

FUNDAMENTAL FINANCIAL ACCOUNTING CONCEPTS

Fifth Edition

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Edmonds / Edmonds / McNair / Olds

FIFTH EDITION

Fundamental Financial ACCOUNTING Concepts

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Chapter 5 Homework
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Chapter 3 Homework

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Chapter 1 Homework

- ☐ 1/26/04 at 5:28 PM homework 10 Time taken 1421 minutes.
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Chapter 2 Homework

- ☐ 1/28/04 at 5:14 PM homework 9.43 Time taken 10 minutes.
- ☐ 1/28/04 at 4:57 PM homework 9.78 Time taken 10 minutes.

Chapter 3 Homework

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Question 1: Score 6.5/8

Your response

Exercise 2-1: Using Cost Terms [LO2, LO5, LO7]

Following are a number of cost terms introduced in the chapter:

Period cost	Fixed cost
Variable cost	Prime cost
Opportunity cost	Conversion cost
Product cost	Sunk cost

Choose the cost term or terms above that most appropriately describe the costs identified in each of the following situations. A cost term can be used more than once.

1. Crestline Books, Inc., prints a small book titled *The Pocket Speller*. The paper going into the manufacture of the book would be called direct materials and classified as a **Product cost** (6%). In terms of cost behavior, the paper could also be described as a **Product cost** (0%) with respect to the number of books printed.
2. Instead of compiling the words in the book, the author hired by the company could have earned considerable fees consulting with business organizations. The consulting fees forgone by the author would be called **Opportunity cost** (6%).
3. The paper and other materials used in the manufacture of the book, combined with the direct labor cost involved, would be called **Prime cost** (6%).
4. The salary of Crestline Books' president would be classified as a **Product cost** (0%), and the salary will appear on the income statement as an expense in the time period in which it is incurred.
5. Depreciation on the equipment used to print the book would be classified by Crestline Books as a **Product cost** (6%). However, depreciation on any equipment used by the company in selling and administrative activities would be classified as a **Period cost** (6%). In terms of cost behavior, depreciation would probably be classified as a **Fixed cost** (6%) with respect to the number of books printed.
6. A **Product cost** (6%) is also known as an inventoriable cost,

Correct response

Exercise 2-1: Using Cost Terms [LO2, LO5, LO7]

Following are a number of cost terms introduced in the chapter:

Period cost	Fixed cost
Variable cost	Prime cost
Opportunity cost	Conversion cost
Product cost	Sunk cost

Choose the cost term or terms above that most appropriately describe the costs identified in each of the following situations. A cost term can be used more than once.

1. Crestline Books, Inc., prints a small book titled *The Pocket Speller*. The paper going into the manufacture of the book would be called direct materials and classified as a **Product cost**. In terms of cost behavior, the paper could also be described as a **variable cost** with respect to the number of books printed.
2. Instead of compiling the words in the book, the author hired by the company could have earned considerable fees consulting with business organizations. The consulting fees forgone by the author would be called **Opportunity cost**.
3. The paper and other materials used in the manufacture of the book, combined with the direct labor cost involved, would be called **Prime cost**.
4. The salary of Crestline Books' president would be classified as a **Period cost**, and the salary will appear on the income statement as an expense in the time period in which it is incurred.
5. Depreciation on the equipment used to print the book would be classified by Crestline Books as a **Product cost**. However, depreciation on any equipment used by the company in selling and administrative activities would be classified as a **Period cost**. In terms of cost behavior, depreciation would probably be classified as a **Fixed cost** with respect to the number of books printed.
6. A **Product cost** is also known as an inventoriable cost, since



Immediately after finishing an assignment or quiz, students can compare their answers side by side with the detailed solutions. Students can try again with new numbers to see if they have mastered the concept.

NOTE FROM THE AUTHORS

Over the past 15 years, major changes in accounting education have impacted the way most college and university professors teach introductory accounting. We are gratified that our concepts approach has been so effective it has become a market leader in the change movement. The concepts approach takes traditional accounting to the next level. We not only cover debits and credits, but more importantly explain how those debits and credits impact financial statements.

How have we become market leaders in the introductory accounting course?

We look at ourselves as **innovative traditionalists**. We don't aim to radically transform accounting education, but instead to make it more effective. Students who use this text follow a different path toward the accomplishment of a conventional set of learning objectives. However, the path is easier to walk; and students complete the journey with a far greater understanding of accounting.

In contrast to traditional textbooks, **this is a concepts-based text that focuses on the big picture**. Recording procedures and other details are presented after a conceptual foundation has been established. This approach enables students to understand rather than memorize. Just as a stable house rests on a solid foundation, technical competence and decision making skills must be supported by a strong conceptual framework.

What do we mean by a concepts-based textbook? We mean the text stresses the relationships between business events and financial statements. The primary objective is to develop students who can explain how any given business event affects the income statement, balance sheet, and statement of cash flows. Do assets increase, decrease, or remain unchanged? What effect does the event have on liabilities, equity, revenue, expense, gains, losses, net income, and dividends? Furthermore, how does the event affect cash flows? In summary, **the focus is on learning how business events affect financial statements**.

Balance Between Theory and Practice

This text addresses the issues raised by advocates for change in accounting education. The big picture approach enables professors to focus on developing skills as well as covering content. Students who understand concepts are better able to communicate ideas and more effective at solving unstructured problems. Students who understand concepts are also better prepared to learn technical content. Students using this text will learn the basics of double-entry bookkeeping including debits and credits, journal entries, T-accounts, and trial balances. This text maintains an appropriate balance between skill development and technical competence.

This is not a user or preparer approach. Indeed, the concepts approach serves both users and preparers. In order to function effectively in today's business world both preparers and users must understand event/statement relationships. By teaching concepts, you no longer have to choose between the interests of accounting majors and those of other business students. The concepts approach serves both groups.

Implementing the concepts approach is surprisingly simple.

Instead of teaching students to record transactions in journals or T-accounts, teach them to record transactions directly into financial statements. While this shift is easy for instructors, it represents a dramatic change from how students have traditionally studied accounting. Making a direct connection between business events and financial statements encourages students to analyze conceptual relationships rather than memorize procedures. Early in the course students develop a conceptual framework that supports critical thinking and communication. Students become interested in accounting issues and are motivated to learn.

But don't take our word for it.

With over 200 colleges and universities successfully making the change to the concepts approach, we feel confident you will experience the same success as many of your colleagues have across the country. We would like to thank all of those who have been supportive of our teaching philosophy, and we highly encourage you to contact the author team or your local McGraw-Hill/Irwin representative to learn more about our texts.

Tom Edmonds • Cindy Edmonds • Frances McNair • Phil Olds • Nancy Schneider

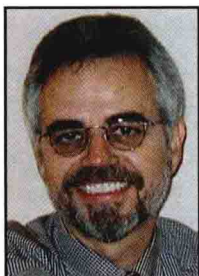
"The text is well organized, covers the critical topics, achieves the advertised balance between theory and practice, and is an appropriate introductory financial accounting text for BOTH the future accounting major and non-accounting major. It gets away from the historic "pure preparer's approach but doesn't go off the "deep end." "

**Robert Derstine –
Villanova University**

"It has totally changed my attitude about teaching the first accounting course. Subject matter is much more "teachable" and easier to learn."

**Elizabeth V. Mulig –
Columbus State
University**

ABOUT THE



Thomas P. Edmonds

Dr. Edmonds holds the Friends and Alumni Professorship in the Department of Accounting at the University of Alabama at Birmingham (UAB). He has been actively involved in teaching accounting principles throughout his academic career. Dr. Edmonds has **coordinated the accounting principles courses at the University of Houston and UAB**. He currently teaches introductory accounting in mass sections that frequently include more than 180 students. Dr. Edmonds has received five prestigious teaching awards including the UAB President's Excellence in Teaching Award and the distinguished Ellen Gregg Ingalls Award for excellence in classroom teaching. He has written a number of articles for many publications including *Issues in Accounting*; the *Journal of Accounting Education*; *Advances in Accounting Education*; *Accounting Education: A Journal of Theory, Practice and Research*; the *Accounting Review*; *Advances in Accounting*; the *Journal of Accountancy*; *Management Accounting*; the *Journal of Commercial Bank Lending*; the *Banker's Magazine*; and the *Journal of Accounting, Auditing, and Finance*. He has published four textbooks, five practice problems (including two computerized problems), and a variety of supplemental materials including study guides, working papers, and solutions manuals. Dr. Edmonds' writing is influenced by a wide range of business experience. He was a successful entrepreneur, worked as a management accountant for Refrigerated Transport, a trucking company, and worked in the not-for-profit sector as a commercial lending officer for the Federal Home Loan Bank. In addition, he has acted as a consultant to major corporations including First City Bank of Houston, AmSouth Bank in Birmingham, Texaco, and Cortland Chemicals. Dr. Edmonds began his academic training at Young Harris Community College in Young Harris, Georgia. He received a B.B.A. degree with a major in finance from Georgia State University in Atlanta, Georgia. He obtained an M.B.A. degree with a concentration in finance from St. Mary's University in San Antonio, Texas. His Ph.D. degree with a major in accounting was awarded by Georgia State University. Dr. Edmonds' work experience and academic training have enabled him to bring a unique user perspective to this textbook.



Cindy D. Edmonds

Cindy D. Edmonds, Ph.D., is an Associate Professor of Accounting at the University of Alabama at Birmingham. She serves as the coordinator of the introductory accounting courses at UAB. Dr. Edmonds received the 2001 Loudell Ellis Robinson Excellence in Teaching Award. Also, in 2000 and 2001 she was one of two School of Business faculty members nominated for the Ellen Gregg Ingalls Award for excellence in classroom teaching. She has written a variety of supplemental text materials including practice problems, a study guide, work papers, and test banks. Dr. Edmonds' articles appear in numerous publications including *Advances in Accounting Education*, *Journal of Education for Business*, *Journal of Accounting Regulation*, *Advances in Accounting*, *Management Accounting*, *CMA Journal*, *Disclosures*, and *Business & Professional Ethics Journal*. Her manuscript "Running a City on a Shoe String" received a certificate of merit award from the Institute of Management Accountants. The manuscript was used by the City of Vestavia in its application for Moody's Municipal Bond Rating. Dr. Edmonds is heavily involved in service activities. She is the 2001 president of the Birmingham Chapter of the American Society of Women Accountants. Dr. Edmonds has worked in the insurance industry, in a manufacturing company, and in a governmental agency. This work experience has enabled her to bring a real-world flavor to her writing. Dr. Edmonds holds a B.S. degree from Auburn University, an M.B.A. degree from the University of Houston and a Ph.D. degree from the University of Alabama.

AUTHORS



Frances M. McNair

Dr. McNair holds the KPMG Peat Marwick Professorship in Accounting at Mississippi State University (MSU). She has been involved in teaching principles of accounting for the past 12 years and currently serves as the **coordinator for the principles of accounting courses at MSU**. She joined the MSU faculty in 1987 after receiving her Ph.D. from the University of Mississippi. The author of various articles that have appeared in the *Journal of Accountancy*, *Management Accounting*, *Business and Professional Ethics Journal*, *The Practical Accountant*, *Taxes*, and other publications, she also coauthored the book *The Tax Practitioner* with Dr. Denzil Causey. Dr. McNair is currently serving on committees of the American Taxation Association, the American Accounting Association, and the

Institute of Management Accountants as well as numerous School of Accountancy and MSU committees.



Philip R. Olds

Professor Olds is Associate Professor of Accounting at Virginia Commonwealth University (VCU). He serves as the **coordinator of the introduction to accounting courses at VCU**. Professor Olds received his A.S. degree from Brunswick Junior College in Brunswick, Georgia (now Coastal Georgia Community College). He received a B.B.A. in Accounting from Georgia Southern College (now Georgia Southern University) and his M.P.A. and Ph.D. degrees are from Georgia State University. After graduating from Georgia Southern, he worked as an auditor with the U.S. Department of Labor in Atlanta, Georgia. A CPA in Virginia, Professor Olds has published articles in various professional journals and presented papers at national and regional conferences. He also served as the faculty

adviser to the VCU chapter of Beta Alpha Psi for five years. In 1989, he was recognized with an Outstanding Faculty Vice-President Award by the national Beta Alpha Psi organization.

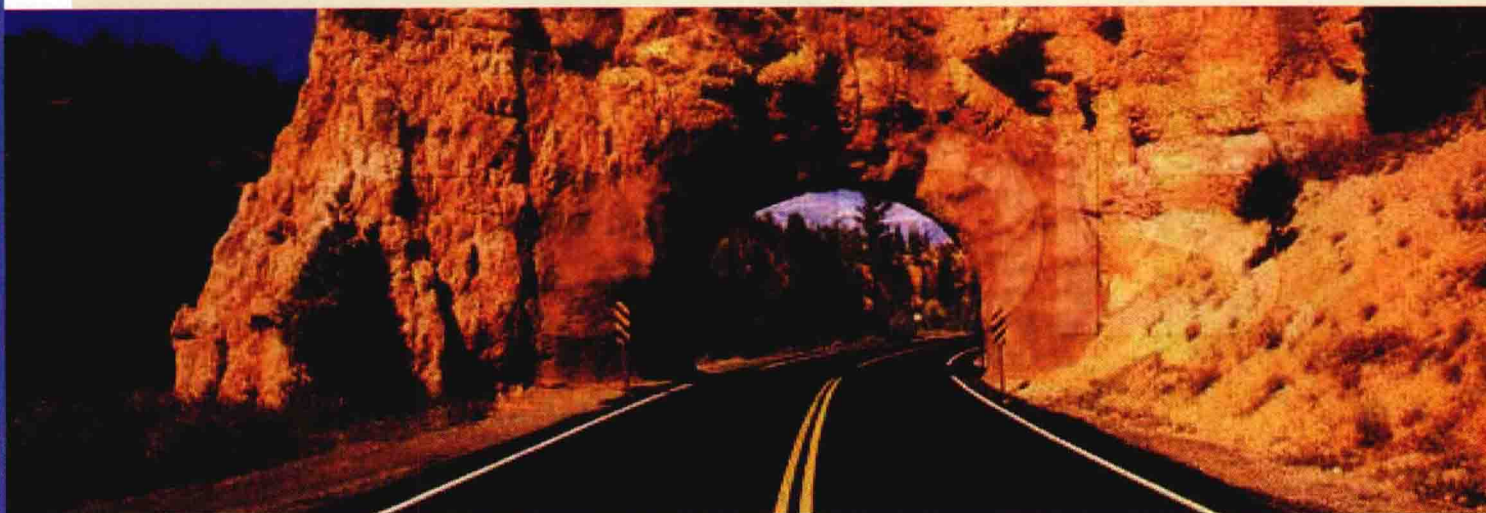


Nancy W. Schneider

Professor Schneider is Associate Professor of Accounting at Lynchburg College in central Virginia where she has served for many years as the lead instructor for the accounting principles courses. Since attending graduate school she has participated in the writing, reviewing, editing, checking, and revising of college-level accounting and finance textbooks, textbook supplements, and related teaching materials. She has a deep personal commitment to student learning and to finding and

sharing ways to improve college teaching. She is a recipient of the Sydnor Award for Teaching Excellence in Business at Lynchburg College and is frequently nominated by students for the College Excellence in Teaching Award. Professor Schneider initiated and organizes a highly popular annual symposium in which professors across all disciplines at the College exchange good teaching ideas. She has made numerous presentations at local and regional conferences, often related to teaching strategies, and is the coauthor of articles published in professional journals. Professor Schneider's professional activities also include active membership on the board of her local chapter of the Institute of Management Accountants where she regularly involves students in professional accounting educational meetings. Prior to teaching accounting, she was an auditor with an international public accounting firm in Atlanta and an internal auditor for a large integrated oil and gas company in Houston. Professor Schneider has maintained an active license to practice as a certified public accountant since 1980, and became a certified management accountant in 1992. She is a member of the American Institute of Certified Public Accountants and the Virginia Society of Certified Public Accountants. Professor Schneider received a Bachelor's degree in Mathematics Education with High Honors from the University of Florida in 1973, and a Master's degree in Professional Accountancy from Georgia State University in 1978.

HOW DOES THE BOOK HELP



STUDENTS SEE THE BIG PICTURE?

"Greatly benefited our students. They learn how business transactions affect financial position of a business without the debit/credits nuances. I think this is a great learning tool for intro students. They have no difficulty making the transition to Dr/Cr later in Chapter 4."

Peter Theuri – Northern Kentucky University

"I am a big supporter of the horizontal model! It is amazing what students know only by the end of chapter three. If a student were to drop the course at that point, they still would have a good foundational understanding of the four basic financial statements and accounting events."

Linda Bell – William Jewell College

PRINCIPAL FEATURES

Horizontal Financial Statements Model

A horizontal financial statements model replaces the accounting equation as the predominant teaching platform in this text. The model arranges the balance sheet, income statement and statement of cash flows horizontally across a single line of text as shown below.

Assets	=	Liabilities	+	Stockholders' Equity	Revenue	-	Expense	=	Net Income	Cash Flow
--------	---	-------------	---	----------------------	---------	---	---------	---	------------	-----------

The statements model approach enables students to more clearly see how accounting relates to real-world decision making. Under the traditional approach students learn to journalize a series of events and to present summarized information in financial statements. They never see how individual transactions affect financial statements. In contrast, when students record transactions into a statements model, they see a direct connection between business events and financial statements. Most business people think "if I take this particular action, how will it affect my financials," not "if I do these fifteen things how will they be journalized." Accordingly, the statements model approach provides a learning experience that is more intuitive and relevant than the one provided by traditional teaching methodology.

Establishing the Conceptual Framework

Chapter 1 introduces the key components of the conceptual framework for financial accounting. Accruals are introduced in Chapter 2, deferrals in Chapter 3. The first three chapters use only non-technical terms (increase/decrease rather than debit/credit) to discuss the effects of events on the financial statements. Chapter 4 introduces recording procedures, including debits and credits. By the end of the first four chapters, students using this text will have been exposed to the same accounting content as those who use traditional books.

After Chapter 4, the text demonstrates both the conceptual structure and the recording procedures in tandem. For example, the purchase of treasury stock would be shown as follows:

Assets	=	Liabilities	+	Equity	Revenue	-	Expense	=	Net Income	Cash Flow
(1,000)		n/a		(1,000)	n/a		n/a		n/a	(1,000) FA

Account Title	Debit	Credit
Treasury Stock	1,000	
Cash		1,000

The Effects of Cash Flows Are Shown Through the Entire Text

The statement of cash flows is introduced in the first chapter and included throughout the text. Students learn to prepare a statement of cash flows in the first chapter by learning to analyze each increase and decrease in the cash account. They can prepare a statement of cash flows by classifying each entry in the cash account as an operating, investing, or financing activity.

Effects on Financial Statements Over Multiple Accounting Cycles

The text also uses a vertical statements model that shows financial statements from top to bottom on a single page. This model displays financial results for consecutive accounting cycles in adjacent columns, thereby enabling the instructor to show how related events are reported *over multiple accounting cycles*.

Exhibit 2 Elden Enterprises Financial Statements Under Double-declining-balance					
Income Statements					
	2003	2004	2005	2006	2007
Rent Revenue	\$15,000	\$ 9,000	\$ 5,000	\$ 3,000	\$ -0-
Depreciation Expense	12,000	6,000	2,000	-0-	-0-
Operating Income	\$ 3,000	\$ 3,000	\$ 3,000	\$ 3,000	\$ -0-
Gain on sale of Van	-0-	-0-	-0-	-0-	500
Net Income	\$ 3,000	\$ 3,000	\$ 3,000	\$ 3,000	\$ 500
Balance Sheets					
Assets:					
Cash	\$16,000	\$25,000	\$30,000	\$33,000	\$37,500
Van	24,000	24,000	24,000	24,000	-0-
Accumulated Depreciation	(12,000)	(18,000)	(20,000)	(20,000)	-0-
Total Assets	\$28,000	\$31,000	\$34,000	\$37,000	\$37,500
Stockholders' Equity					
Common Stock	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
Retained Earnings	3,000	6,000	9,000	12,000	12,500
Total Stockholders' Equity	\$28,000	\$31,000	\$34,000	\$37,000	\$37,500
Statements of Cash Flows					
Operating Activities					
Inflow from Customers	\$15,000	\$ 9,000	\$ 5,000	\$3,000	\$ -0-
Investing Activities					
Outflow to Purchase Van	(24,000)				
Inflow from Sale of Van					4,500
Financing Activities					
Inflow from Stock Issue	25,000				
Net Change in Cash	\$16,000	\$ 9,000	\$ 5,000	\$ 3,000	\$ 4,500
Beginning Cash Balance	0	16,000	25,000	30,000	33,000
Ending Cash Balance	\$16,000	\$25,000	\$30,000	\$33,000	\$37,500

"For the most part students are very visual and it is important to see how events impact the various statements. As stated, this approach is simplified, but I can see that it would be easier for a student to understand a concept like buying and depreciating an asset using this format as opposed to having to look at several complete financial statements."

Patricia Lopez – Valencia Community College

"This is absolutely the best way to teach the SCF."

Paul Clikeman – University of Richmond

"Great; very logical. SCF is the least understood and appreciated by students. This focus keeps cash flows ever present and helps show the relationship to other financial statements."

George R. Violette – University of Southern Maine

"Excellent! Many books don't talk about cash flows until the end of the book."

James M. Lukawitz – University of Memphis

"It is easy for students to follow and presents the information in a natural approach."

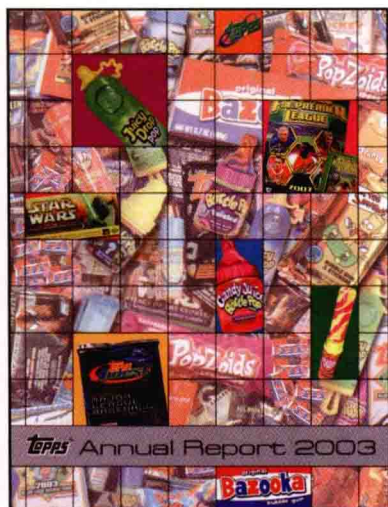
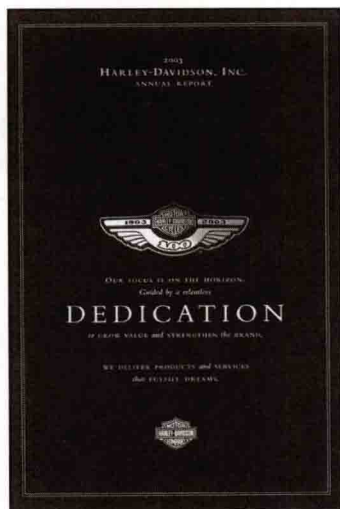
Bruce Chase – Radford University

"I agree with it completely.

This is how it should be taught. You cannot understand accrual accounting without comparing/contrasting cash flow."

Irvin T. Nelson – Utah State University

WHAT'S NEW THIS EDITION?



"The new manuscript exhibits a more personal approach in its writing style. This makes a big difference in it being 'readable.' I compare it to the difference between reading a factual and informative textbook, to reading a personal letter or even an interesting novel."

Steve Muller, Valencia Community College

Revisions for Fundamental Financial Accounting Concepts are in response to extensive feedback from instructors and students. Through formal reviews, instructor and student comments and suggestions, and focus groups, we have responded with constructive changes. There are three significant features.

Annual Report Projects

Two annual reports accompany the text.

- The 2003 annual report for Harley-Davidson, Inc. is packaged separately with the text.
- The 2003 annual report for The Topps Company, Inc. is printed in Appendix B.

In the Annual Report and Financial Statement Analysis Projects section (Appendix D) projects for each of these companies are included as well as a general purpose annual report project instructors can assign for any company's annual report.

Comprehensive Problem to Integrate Concepts Across Chapters

Chapters 5 through 11 include a comprehensive problem designed to integrate concepts across chapters. These problems help students understand interrelationships between various accounting concepts. The problem builds in each successive chapter, with the ending account balances in one chapter becoming the beginning account balances in the next chapter.

User-Friendly Writing Style

Every chapter of the text has been completely rewritten in an easy to read and easy to comprehend writing style. The revised, student-friendly writing style is designed to encourage students to read the book.

Overall revisions

- The presentation of material has been simplified.
- We have expanded coverage of the matching concept throughout the text.
- The text has been thoroughly updated to include all relevant changes in authoritative pronouncements.
- The exercises and problems have been thoroughly revised.
- Financial statement analysis is highlighted in each chapter under the heading *The Financial Analyst*.
- All real world data have been updated to reflect information contained in the companies' most recent annual reports.
- There is an ethics case in the *Analyze, Think, Communicate* section of the end-of-chapter materials for each chapter.
- Check figures added to Problems for Series A.

Chapter specific changes

Chapter 1

Curious Accountant vignette now features Coca-Cola Company.

Coverage of the closing process and the vertical statements model moved from Chapter 1 to Chapter 2.

Chapter 2

Curious Accountant vignette features Union Pacific Railroad.

Coverage of the closing process and the vertical statements model moved from Chapter 1 to Chapter 2.

We have included coverage of the Sarbanes-Oxley Act.

New Reality Bytes on Enron Corporation.

Chapter 3

Revised end-of-chapter material.

Chapter 4

Change of title from The Recording Process to The Double-Entry Accounting System.

We have included coverage of the Sarbanes-Oxley Act.

New Reality Bytes on filing Form 8-K with the SEC related to American Airlines and September 11 World Trade Center attacks.

Chapter 5

We have changed the coverage of cash discounts from the gross method to the net method. While most texts use the gross method, the net method is more intuitive and theoretically preferable, not to mention that it is the method used more frequently in practice.

We have moved coverage of the periodic method to the appendix. As a result of advances in technology, the perpetual method is the dominant approach used in practice today.

Chapter 6 (Formerly chapter 8)

Chapter 5 is now followed immediately by coverage of advanced inventory topics (cost flow methods, lower of cost or market, and inventory errors). This change facilitates the growing practice of covering these two subjects back-to-back.

Innocent inventory errors that are material in amount are highly unlikely in today's business environment. We have changed the write-up on inventory errors so as to couch the subject in terms of fraud prevention.

Chapter 7 (Formerly chapter 6)

Curious Accountant vignette now features WorldCom.

Chapter 8 (Formerly chapter 7)

Change in title from Advanced Topics: Receivables and Payables to Advanced Topics Related to Receivables.

Curious Accountant now features Costco and Procter & Gamble.

Coverage of accounting for discount notes moved to the appendix. Reviewers suggested that this subject is too technical for most professors to cover in an introductory accounting course.

Chapter 9

New Reality Bytes on Hewlett-Packard Company and Compaq Computer Corporation.

Chapter 10

Curious Accountant now features Time Warner.

Chapter 11

New Realty Bytes on Sarbanes-Oxley Act.

Chapter 12

Updated Priceline Exhibit 12-3.

New Appendix B Topps Company Annual Report

New Appendix C Summary of Financial Ratios

New Appendix D Annual Report and Financial Statement Analysis Projects

HOW DOES THE BOOK

Real World Examples

The Edmonds' text provides a variety of thought-provoking, real-world examples of financial accounting as an essential part of the management process. There are descriptions of accounting practices from real organizations such as Coca-Cola, Union Pacific Railroad, Enron, General Motors, JCPenney, and Amazon.com. These companies are highlighted in blue in the text.

The Curious Accountant

Each chapter opens with a short vignette that sets the stage and helps pique student interest. These vignettes pose a question about a real-world accounting issue related to the topic of the chapter. The answer to the question appears in a separate sidebar a few pages further into the chapter.

Focus on International Issues

These boxed inserts expose students to international issues in accounting.

Check Yourself

These short question/answer features occur at the end of each main topic and ask students to stop and think about the material just covered. The answer follows to provide immediate feedback before students go on to a new topic.

"These are very effective and I have used some of them for class discussions – these boxes capture the interest of the students since they see the application to the real world."

Jacqueline Burke – Hofstra University



THE curious ACCOUNTANT

If a person wishes to subscribe to *Reader's Digest* for one year (12 issues), the subscriber must pay for the magazines before they are actually published. Suppose Paige Long sends \$12 to the Reader's Digest Association in September 2007 for a one-year subscription; she will receive her first issue in October.

How should Reader's Digest account for the receipt of this cash? How would this event be reported on Reader's Digest's December 31, 2007, financial statements? (Answers on page 115.)

CHAPTER opening

In Chapter 2, we defined accruals as the recognition of revenue and expense before the receipt or payment of cash. In this chapter, you will learn that accrual accounting involves deferrals and allocations as well as accruals. A *deferral* involves recognizing a revenue or expense at some time after cash has been collected or paid. For example, if a business collects cash in 2004 for services it will perform in 2005, the revenue is recognized in 2005 even though the cash was collected in 2004.

focus on INTERNATIONAL ISSUES

Is There Global GAAP?

As explained in this chapter, financial reporting is a measurement and communication discipline based on rules

referred to as *generally accepted accounting principles*. The accounting rules described in this text are based on GAAP used in the United States. Not all economies throughout the world use the same accounting rules. Although there are many similarities among the accounting principles used in different countries, there also are major differences. Accountants have made attempts to create international accounting standards, but individual countries have retained the authority to establish their own GAAP. Simply put, each country has its own GAAP; there is no single "global GAAP." Examples of how financial reporting in other countries differs from that in the United States are presented throughout this book.

Accounting rules differ among countries for a variety of reasons, including the economic and legal environments in each country and how the GAAP in that country is established. Generally accepted accounting principles in the United States are primarily established by the Financial Accounting Standards Board (FASB). The FASB is a nongovernment rule-making body established by the accounting profession. In countries such as Germany and Japan, for example, the GAAP is established by government bodies. In these countries GAAP is established more like the way federal laws and regulations are established in the United States.

Furthermore, in the United States any connection between GAAP established by the FASB and tax accounting rules established by Congress and the Internal Revenue Service (IRS) is coincidental, not deliberate. In some countries there is a close connection between tax accounting rules and GAAP.

ing the total deferral to
tainer fee of \$30,000
trustee for the client's
e deferred until it was
based on the amount

\$1,500 of the \$18,000 cash received is recognized as revenue in 2006 (\$1,500 is included in the \$168,500 of revenue reported on the income statement) but the entire \$18,000 is reported in the operating activities section of the statement of cash flows (\$18,000 is included in the \$147,000 cash receipts from customers). Trace the effects of these transactions to the financial statements.


On January 1, 2002, Lambert Company paid \$28,000 cash to purchase office furniture. The furniture has a \$3,000 salvage value and a five-year useful life. Explain how Lambert would report this asset purchase on the 2002 statement of cash flows. Also, determine the amount of depreciation expense and accumulated depreciation Lambert would report in the 2004 financial statements.

Answer Lambert would report a \$28,000 cash outflow in the investing activities section of the 2002 statement of cash flows. During 2004 and every other year of the asset's useful life, Lambert would report \$5,000 $((\$28,000 - \$3,000) \div 5)$ of depreciation expense on the income statement. The accumulated depreciation would increase by \$5,000 each year of the asset's useful life. As of December 31, 2004, Lambert would report accumulated depreciation on the balance sheet of \$15,000 $(3 \text{ years} \times \$5,000 \text{ per year})$.

Check
Yourself
3-3


THE FINANCIAL ANALYST

MOTIVATE STUDENTS?




As noted in the text discussion, independent auditors are primarily responsible to the investing public, not to the company that hires and pays them. In 2002 numerous accounting scandals involving some very large public companies caused investors to question whether or not the external auditors really were independent. The public learned that external audit firms were often also serving as consultants to the companies they audited. The fees earned for consulting services were sometimes significantly higher than the fees earned auditing the same company. These arrangements caused many people, including members of Congress, to doubt that auditors would take a tough stance with a company's management over financial reporting issues if doing so might threaten future consulting fees.

No situation demonstrated this concern more than that of *Enron*. The well-publicized accounting problems that led to Enron's downfall were equally devastating for its auditor, *Arthur Andersen*. Within six months after Enron's troubles became public knowledge, Arthur Andersen lost over half its public company audit clients and almost two-thirds of its employees. Further, Andersen was convicted of obstruction of justice by a Houston jury and was told by the SEC that it could no longer audit public companies. The partner in charge of the



3-2



THE FINANCIAL ANALYST

Suppose a company earned net income of \$1,000,000. Is the company's performance good or poor? If the company is *General Motors*, the performance is poor. If it is a small shoe store, the performance is outstanding. So, how do financial analysts compare the performance of differing size companies? Financial ratios are very helpful in this regard.

Reality Bytes

This feature provides examples or expansions of the topics presented by highlighting companies and showing how they use the accounting concepts discussed in the chapter to make business decisions.

The Financial Analyst


Financial statement analysis is highlighted in each chapter under this heading.

Topic Tackler Plus

A logo indicates a topic explained on the Topic Tackler Plus DVD. The DVD includes two hard-to-learn topics for each chapter explained with video, PowerPoint, practice quizzes, self tests, and a demonstration problem walkthrough.


A Look Back/A Look Forward

Students need a roadmap to make sense of where the chapter topics fit into the whole picture. A Look Back reviews the chapter material and a Look Forward introduces new material to come in the next chapter.



This chapter introduced the role of accounting in society and business: to provide information helpful to operating and evaluating the performance of organizations. Accounting is a measurement discipline. To communicate effectively, users of accounting must agree on the rules of measurement. *Generally accepted accounting principles (GAAP)* constitute the rules used by the accounting profession in the United States to govern financial reporting. GAAP is a work in progress that continues to evolve.

This chapter has discussed eight elements of financial statements: *assets, liabilities, equity, common stock (contributed capital), revenue, expenses, dividends (distributions), and net income*. The elements represent broad classifications reported on financial statements. Four basic financial statements appear in the reports of public companies: the *balance sheet*, the *income statement*, the *statement of changes in stockholders' equity*, and the *statement of cash flows*. The chapter discussed the form and content of each statement as well as the interrelationships among the statements.



come statement, the statement of changes in stockholders' equity, and the statement of cash flows. The chapter discussed the form and content of each statement as well as the interrelationships among the statements.

This chapter introduced a *horizontal financial statements model* as a tool to help you understand how business events affect a set of financial statements. This model is used throughout the text. You should carefully study this model before proceeding to Chapter 2.

To keep matters as simple as possible and to focus on the interrelationships among financial statements, this chapter considered only cash events. Obviously, many real-world events do not involve an immediate exchange of cash. For example, customers use telephone service throughout the month without paying for it until the next month. Such phone usage represents an expense in one month with a cash exchange in the following month. Events such as this are called *accruals*. Understanding the effects that accrual events have on the financial statements is the subject of Chapter 2.

HOW CAN TECHNOLOGY

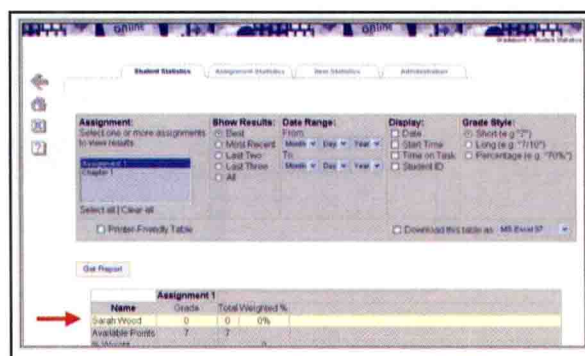
Our technology resources help students and instructors focus on learning success. By using the Internet and multimedia students get book-specific help at their convenience. Compare our technology to those of any other book and we're confident you'll agree that *Fundamental Financial Accounting Concepts* has the best in the market.

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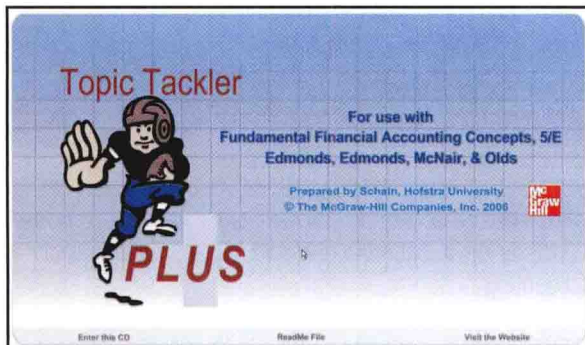
is a Web-based supplement that duplicates problem structures directly from the end-of-chapter material in your textbook, using algorithms to provide a limitless supply of online self-graded assignments that can be used for student practice, homework, or testing. Each assignment has a unique solution. Say goodbye to cheating in your classroom; say hello to the power and flexibility you've been waiting for in creating assignments. All Exercises and Problems in Series A are available with Homework Manager.



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HELP STUDENT SUCCESS?



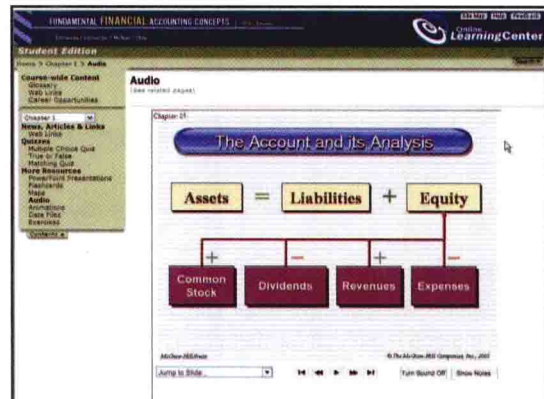
Topic Tackler Plus DVD

This software is a complete tutorial focusing on areas in the course that give students the most trouble. It provides help on two key topics for each chapter by use of

- Video clips
- PowerPoint slide shows
- Interactive exercises
- Self-grading quizzes

The DVD also includes the Self-Study Review Problems in the book presented in an audio-narrated PowerPoint slide presentation.

A logo in the text marks the topic given further coverage in Topic Tackler Plus.



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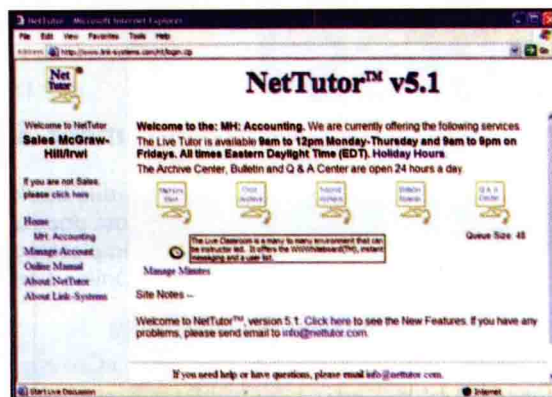
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More and more students are studying online. That's why we offer an Online Learning Center (OLC) that follows Fundamental Financial Accounting Concepts chapter by chapter. The OLC now includes the following:

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For instructors, the book's secured OLC contains essential course materials. You can pull all of this material into your PageOut course syllabus or use it as part of another online course management system. It doesn't require any building or maintenance on your part. It's ready to go the moment you type in the URL.

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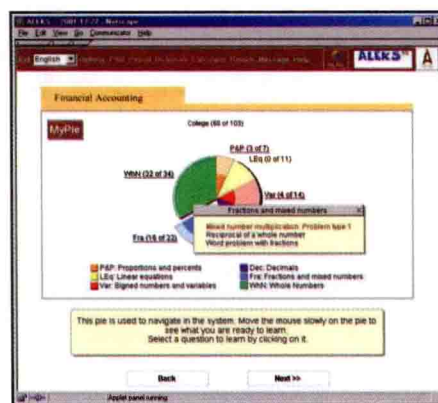
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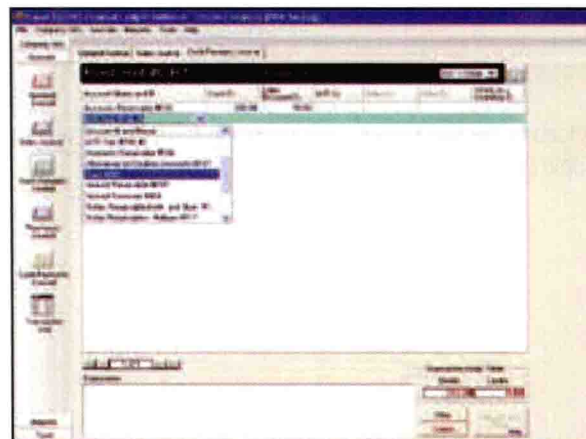


ALEKS

ALEKS for the Accounting Cycle and ALEKS for Financial Accounting

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Carol Yacht's General Ledger & Peachtree Complete 2005 CD

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