

Financial Accounting

Basic Concepts

Fifth Edition

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Homewood, IL 60430

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Senior sponsoring editor: Ron M. Regis
Project editor: Margaret A. Schmidt
Production manager: Bette K. Ittersagen
Compositor: Beacon Graphics Corporation
Typeface: 10½/12 Times Roman
Printer: R. R. Donnelley & Sons Company

Library of Congress Cataloging-in-Publication Data

Spiller, Earl A.

Financial accounting.

1. Accounting. I. May, Phillip T. II. Title.
HF5635.S787 1990 657 89-19788
ISBN 0-256-06637-X

Printed in the United States of America
1 2 3 4 5 6 7 8 9 0 D O 7 6 5 4 3 2 1 0

PREFACE

This fifth edition of *Financial Accounting: Basic Concepts* began as a traditional updating of material. It quickly evolved into a substantial modification. Added emphasis has been placed on improving the text's readability for the student and teachability for the instructor.

This edition retains its basic thrust, however, as it addresses the same audiences and embraces the same educational objectives as its predecessors. The book introduces financial accounting to those whose backgrounds include little or no prior knowledge of the subject. It is particularly suitable for a one-semester course offered to MBA students or highly motivated undergraduate students. The text is also appropriate for professional courses taught in schools of law or public administration, in executive MBA programs, and in management development programs for security analysts, credit evaluators, and other users of financial statements.

This edition maintains the same conceptual-analytical approach that was the hallmark of previous editions. However, we have tried to apply that approach more frequently to real-world situations and other events likely to be encountered by financial-statement readers.

The primary aim of the book is to develop the reader's ability to understand, interpret, and analyze the financial statements of business organizations. Several secondary objectives support the achievement of this overall goal:

1. Familiarity with accounting terminology to understand and communicate using the language of accounting.
2. Knowledge of the measurement rules and disclosure regulations governing the recording and reporting of business activity.
3. Understanding the impact that alternative accounting principles have on the financial statements, so that their various meanings can be interpreted.
4. Ability to use the conceptual structure of financial accounting as a benchmark for evaluation.
5. Acquiring a working knowledge of the accounting process to allow the use of the logical framework of accounting as an analytical tool.

CHANGES IN THE FIFTH EDITION

The use of an actual annual report as an integrated teaching device was a successful innovation in the fourth edition. This feature has been retained. Most of the 1987 Annual Report of Kimberly-Clark Corporation is reproduced in an Appendix to Chapter 6. Each chapter thereafter ends with a discussion that relates the material of that chapter to the reporting practices of Kimberly-Clark in 1987. These sections in Chapters 6 to 18 feature an in-depth analysis of Kimberly-Clark's financial statements and notes. They help relate the textbook concepts and procedures to real-world situations and increase the reader's confidence in his or her ability to understand actual corporate financial reports.

At the suggestion of a number of instructors, we have included a second annual report as a source of problem material. The annual report of Georgia-Pacific Corporation is reproduced in an Appendix at the end of the book. Most chapters have a major assignment concerning the Georgia-Pacific financial statements. In this way, instructors may employ a continuing problem assignment from chapter to chapter.

Other significant changes in the text of the fifth edition include the following:

1. Rewriting all chapters to simplify the writing style and eliminate unnecessary jargon.
2. Attention focused on conceptual and analytical aspects directly relevant to the financial statements that readers see and the financial analyses that they will be required to complete.
3. Introduction of some appropriate financial statement ratios in a number of early chapters. This enhances the relevance of the early chapters and allows the chapter on Analysis of Financial Statements to serve a summary role and to contain more interpretative discussions.
4. Increased discussion of income flows vis-à-vis cash flows throughout the text.
5. Incorporation of the latest accounting thought and pronouncements.
6. Division of the introduction to financial accounting and its conceptual framework into two chapters. This change makes the first bite of financial accounting smaller and more interesting for first-time readers. The new Chapter 1, for example, relates accounting functions to the everyday experiences of the readers. It introduces them at the outset to the importance of accounting and to the information contained in financial statements.
7. Elimination of the appendix on manual bookkeeping procedures. The material on internal control previously contained in that appendix plus some discussion of information systems have been moved into the body of the chapter.

8. Expansion of the use of appendixes to enhance the instructor's flexibility in the choice of material. The appendixes on lower-of-cost-or-market, group depreciation procedures, and the time value of money have been retained. New appendixes cover installment sales, accounting for bonds as investments, accounting for leases by lessors, and the worksheet approach to consolidated statement preparation.
9. Greater discussion of LIFO liquidations and their effect on the financial statements in the chapter on inventories.
10. Reorganization of the material on bonds and notes. A new section discussing the relationship of bond prices and interest rates has been added. The section on "non-interest-bearing" or discount notes has been deleted (they rarely are used in financial practice) and is replaced by a discussion and illustration of installment notes. Brief analyses of zero-coupon bonds, debt-equity swaps, and in-substance defeasance have been added.
11. Simplification of the discussion and combination of leases and pensions in a single chapter with two underlying themes. One is the use of present value concepts and procedures in complex areas of liability measurement. The second discusses difficulties that arise in applying the definitions and measurement rules for liabilities.
12. A complete rewriting of Chapter 13 on income taxes to explain and illustrate the liability approach to deferred taxes as called for by the standards contained in *FASB Statement No. 96*.
13. Interchange of the material on foreign currency transactions and contingencies. The latter moves from Chapter 14 on Stockholders' Equity to Chapter 16 on Disclosure Issues. The former moves in the other direction. We believe the new placement of these sections provides a more logical cohesiveness to both chapters.
14. Use of a direct approach, unencumbered by worksheet forms, for the initial discussion of consolidated statements. The direct approach builds the consolidated statements from the basic concept of what the statements should show if there were just a single company. A modern integrated worksheet is discussed in an appendix for those interested in greater procedural depth.
15. Extensive revision of Chapter 17 to emphasize the cash definition of funds flows and the reporting formats of *FASB Statement No. 95*.

Problem Material

The major reworking of the text material extends also to the problem material. The number of problems has been expanded by a third. Over half of them are totally new or significantly changed. Some of the long problems have been cut back in length or divided into two problems. The problems

are ordered generally in terms of increasing difficulty and/or length. Lower numbered problems follow directly from the text discussions or illustrate basic material. A short description has been added as a title to each problem to aid in quickly identifying its major thrust. Most of the problems continue to stress the application of conceptual knowledge and the development of analytical skills.

An innovation in this edition is the inclusion of cassettes (as in “small cases”). Each chapter contains from one to four cassettes. Many of these come from the annual reports of actual companies. They tend to be longer, more challenging, and more thought-provoking than the regular problems. They often contain questions requiring a discussion of rationale or motivation or an evaluation or comparison of accounting practices. We hope the cassettes will provide an interesting and relevant challenge for students where time allows an in-depth exploration of a topic.

Other Features

The book is organized in four sections. The first six chapters, comprising Section I, establish the fundamental concepts and procedures of financial accounting and reporting. Sections II and III discuss selected areas involved in the measurement of assets and equities. The material in these sections builds on the conceptual-analytical framework in the first section. Current accounting principles and procedures are explained and examined critically. Section IV contains four chapters which concern problems of analysis, disclosure, and interpretation in the financial statements.

A glossary, containing more than 300 technical terms and phrases used in financial accounting and their definitions, appears at the end of the book. The items are arranged in alphabetical order for easy reference by the user. Each entry contains a clear, concise definition of the term and a reference to the first text chapter in which the item is discussed in depth.

An instructor’s manual containing solutions to all problems is available to adopters. However, we have tried to make it more than just a solutions manual. It contains outlines of each chapter and some short suggestions or teaching hints to assist the instructor. Some sample examinations and lists of check figures are included for instructors to copy and distribute if they desire.

A computer diskette to be used by those having interest in and access to microcomputers accompanies the instructor’s manual. The diskette contains spreadsheet templates that can be used to solve many of the problems in the text.

ACKNOWLEDGMENTS

A notable change in this edition has been the replacement of Professor Martin Gosman as coauthor with Professor Phillip May. The press of other

duties prevented Professor Gosman from continuing with this edition. We acknowledge with gratitude his innovations and contributions to the fourth edition which we have carried forward.

We have been fortunate to receive a number of comments and suggestions from users of the fourth edition. We are grateful for their input. Three faculty members deserve a special mention of appreciation. Professor Janet D. Daniels (University of Hartford), Professor Randall B. Hayes (College of William and Mary), and Professor Charles Tritschler (Purdue University) provided detailed reviews of the fourth edition. Professor Hayes, for example, gave us 13 pages of suggestions covering organizational improvements, topic coverage, and writing style. Professor Daniels made a number of valuable suggestions to improve the book's readability, particularly for use in executive programs. Professor Tritschler's insights, gained from many years of experience with the text, aided immeasurably in keeping us on target with respect to the major thrust and audience for the book. Both Professors Daniels and Tritschler, in addition, critically evaluated our revision plan and helped us to resolve some thorny issues of coverage and organization. Many of the changes in the fifth edition outlined earlier grew out of the comments of these three people to whom we are deeply indebted.

Professor David Gotlob (University of Wisconsin at Oshkosh) read the entire revised manuscript. He corrected our errors, suggested material in need of clarification, class-tested some new chapters, and generally provided assurance that the changes implemented in this edition were indeed improvements.

Professor Leland Mansuetti of Sierra College prepared the computer diskette. His mastery of computer worksheet preparation and of problem-solving analysis has added a significant feature to the book.

We were aided by some very able graduate assistants. Michael McCartney at Indiana University and Robin Gerety at Wichita State University verified references and numbers, checked all calculations, critiqued text and problem material, and provided other valuable assistance.

We are grateful to Kimberly-Clark Corporation and Georgia-Pacific Corporation for allowing us to reproduce their annual reports.

All of the foregoing people share in the completion of this book and in any improvements it contains. However, to our wives—Elinor and Mary—go our greatest thanks. Their encouragement, support, and assistance have made this book possible; their patience, understanding, and approval have made our efforts in writing it worthwhile; and their marginal propensities to consume have made the whole project necessary.

Comments and suggestions from users are most welcome.

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