionary process of providing the most cost-effective and useful information possible. The text involves the student in that process. Many of the end-of-chapter cases and problems require students to identify and solve unstructured problems and consider multiple data sources. Our longer cases and problems help to stimulate a more interactive and involved process on the part of the student—learning by doing.

KEY FEATURES

Several new features have been incorporated into this edition with the intention of expanding its real-world emphasis, introducing international accounting issues, staying current with FASB’s agenda, and increasing the students involvement in learning. These features are:



Global View

A boxed element with a related end-of-chapter question appearing in many chapters.

Provides exposure to the GAAP of other countries and the International Accounting Standards Committee; reflects an increasingly strong call for international accounting standards.



On the Horizon

A boxed element appearing in several chapters.

Introduces topics currently on the FASB’s agenda and discusses their possible impact on financial reporting.

Margin Notes

Appearing in the margins of all chapters

Highlights the name and brief description of companies used to exemplify specific financial reporting treatments.

Laurie's Bakery

This is a brief description similar to that found in the marginal notes.



You Make the Call

New end-of-chapter item appearing in several chapters.

Presents a reporting issue that has not been considered by the FASB or which continues to be controversial; requires the student to think about issues that may not have been explicitly discussed in the chapter and to render a reasoned opinion on how to resolve the issue using knowledge of accounting theory.

Analyzing Financial Statements

New end-of-chapter item appearing in most chapters.

Comparative Analysis

New end-of-chapter item appearing in Chapters 8, 9, 11, 12, 14, 18, 19 and 23.

Writing Assignments

End-of-chapter items appearing in all chapters.

Many features of the previous edition that were well received by both students and faculty have been retained and updated. For example, **real-world situations** are emphasized throughout the text with numerous examples of actual companies' reporting practices, chapter introductions featuring reporting issues, frequent use of the AICPA's *Accounting Trends and Techniques*, and many references taken from *The Wall Street Journal*, *Forbes*, *Financial Executive*, and many other sources. The **Coca-Cola Company** graciously permitted us to reproduce their 1993 financial statements and accompanying notes. Almost all chapters have either a case or a financial statement analysis problem based on this material. Frequent references to well-known corporations help to capture the students' interest and reflect the variety of current accounting practices.

Issues involving **ethics** are emphasized through cases identified by a special logo at the end of several chapters. These cases focus on the ethical implications of particular actions and reporting decisions. In addition, explicit references are made to the ethics of financial reporting throughout the text.

Concept reviews, consisting of a brief list of questions, are placed at the end of major sections in each chapter to help students check their understanding of the basic concepts that have just been presented. These questions are answerable directly from the text and serve the same function as a short quiz. The answers are provided in the solutions manual for the convenience of the instructor. Each chapter has a **review problem** with solution to provide additional practice for the student. In some cases, these problems contain new twists and features not covered in

Provides additional real-world examples by keying problems to excerpts from the financial statements of actual companies; requires students to apply their knowledge to a less structured situation.

Uses excerpts from the financial statements of more than one company to highlight different measurement and reporting choices made within one area of financial reporting; considers the differential effects of these choices, as well as possible incentives for making particular reporting choices.

Requires the students to write memos, reports, and other types of written accounting communications as part of the solution to many of the problems and cases; incorporates group work where applicable in developing an idea, writing a rough draft, and finalizing the report.

the text. Many of the chapters contain one or more **comprehensive problems** that cover several of the chapter's learning objectives. Their purpose is to provide an opportunity to integrate the more important ideas into one situation. Many chapters contain problems and exercises that can be solved on a computerized spreadsheet (**SPATS**). Templates are provided for these problems.

TOPICAL CHANGES IN THE THIRD EDITION

Along with the new features included in the third edition, many changes in topical coverage have been made to reflect advances in accounting principles since the previous edition and to fine-tune the coverage.

The appendixes to several chapters were shortened and incorporated into the chapter for better integration of the subject matter. Also, we have reduced the number of examples in certain chapters to focus on the more important and controversial issues and streamline the material. In this effort, our team of reviewers was especially helpful in suggesting areas that faculty across the country typically do not assign or cover.

The following list highlights the more substantive changes made to the chapters:

Chapter 1 *Environment*

Ethics coverage from the appendix is now integrated into the chapter.

Chapter 2 *Conceptual Framework*

Increased emphasis has been placed on the discus-

sion of the *Statements of Financial Accounting Concepts*.

Chapter 4 *Income Statement*

A generalized method of determining disclosures for discontinued operations has been added. The section on conceptual issues in the determination of income and comprehensive income has been moved to an appendix.

Chapter 5 *Balance Sheet and SCF*

The chapter now reflects increased coverage of the direct method statement of cash flows.

Chapter 7 *Revenues/Expenses*

The coverage of losses on long-term contracts has been expanded and improved, and the examples for when a right of return exists are more involved. A section on ethical considerations has been added.

Chapter 8 *Cash/Receivables*

The "proof-of-cash" bank reconciliation has been deleted as it is covered more substantially in auditing classes. New to the chapter is a section on *SFAS No. 114*, which addresses accounting for loan impairments by creditors.

Chapter 9 *Inventory*

A new section on pooled LIFO has been added, along with increased discussion of the drawbacks of dollar-value LIFO.

Chapter 11 *Plant Assets*

The more complex interest capitalization examples now appear in an appendix; emphasis is on the fundamentals. A section on *SFAS No. 116*, which addresses accounting for contributions made and received, has been added.

Chapter 12 *Depreciation*

The material on tax depreciation and coinsurance (formerly appendixes) has been revised, shortened, and integrated into the chapter. The asset impairments section has been completely rewritten to reflect the new FASB Exposure Draft.

Chapter 13 *Intangibles*

The material comparing the successful efforts and full costing methods has been moved from the appendix to the chapter. An exhibit illustrating the decision process pertaining to accounting for computer software costs is presented. Expanded coverage of methods used to estimate goodwill are now in an appendix.

Chapter 14 *Investments*

A new summary table and discussion about classifying and accounting for investments in debt and equity securities has been added as a result of *SFAS No. 115*. Comprehensive coverage of this new standard

replaces the former coverage of *SFAS No. 12*. The chapter also includes increased coverage of *SFAS Nos. 105* and *107* regarding fair value of financial instruments and off-balance sheet risk, as well as coverage of the new Exposure Draft or derivative instruments. The appendix on consolidated financial statements has been deleted, based on reviewer comments suggesting a general lack of interest at the intermediate level.

Chapter 15 *Short-Term Liabilities*

The discussion of contingencies has been revised and coverage of *SFAS No. 112*, "Other Postemployment Benefits," has been added as an appendix.

Chapter 16 *Long-Term Liabilities*

The chapter has been shortened by reducing the coverage of certain bond accounting examples, troubled debt restructure, and debt extinguishment. The coverage on certain aspects of bond investment accounting and special mortgage notes has been reduced or eliminated. Troubled debt restructure coverage now appears in Appendix A and serial bonds in Appendix B. Coverage of *SFAS No. 114* as it applies to troubled debt restructure has been added.

Chapter 17 *Income Taxes*

The chapter reflects a substantial revision and increased focus on *SFAS No. 109*. Coverage of the deferral method and other non-GAAP alternatives is reduced. Accounting for net operating losses now appears after deferred taxes because the primary focus of the chapter is on interperiod tax allocation. The appendix on *SFAS No. 96* has been deleted.

Chapter 18 *Leases*

Several technical revisions have been made concerning accounting for bargain purchase options, residual values, and initial direct costs. Certain material in the appendixes of the previous edition was condensed and integrated into the chapter.

Chapter 19 *Pensions*

The appendix on settlements and curtailments has been shortened and integrated into the chapter; the appendix on financial reporting by pension plans has been deleted.

Chapter 20 *Contributed Capital*

The discussion of the categories of stockholders' equity has been rewritten to reflect the variety of alternative accounting procedures used in practices.

Chapter 21 *Retained Earnings and Stock Options*

A section discussing the proposed FASB standard on stock options and its implications for financial reporting has been added.

Chapter 22 *Earnings per Share*

The discussion leading to the calculation of EPS is reorganized for clarity. The discussion of the trea-

sure stock method and of the dilutive/antidilutive test has been rewritten.

Chapter 23 *SCF*

The complex cash flow preparation case is now an appendix. The appendix on the T-account method of preparing the statement of cash flows has been deleted; instead, use of T-accounts is integrated throughout the chapter examples.

Chapter 24 *Accounting Changes*

The chapter has been shortened but the central emphasis on reporting accounting changes remains. The section on worksheet techniques and preparing financial statements from incomplete data has been deleted.

Chapter 25 *Special Topics*

The chapter reflects the topics of Chapter 26 in the previous edition (segmental disclosures and interim reporting), as revised. The discussion on segment reporting is more complete; the discussion of standards overload has been reduced. On the advice of our reviewers and many other interested faculty, the material found in Chapter 25 of the previous edition (financial statement analysis and changing prices) has been deleted because this material was seldom assigned in intermediate accounting classes.

END-OF-CHAPTER MATERIAL

In addition to the new end-of-chapter features discussed in an earlier section, many changes and revisions were made to the questions, cases, exercises, and problems. Cases now appear before the exercises and problems, highlighting the conceptual and more open-ended material before the more procedural and computational. Older and more repetitive items were deleted, and many new items were added including new CPA examination elements, particularly those in a multiple-choice format.

The *questions* at the end of each chapter provide a context for in-class discussion; *cases* often require the student to integrate several issues in the chapter and provide an opinion on a reporting problem or situational aspect; *exercises* are generally structured applications of specific issues in the chapter; while *problems* generally are longer and less structured applications of one or more specific issues in the chapter.

The cases and some problems provide an opportunity for students to practice their analytical and written communication skills. Furthermore, they frequently place the student in an unstructured situation requiring a broad view to be taken of a business reporting problem. The context in which financial reporting is used must be considered in these instances.

ANCILLARIES AND SUPPLEMENTARY MATERIALS

For the Professor:

We have provided you with two different ways to purchase *Intermediate Accounting*. You can purchase *Intermediate Accounting, Chapters 1–14 and Chapters 15–25* in two separate volumes, or *Chapters 1–25* in one volume.

Intermediate Accounting, Third Edition, offers numerous teaching aids to assist the instructor.

Solutions Manual, Chapters 1–14 and 15–25 Done in two volumes, this comprehensive solutions manual provides complete solutions and explanations for all end-of-chapter questions, cases, exercises, and problems. The estimated completion time for each item is given in the assignment assistance schedule at the beginning of each chapter. Answers to the concept review questions are included at the end of each volume of the solutions manual.

Test Bank, Chapters 1–14 and 15–25 Prepared by the authors revised and expanded with this edition, the test bank offers approximately 4,000 questions and problems from which to choose in preparing examinations. This test bank contains true–false, short-answer, problems, and cases.

Solutions Transparencies, Chapters 1–14 and 15–25 Acetate transparencies of solutions to all exercises, problems, and cases are free to adopters. Now increased in clarity, these transparencies are especially useful when covering problems in large classroom settings.

Teaching Transparencies, Chapters 1–14 and 15–25 Selected lecture transparencies based on material from the textbook and based on material from outside the book.

Instructor's Resource Manual, Chapters 1–14 and 15–25 This manual includes overviews, learning objectives, lecture outlines, problem analysis, and transparency masters. It was prepared by Norman Sunderman, Angelo State University.

Computerized Testing Software This microcomputer test generator program allows the instructor to select and edit exam questions from the test bank database. Questions can be selected using several criteria, such as chapter, type of question (e.g., multiple choice, true–false, problem solving), and level of difficulty. The software is menu-driven, requiring little computer knowledge. It comes with a program disk, data disks containing the Test Bank database, and clearly written documentation. It provides password protection, can be used on a network, and is available on both 5.25" and 3.5" diskettes for IBM compatible microcomputers.

Teletest Irwin is happy to serve those customers without access to administrative support or a computer system. Simply choose your questions from the Test Bank and call Irwin College New Media. By calling a toll free number, users can specify the content of exams and have a laser printed copy of the exam mailed to them within one day.

The following item is intended for student use at the option of the instructors.

Spreadsheet Applications Template Software (SPATS) Selected exercises and problems in each chapter, identified by a spreadsheet symbol, can be solved using SPATS. The software contains innovatively designed templates based on Lotus 1-2-3 and includes a very effective Lotus 1-2-3 tutorial. SPATS is available on 5.25" and 3.5" disks. Upon adoption, this package is available for classroom or laboratory use.

For the Student:

Several support materials have been designed especially for the student.

Study Guides, Chapters 1–14 and Chapters 15–25 The study guides provide the student with a summarized look at each chapter's issues. Included are outlines, chapter overviews, key concepts, review questions, true–false, multiple choice questions, and critical thinking exercises. The study guides were prepared by Rosita Chen and Sheng-Der Pan, both of California State University–Fresno.

Working Papers, Chapters 1–14 and Chapters 15–25 Two sets of working papers are available for completing assigned problems and exercises. In many instances, the working papers are partially filled in to reduce the "pencil pushing" required to solve the problems, yet not so complete as to reduce the learning impact.

Manual Practice Set Video One Wholesalers, a manual practice set, can be assigned after Chapter 6 as a review of the accounting cycle.

Computer Supplement Wild Goose Marina, Inc. offers a complete corporate simulation and is intended for use after coverage of stocks, bonds, and cash flows. The corporate simulation is prepared by Leland Mansuetti and Keith Weidkamp, both of Sierra College.

Check Figures A list of check figures for selected end-of-chapter items is available.

COMMITMENT TO QUALITY

A major concern of any intermediate accounting textbook user is the issue of accurate textual material and end-of-chapter materials. As accounting faculty, we

are keenly aware that errors cause instructors considerable frustration and loss of time. Consequently, we have taken many steps to ensure the accuracy of this edition and the solutions manual.

Text Fourteen reviewers read the previous edition of the text and have checked the accuracy of our treatment of the official pronouncements and the facts and examples that appear in the third edition. The authors have read the text in manuscript form, galley proof, and page proof. Another accounting instructor read the galley proof for accuracy and checked numerical examples, illustrations, and boxed material. The final step was a complete proof-reading of page proof at Irwin.

End-of-Chapter Material and Solutions Manual Every question, case, exercise, and problem has been solved by five accounting instructors, at different universities, before the authors submitted the manuscript to Irwin. In addition, the authors and nine other accounting instructors have checked and solved all the end-of-chapter items with the corresponding solution. We have made every effort to ensure this product is as error-free as possible. If you should come across an issue of concern, please contact us, via E-mail, any time. We value your input and want to be of help.

Thomas Dyckman (tdyckman@johnson.cornell.edu)

Roland Dukes (rdukes@u.washington.edu)

Charles Davis (davisdj@csus.edu)

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Our thanks are extended to outstanding faculty reviewers, some of whom provided constructive criticism during the preparation of the third edition and others who reviewed portions of the final version of the text to let us know how well we achieved our goals for the book. Their comments and suggestions were instrumental in making the text more complete, accurate, and understandable. These reviewers are:

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Loren K. Waldman
Franklin University

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Barbara Askren
Loyola University

Linnae Bryant
Chicago State University

Tollie Carter
Chicago State University

James M. Emig
Villanova University

Gary Fernandez
Governors State University

Thomas Forehand
Marist College

Janet Grange
Chicago State University

Stephen Hollander
Rockford Business College

Sally Kopke
Rosary College

Daphne Lee
North Central College

Don Lucy
Ursuline College

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| NOTE TO THE STUDENT

The most important goal of a text is to assist you in learning the material of the course. The learning process is more effective when the ideas are presented in real-world contexts. Thus, each chapter begins with an actual situation.

The subject matter of this book, financial accounting, is critically important to many of the major decisions made in this country and abroad. Financial accounting information impacts the decisions that lead to resource allocation, the distribution of wealth, and the comparative competitive strengths of firms, industries, and economies.

Financial accounting is the study of the public information that organizations publish about their economic performance. This information is disseminated to those outside the organization for evaluation and action. Investors decide which firms' stocks or bonds they will buy. Other organizations use the data to decide whether to acquire them. Unions use the data in contract negotiations. Governments develop tax and trade policies based in part on financial reporting information, and these are only a few of the major

types of decisions which rely heavily on accounting data.

It is our aim to develop the subject matter of this area so that you will be aware of the types of information that are made available, the rules that govern its composition and disclosure, and the limitations to current financial reporting practice.

Financial reporting is a dynamic field. It is changing daily. Issues of comparability, relevance, reliability, and practicality underlie the choices that must be made in preparing financial statements. Critical thinking and judgment are essential. Ethical and international considerations are often involved. We will be considering all these issues in the chapters ahead and in the problems, cases, and exercises you will be asked to complete.

Our adventure through the window of this book into the world of financial accounting will, we hope, be exciting, challenging, and rewarding. With your instructor's help, you should be able to master the material soon to be placed at your fingertips. Let the voyage begin!

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