

KIMMEL • WEYGANDT • KIESO

FINANCIAL ACCOUNTING

TOOLS FOR BUSINESS DECISION MAKING

**2ND
EDITION**





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Tools for Business Decision Making

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**Dedicated to
our parents and our in-laws,
and to our families,
most especially our spouses,**

**Merlynn
Enid
Donna**

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ABOUT THE AUTHORS

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the CPA exam. He is a member of the American Accounting Association and has published articles in the *Accounting Review*, *Accounting Horizons*, *Issues in Accounting Education*, and the *Journal of Accounting Education* as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education. He has published papers and given numerous talks on incorporating critical thinking into accounting education and helped prepare a catalog of critical thinking resources for the Federated Schools of Accountancy.

Jerry J. Weygandt, PhD, CPA, is Arthur Andersen Alumni Professor of Accounting at the University of Wisconsin–Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review*, *Journal of Accounting Research*, the *Journal of Accountancy*, and other professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting

Association and as a member of the editorial board of the *Accounting Review*. In addition, he is actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to “accounting for income taxes” and is presently a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching; he also has served as President and Secretary-Treasurer of the American Accounting Association. Recently he received the Wisconsin Institute of CPAs' Outstanding Educator's Award and the Lifetime Achievement Award.

Donald E. Kieso, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Peat Marwick Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. He has served as a member of the Board of Directors of the Illinois CPA Society, the AACSB's Accounting Accreditation Committee, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Feder-

ation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is serving as Chairman of the Board of Trustees and Executive Committee of Aurora University, the Boards of Directors of Castle BancGroup Inc. and Valley West Community Hospital, and as Secretary-Treasurer of The Sandwich Hospital Resolution Board. From 1989 to 1993 he served as a charter member of the national Accounting Education Change Commission. In 1988 he received the Outstanding Accounting Educator Award from the Illinois CPA Society; in 1992 he received the FSA's Joseph A. Silviso Award of Merit and the NIU Foundation's Humanitarian Award for Service to Higher Education; and in 1995 he received a Distinguished Service Award from the Illinois CPA Society.

PREFACE

In recent years accounting education has seen numerous efforts to change the way accounting is taught. These efforts reflect the demands of an ever-changing business world, opportunities created by new instructional technologies, and an increased understanding of how students learn. In this book we have drawn from what we believe to be the most promising of these innovations. Our efforts were driven by a few key beliefs.

- “Less is more.”** Our instructional objective is to provide students with an understanding of those concepts that are fundamental to the use of accounting. Most students will forget procedural details within a short period of time. On the other hand, concepts, if well taught, should be remembered for a lifetime. Concepts are especially important in a world where the details are constantly changing.
- “Don’t just sit there—do something.”** Students learn best when they are actively engaged. The overriding pedagogical objective of this book is to provide students with continual opportunities for active learning. One of the best tools for active learning is strategically placed questions. Our discussions are framed by questions, often beginning with rhetorical questions and ending with review questions. Even our selection of analytical devices, called Decision Toolkits, uses key questions to demonstrate the purpose of each.
- “I’ll believe it when I see it.”** Students will be most willing to commit time and energy to a topic when they believe that it is relevant to their future career. There is no better way to demonstrate relevance than to ground discussion in the real world. Consistent with this, we adopted a macro-approach: Chapters 1 and 2 show students how to use financial statements of real companies. By using high-profile companies such as Tootsie Roll, Microsoft, Nike, and Intel to frame our discussion of accounting issues, we demonstrate the relevance of accounting while teaching students about companies with which they have daily contact. As they become acquainted with the financial successes and failures of these companies, many students will begin to follow business news more closely, making their learning a dynamic, ongoing process. We also discuss small companies to highlight the challenges faced by small companies as they try to grow big.
- “You need to make a decision.”** All business people must make decisions. Decision making involves critical evaluation and analysis of the information at hand, and this takes practice. We have integrated important analytical tools throughout the book. After each new decision tool is presented, we summarize the key features of that tool in a Decision Toolkit. At the end of each chapter we provide a comprehensive demonstration of an analysis of a real company using the decision tools presented in the chapter. The presentation of these tools throughout the book is logically sequenced to take full advantage of the tools presented in earlier chapters, culminating in a capstone analysis chapter.
- “It’s a small world.”** Rapid improvements to both information technology and transportation are resulting in a single global economy. The Internet has made it possible for even small businesses to sell their products virtually anywhere in the world. Few business decisions can be made without consideration to international factors. To heighten student awareness of international issues, we have increased references to international companies and issues and have added a new type of exercise, called A Global Focus, in each chapter.

KEY FEATURES OF EACH CHAPTER

Chapter 1, Introduction to Financial Statements

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

Chapter 2, A Further Look at Financial Statements

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

Chapter 3, The Accounting Information System

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

Chapter 4, Accrual Accounting Concepts

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

Chapter 5, Merchandising Operations

- Introduces merchandising concepts using perpetual inventory approach.
- Presents the multiple-step income statement.
- Applies ratio analysis to real companies—**Kmart** and **Wal-Mart** (gross profit rate and operating expenses to sales ratio).

Chapter 6, Reporting and Analyzing Inventory

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

Chapter 7, Internal Control and Cash

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

Chapter 8, Reporting and Analyzing Receivables

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

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

Chapter 9, Reporting and Analyzing Long-Lived Assets

- Covers the basics of plant assets and intangible assets.
- Discusses basics of buy or lease decision.
- Covers the implications of depreciation method choice; shows details of accelerated methods in appendix.
- Applies ratio analysis to real companies—**Southwest Airlines** and **AirTran**.
- Demonstrates implications of estimated useful life for intangible amortization to a real company—**Roberts Pharmaceuticals**.

Chapter 10, Reporting and Analyzing Liabilities

- Covers current liabilities: notes payable, sales taxes, payroll, unearned revenues, and current maturities of long-term debt.
- Covers long-term liabilities, including debt versus equity choice, bond pricing, and various types of bonds. For simplification, emphasizes straight-line amortization; effective interest method covered in an appendix.
- Includes present value discussion in an appendix.
- Discusses basics of contingent liabilities, lease obligations, and off-balance-sheet financing.
- Applies ratio analysis to real companies—**Ford** and **General Motors** (acid-test ratio, debt to total assets ratio, and times interest earned).

Chapter 11, Reporting and Analyzing Stockholders' Equity

- Presents pros and cons of corporate form of organization.
- Covers issues related to common and preferred stock, and reasons companies purchase treasury stock.
- Explains reasons for cash dividends, stock dividends, and stock splits and implications for analysis.
- Applies ratio analysis to real companies—**Nike** and **Reebok** (earnings per share, price-earnings ratio, return on common stockholders' equity, payout ratio, and dividend yield).

Chapter 12, Reporting and Analyzing Investments

- Explains why companies purchase investments.
- Presents alternative methods of accounting for investments.
- Discusses consolidation accounting at conceptual level.
- Analyzes implications of unrealized gains and losses of real company—**KeyCorp**.

Chapter 13, Statement of Cash Flows

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

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

Chapter 14, Financial Analysis: The Big Picture

- Capstone chapter—reinforces previous analytical tools and demonstrates their interrelationships, as well as presents new tools.
- Discusses “earnings power” and implications of discontinued operations, extraordinary items, accounting changes, nonrecurring charges, and comprehensive earnings.
- Demonstrates horizontal and vertical analysis.
- Applies comprehensive ratio analysis to real companies—**Kellogg** and **Quaker Oats**.

NEW IN THIS EDITION

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

Throughout the Book

- With this edition our “focus companies” are **Tootsie Roll Industries** and **Hershey Foods**. They were chosen because they had high name recognition with students, they operate primarily in a single industry, and they have relatively simple financial statements. Most importantly, the idea of evaluating candy companies seemed fun.
- In order to more closely tie the topic of each chapter to the real world, Review It questions relating to Tootsie Roll Industries have been added in every chapter.
- To enhance students’ conceptual understanding of the impact of transactions, accounting equation analyses have been added in the margins next to each journal entry, beginning in Chapter 5.
- For those instructors wanting to incorporate technology in the course, most chapters now have problems that can be completed using General Ledger Software.
- Financial Reporting Problems and Comparative Analysis Problems in the Broadening Your Perspective section now cover Tootsie Roll Industries and Hershey Foods.
- We have enhanced relevance by adding many new references to real companies and many new brief exercises, exercises, and problems that use real-company data.
- To emphasize the global nature of today’s business world, additional references to non-U.S. companies have been added, and a new Global Focus problem has been added in the Broadening Your Perspective section in every chapter.
- To ensure complete coverage of concepts, we have included 17 new Brief Exercises, 32 new Exercises, and 39 new Problems.

Chapter 1, Introduction to Financial Statements

- New feature story introducing Tootsie Roll Industries.
- Simpler financial statements used throughout the chapter.
- New Interpreting Financial Statements problem.

Chapter 2, A Further Look at Financial Statements

- Revised feature story to further emphasize the impact of the Internet by including actual Internet bulletin board postings about Best Buy Company.
- Updated data for Best Buy Company and Circuit City.
- New infographic on characteristics of useful information.
- New introduction to ratio analysis, with explanation of percentage, rate, and proportion.
- New infographic to illustrate liquidity, solvency, and profitability measures.
- New text discussion of Best Buy’s recent dividend policy, drawn from Internet bulletin board.
- New excerpts from real-world companies to illustrate balance sheet classifications.
- Moved discussion of multiple-step income statement and nonoperating items to Chapter 5.
- Reorganized Section 2 to highlight balance sheet and to pull together ratio analysis tools in a section titled “Using the Financial Statements.”
- New Business Insight about French attitudes regarding investing.
- New Interpreting Financial Statements problem.
- New Financial Analysis on the Web exercise.

Chapter 3, The Accounting Information System

- Expanded presentation and explanation of services on account (accounts payable).
- New Business Insight on Rhino Foods’ efforts to motivate factory workers by teaching them the impact of transactions on financial statements.
- New Research Case.

Chapter 4, Accrual Accounting Concepts

- Four new Business Insights: on revenue recognition in the film industry; accrual accounting practices of New Zealand’s government; Microsoft’s use of an unearned revenue account to smooth earnings; and the speeding up of quarterly closings due to advances in information technology.
- New illustrations that provide additional explanation on closing entries and posting of closing entries.
- Expanded illustration in chapter appendix that provides additional explanation of the use of work sheets.

Chapter 5, Merchandising Operations

- Updated data for Wal-Mart and Kmart.
- New Before You Go On section added on the perpetual inventory system.
- Expanded discussion of multiple-step income statement and nonoperating activities—moved here from Chapter 2.

- Equation analyses added to margins, beginning in this chapter.
- New Research Case.

Chapter 6, Reporting and Analyzing Inventory

- Updated data for Caterpillar Corporation and Manitowoc Company.
- New comparison (text and illustration) of perpetual versus periodic inventory systems.
- Revised discussion of LIFO reserve; new illustration of adjustments to determine FIFO cost of goods sold.
- New Appendix 6A on inventory cost flow methods for perpetual systems (including a Demonstration Problem).
- New Research Case.

Chapter 7, Internal Control and Cash

- Two new Business Insights: on fraud at Bankers' Trust; and the practice of many banks of processing checks from biggest to smallest to maximize their fees on bounced checks.
- Many new end-of-chapter problems.
- New Research Case.
- Two new Financial Analysis on the Web exercises.
- New Ethics Case.

Chapter 8, Reporting and Analyzing Receivables

- Provided data for pharmaceutical giant McKesson HBOC and for Del Laboratories.
- Expanded coverage of direct write-off of uncollectible accounts.
- Reorganized presentation of direct write-off and allowance methods for uncollectible accounts.
- New infographics on managing receivables.
- Expanded discussion, with real-world example, of credit risk.
- Using the Decision Toolkit revised with pharmaceutical company data.
- Four new Business Insights: on Rite Aid's attempt to boost net income by dramatically increasing its allowances from its suppliers; Sears' increase in net income resulting from the reduction of its bad debt expense; international debt problems; and the failure of JWA Security Services due to poor receivables management.
- New Research Case.

Chapter 9, Reporting and Analyzing Long-Lived Assets

- Updated data on Southwest Airlines and AirTran.
- New Business Insight on the effect on Willamette Industries' net income of a change in depreciable life.
- New Research Case.

Chapter 10, Reporting and Analyzing Liabilities

- Discussion of bond trading moved out of this chapter (and into investments chapter).
- Two new Business Insights: on lack of sales tax on Internet e-commerce; and Y2K contingent liabilities.
- New end-of-chapter appendix and related assignment materials on the effective-interest method.
- New end-of-chapter appendix and related assignment

- materials on accounting for long-term notes payable.
- New Research Case.
- New Interpreting Financial Statements problem.

Chapter 11, Reporting and Analyzing Stockholders' Equity

- Updated data for Nike and Reebok.
- New real financial statements (Amazon.com, Tektronix) in presentation section.
- New Business Insight on subchapter S corporations.
- New Research Case.

Chapter 12, Reporting and Analyzing Investments

- Terminology changed from "temporary investments" to "short-term investments."
- Added bond trading discussion.
- New Business Insight on the reporting of bonds in the financial press.
- New Research Case.
- Two new Financial Analysis on the Web exercises.

Chapter 13, Statement of Cash Flows

- Updated data for Microsoft, Oracle, Intel, and AMD.
- New Business Insight on use of cash flow numbers by analysts.
- New Research Case.
- New Interpreting Financial Statements problem.

Chapter 14, Financial Analysis: The Big Picture

- New feature story that emphasizes just how much the investment world has changed by telling the true story of a cabby who trades online while driving his cab.
- Updated all ratios and financial measures to reflect Kellogg's 1997 and 1998 results.
- Provided Kellogg's simplified financial statements to allow calculation of all ratios.
- Two new Financial Analysis on the Web exercises.

PROVEN PEDAGOGICAL FRAMEWORK

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

Learning How to Use the Text

A **Student Owner's Manual** begins the text to help students understand the value of the pedagogical framework and how to use it. After becoming familiar with the pedagogy, students can take a **learning styles quiz** (page xxiv) to help them identify how they learn best (visually, aurally, through reading and writing, kinesthetically, or through a combination of these styles). We then offer tips on in-class and at-home learning strategies, as well as help in identifying the text pedagogy that would be most useful to them for their learning style. Finally, Chapter 1 contains notes (printed in red) that explain each pedagogical element the first time it appears.

Understanding the Context

- **Study Objectives**, listed at the beginning of each chapter, form a learning framework throughout the text, with each objective repeated in the margin at the appropriate place in the main body of the chapter and again in the **Summary of Study Objectives**. Also, end-of-chapter assignment materials are linked to the Study Objectives.
- A **Chapter-Opening Vignette** presents a scenario that relates an actual business situation of a well-known company to the topic of the chapter. The vignette also serves as a recurrent example throughout the chapter. Most of the vignettes include the Internet address of the company cited in the story to encourage students to go on-line to get more information about these companies.
- A chapter **Preview** links the chapter-opening vignette to the major topics of the chapter. First, an introductory paragraph explains how the vignette relates to the topics to be discussed, and then a graphic outline of the chapter provides a “visual road map,” useful for seeing the big picture as well as the connections between subtopics.

Learning the Material

- This book emphasizes the accounting experiences of **real companies throughout**, from chapter-opening vignettes to the chapter's last item of homework material. Details on these many features follow. In addition, every chapter uses **financial statements** from real companies. These specimen financial statements are easily identified by the company logo or related photo that appears near the statement heading.
- Continuing the real-world flavor of the book, **Business Insight** boxes in each chapter give students glimpses into how real companies make decisions using accounting information. The boxes, highlighted with striking photographs, focus on three different accounting perspectives—those of investors, managers, and international business.
- Color **illustrations** support and reinforce the concepts of the text. Infographics are a special type of illustration that help students visualize and apply accounting concepts to the real world. The infographics often portray important concepts in entertaining and memorable ways.
- **Before You Go On** sections occur at the end of each key topic and consist of two parts: **Review It** serves as a learning check within the chapter by asking students to stop and answer knowledge and comprehension questions about the material just covered. **Review It** questions marked with the Tootsie Roll icon send students to find information in Tootsie Roll Industries' 1998 annual report, which is packaged with new copies of the book and printed in Appendix A at the back of the book. These exercises help cement students' understanding of how topics covered in the chapter are reported in real-world financial statements. Answers







appear at the end of the chapter. **Do It** is a brief demonstration problem that gives immediate practice using the material just covered. Solutions are provided to help students understand the reasoning involved in reaching an answer.

- **Accounting equation analyses** have been inserted in the margin next to key journal entries. This new feature reinforces students' understanding of the impact of an accounting transaction on the financial statements.
- **Helpful Hints** in the margins expand upon or help clarify concepts under discussion in the nearby text. This feature actually makes the book an Annotated Student Edition.
- **Alternative Terminology** notes in the margins present synonymous terms that students may come across in subsequent accounting courses and in business.
- Marginal **International Notes** provide a helpful and convenient way for instructors to begin to expose students to international issues in accounting, reporting, and decision making.
- Each chapter presents **decision tools** that are useful for analyzing the financial statement components discussed in that chapter. At the end of the text discussion relating to the decision tool, a **Decision Toolkit** summarizes the key features of that decision tool and reinforces its purpose. For example, Chapter 8 presents the receivables turnover ratio and average collection period as tools for use in analyzing receivables. At the end of that discussion the Toolkit you see at the top of page ix is shown.
- A **Using the Decision Toolkit** exercise, which follows the final Before You Go On section in the chapter, asks students to use the decision tools presented in that chapter. Students evaluate the financial situation of a real-world company, often using ratio analysis to do so. In most cases the company used in this analysis is a competitor of the example company in the chapter. For example, in Chapter 11, Nike was analyzed as the example company in the chapter discussion, so Reebok is analyzed in the Using the Decision Toolkit at the end of the chapter. Such comparisons expand and enrich the analysis and help focus student attention on comparative situations that flavor real-world decision making.



Putting It Together


- At the end of each chapter, between the body of the text and the homework materials, are several useful features for review and reference: a **Summary of Study Objectives** lists the main points of the chapter; the **Decision Toolkit—A Summary** presents in one place the decision tools used throughout the chapter; and a **Glossary** of important terms gives definitions with page references to the text.
- Next, a **Demonstration Problem** gives students another opportunity to refer to a detailed solution to a representative problem before they do homework assignments. **Problem-Solving Strategies** help establish a logic for approaching similar problems and assist students in understanding the solution.

DECISION TOOLKIT

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

Developing Skills Through Practice

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

- **Self-Study Questions** comprise a practice test to enable students to check their understanding of important concepts. These questions are keyed to the Study Objectives, so students can go back and review sections of the chapter in which they find they need further work.
- **Questions** provide a full review of chapter content and help students prepare for class discussions and testing situations.
- **Brief Exercises** build students' confidence and test their basic skills. Each Brief Exercise focuses on one of the Study Objectives.
- Each of the **Exercises** focuses on one or more of the Study Objectives. These tend to take a little longer to complete, and they present more of a challenge to students than Brief Exercises. The Exercises help instructors and students make a manageable transition to more challenging problems.
- **Problems** stress the applications of the concepts presented in the chapter. Two sets—**A** and **B**—have corresponding problems keyed to the same **Study Objectives**, thus giving instructors greater flexibility in assigning homework. Certain problems, marked with the icon , help build business writing skills.
- Each Brief Exercise, Exercise, and Problem has a **description of the concept** covered and is keyed to the Study Objectives.

Expanding and Applying Knowledge

Broadening Your Perspective is a unique section at the end of each chapter that offers a wealth of resources to help instructors and students pull together the learning for the chapter. This section offers problems and projects

for those instructors who want to broaden the learning experience by bringing in more real-world decision making and critical thinking activities.

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

ACTIVE TEACHING AND LEARNING SUPPLEMENTARY MATERIAL

The supplementary material for students and instructors is driven by the same basic beliefs as the textbook, providing a consistent and well-integrated active learning system. This hands-on, real-world package guides *instructors* through the processes of active learning and gives them the tools to create an interactive learning environment. With its emphasis on activities, exercises, and the Internet, the package encourages *students* to take an active role in the course and prepares them for decision making in a real-world context.

Instructor's Active Teaching Aids

Financial Accounting Web Site at <http://www.wiley.com/college/kimmel>. As a resource and learning tool for instructors and students, the Financial Accounting Web Site serves as a launching pad to numerous activities, resources, and related sites. Available through the Web site are links to companies discussed in the text and Instructor's Manual, additional cases and problems for students, and items such as the Checklist of Key Figures and PowerPoint Presentations for download. This site also provides a link to the Business Extra Web Site discussed below. Visit this site often for updated and new materials.

Instructor's Resource System on CD-ROM. Responding to the changing needs of instructors and to developments in distance learning and electronic classrooms, the Supplement CD-ROM provides all the instructor support material in an electronic format that is easy to navigate and use. This CD-ROM contains all the print supplements, as well as the electronic ones, for use in the classroom, for printing out material, for uploading to your own Web site, or for downloading and modifying, thus giving you the flexibility to access and prepare the material based on your needs.

Solutions Manual. The Solutions Manual contains detailed solutions to all exercises and problems in the textbook and suggested answers to the questions and cases. Print is large and bold for easy readability in lecture settings, and instructors may duplicate any portion of the manual without paying a permissions fee. Each chapter includes an *assignment classification table*, which identifies end-of-chapter items by study objectives, and an *assignment characteristics table*, describing each problem and alternative problem and identifying difficulty level and estimated completion time. The Solutions Manual has been carefully verified by a team of independent accuracy checkers.

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

Instructor's Manual. *Jessica Frazier, Eastern Kentucky University.* The Instructor's Manual is a comprehensive set of resources for preparing and presenting an active learning course. The Instructor's Manual discusses how to incorporate all the supplements, includes information on group and active learning, and has sample syllabi for use of the textbook. The Instructor's Manual also includes a series of discussions on how to incorporate ethics material, group activities, and communication activities in the course.

In addition to reading comprehension checks and short vocabulary and multiple-choice quizzes, each chapter also includes a number of activities and exercises designed to engage students in the learning process, including Research and Communication exercises, World Wide Web Research Exercises, Ethics Exercises, and International and Social Responsibility Exercises. The Web site for the text includes links for all Internet-based activities and exercises. Suggested solutions are provided where appropriate. Also included for each chapter are an *assignment classification table*; an *assignment characteristics table*; a *list of study objectives* in extra large, bold print for transparencies; and *suggestions for integrating supplements* into the classroom.

PowerPoint Presentation Material. *Ellen Sweatt, Georgia Perimeter College.* This PowerPoint lecture aid contains a combination of key concepts, images, and problems from the textbook for use in the classroom. Designed according to the organization of the material in the textbook, this series of electronic transparencies can be used to reinforce accounting principles visually and graphically.

Test Bank. *Lee Cannell, El Paso Community College.* Keeping assessment consistent with the focus of the text is the main objective of this comprehensive testing package. The Test Bank features over 3,000 questions with an emphasis on concepts, decision making, and a real-world environment. Actual financial statements have been used throughout the Test Bank to provide a relevant context for questions. All questions are classified according to study objectives and learning skills in tables at the beginning of each chapter, to make selection of exam questions easier. In addition to the examination material provided for each chapter, four comprehensive examinations covering four to five chapters are also included.

The Test Bank also includes a series of preprinted Achievement Tests for easy testing of major concepts. Each test covers two chapters from the textbook. In addition, a final exam covering all chapters in the text is included. The tests, easy to photocopy and distribute directly to students, consist of multiple-choice, matching, and true/false questions, and problems and exercises (computation and journal entries). Solutions are included at the end of each Achievement Test.

Computerized Test Bank. The Test Bank is also available for use with IBM and IBM true-compatibles running Windows 3.1 or higher. This Computerized Test Bank offers a number of valuable options that allow instructors

to create multiple versions of the same test by scrambling questions; generate a large number of test questions randomly or manually; and modify and customize test questions by changing existing problems or adding your own.

Test Preparation Service. Simply call Wiley's special number (1-800-541-5602) with the questions you want on an examination. Wiley will provide a customized master exam within 24 hours. If you prefer, questions can be selected from a number of chapters.

Checklist of Key Figures. A list of key amounts for problems allows students to verify the accuracy of their answers as they work through the assignments. Available for download through our Web site at <http://www.wiley.com/college/kimmel>.

Nightly Business Report Video. To bring the relevance of financial accounting into the classroom, the authors have selected a series of video clips from the *Nightly Business Report*, related to some of the actual companies discussed in the text. Each of the segments is approximately 3–5 minutes long and can be used to introduce topics to the students, enhance lecture material, and provide real-world context for related concepts. An Instructor's Manual with suggestions for integrating the material into the classroom accompanies the video.

General Ledger Evaluator Disk. This program is a simple way to evaluate students' answers prepared using the General Ledger Software. It evaluates both the transactions that were posted and the ending balances for each of the accounts. The program also includes many reporting options, allowing instructors to print detailed or summary reports for a student or a class using a variety of sort sequences.

WebCT. Available to adopters of *Financial Accounting*, WebCT is an integrated set of course management tools that enable instructors to easily design, develop, and manage Web-based and Web-enhanced courses.

The Wiley *Financial Accounting* WebCT course is the WebCT shell, with all its course management features, filled with Wiley content; it is an on-line learning and resource guide for the student. This WebCT course allows the professor to present all or part of a course on-line and helps the student organize the course material, understand key concepts, and access additional on-line resources and tools. Your Wiley WebCT course can be customized by the instructor. Contact your Wiley representative for more information.

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Student Active Learning Aids

Student Workbook. The Student Workbook is a comprehensive review of accounting and a powerful tool for students to use in the classroom, guiding students through chapter content, tied to study objectives, and providing resources for use during lectures. This is an excellent resource when preparing for exams. The Student Workbook is also an active learning tool, providing students with opportunities to engage in the learning and decision-making process.

Each chapter of the Student Workbook includes study objectives and a chapter review consisting of 20–30 key points; a demonstration problem linked to study objectives in the textbook; true/false, multiple-choice, and matching questions related to key terms; and exercises linked to study objectives. Solutions to the exercises explain the hows and whys so students get immediate feedback. A chapter outline and blank working papers allow students space to take lecture notes and record problems worked in class.

Working Papers. *Dick Wasson, Southwestern College.* Working Papers are partially completed accounting forms for all end-of-chapter exercises, problems, and cases. A convenient resource for organizing and completing homework assignments, they demonstrate how to correctly set up solution formats and are directly tied to textbook assignments. Each page of the Working Papers has the problem number and company name, and space for students to write their name and course information, providing instructors with consistent forms to grade.

Take Note! This handy note-taking guide includes all the PowerPoint presentations printed out three to a page, with spaces next to them for you to take notes. Take Note! allows you to focus on the discussions at hand, instead of focusing on copying down slides projected in class.

General Ledger Software. The General Ledger Software (GLS) is one of the most exciting technology supplements accompanying the Second Edition. Available in a Windows or Network version, the GLS program allows students to solve selected end-of-chapter problems, which are identified by a diskette icon in the margin of the text.

- GLS is ideal for instructors who want their students to gain a hands-on feel for a computerized accounting system. The program demonstrates the immediate effects of each transaction, helping students understand the use of computers in a real-world accounting environment.
- GLS has the ability to modify the existing chart of accounts and beginning balances when creating new problems. This increases the instructor's flexibility in assigning alternate problems within the textbook. This feature also provides students with more opportunity to practice with computerized accounting systems.
- GLS is user-friendly and easy to use, with little start-up time. The Windows version is on two disks, plus a data disk.

Financial Accounting Tutor (FaCT) Dan Gode, *New York University Stern School of Business*. FaCT is a self-paced CD-ROM tutorial designed to review financial accounting concepts. It uses simple examples that have been carefully crafted to introduce concepts gradually. Throughout, the program emphasizes the logic underlying the accounting process. FaCT uses interactive and graphical tools to enhance the learning process. Intuitive navigation and a powerful search mechanism allow you to easily follow the tutorial from start to finish or skip to the topics you want to complete. The discussions and examples are followed by brief, interactive problems that provide immediate feedback. Built-in tools, such as an on-line financial calculator, help solve the problems.

On-Line Business Survival Guide. The journey of 1000 Web sites begins with one click, and this practical guide gets instructors and students on the road. The On-Line Business Survival Guide is a brief, clear introduction to using the World Wide Web as a business research tool. Starting with the basics, this manual covers everything students need to know to become master sleuths at finding

critical information on the Internet. In addition, the guide provides a hands-on guide to using *The Wall Street Journal Interactive Edition*, as well as a discount offer for a subscription to *The Wall Street Journal Interactive* on-line.

Business Extra Web Site at <http://www.wiley.com/college/kimmel>. To complement the On-Line Business Survival Guide in Accounting, the Business Extra Web Site gives professors and students instant access to a wealth of current articles dealing with all aspects of financial accounting. The articles are organized by topic, and discussion questions follow each article. Students will find a password inside the On-Line Business Survival Guide that will give them access to the Business Extra Web Site.

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

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

STUDENT OWNER'S MANUAL

STUDENT TO STUDENT

Hello!

For many students, an introductory financial accounting class will be the first of many difficult challenges they will face in their academic career. With the proper use of this textbook, your probability of success in this course will be increased. A good idea is to preread the chapter or at least read the portion of the text that you will be covering in class that day. If you do this, often the professor will clarify points you were unsure of or reduce the number of questions that you may have on the material covered in that chapter.

This textbook has been designed in such a way as to facilitate the learning process for students. Each chapter begins with a situation from the real world. Companies such as Tootsie Roll, Wal-Mart, and Southwest Airlines are featured. Also, at the beginning of each chapter is a list of study objectives covering the key topics of the chapter.

Throughout the chapters there are Decision Toolkits. These toolkits are handy checkpoints that tell you how to put certain financial information to use in various business decisions. The toolkits describe what kind of information to use as well as how to interpret the results. In addition to the Decision Toolkits, scattered throughout the chapter are Before You Go On sections, which are small reviews of the material covered in each section. It is a good idea to make sure you comprehend the key material covered in the section before you move on to the next one. If you are still not sure you have a firm grasp of the material after using the Before You Go On materials, make a note of your question and ask your professor the next day in class.

Perhaps the most helpful aspect of this book is the material included at the end of each chapter. Each chapter contains a full summary of study objectives, a summary of the Decision Toolkits in the chapter, a glossary of new terms used, and a demonstration problem. In my experience, I have found that it is best to attempt to do the demonstration problem before I look at its solution; it is a good way to test your understanding of the material. There are also self-study questions, with answers, as well as many other questions, exercises, and problems. It is a good idea to attempt some of these materials as well, even if they aren't assigned as homework. Usually you will be able to get the answers from your instructor.

I hope that you have been able to pick up a few helpful study hints from this introduction. Ultimately, as with anything in life, what you get out of this class will largely depend on what you put into it.

Good luck, and I hope you enjoy this course as much as I did!

Jeff Robson

Jeff Robson
University of Nevada-Las Vegas

HOW TO USE THE STUDY AIDS IN THIS BOOK

CHAPTER 2

A Further Look at Financial Statements

STUDY OBJECTIVES

After studying this chapter, you should be able to:

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

JUST FOOLING AROUND?

Few people could have predicted how dramatically the Internet would change the investment world. One of the most interesting results is how it has changed the way ordinary people invest their savings. More and more people are spurning investment professionals and instead are choosing to strike out on their own, making their own investment decisions. A whole new breed of investors, known as "day-traders," has arisen. These are people, from doctors to car mechanics, who spend hours a day trading stocks over the Internet. They are empowered by the instant access to never-before-

available information that the Internet provides.

Two early pioneers in this area were Tom and David Gardner, brothers who created an online investor bulletin board called the Motley Fool. The name comes from Shakespeare's *As You Like It*. The fool in Shakespeare plays was the only one who could speak unpleasant truths to kings and queens without being killed. Tom and David view themselves as 20th-century "fools," revealing the "truths" of Wall Street to the small investor, who they feel has been taken advantage of by Wall Street insiders. Their online bulletin board enables in-

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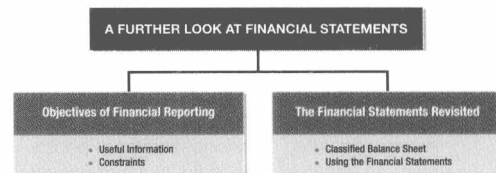
At the beginning of each chapter, **Study Objectives** provide you with a learning framework. Each study objective then reappears at the point within the chapter where the concept is discussed and is also summarized at the end of the chapter.

The **Preview** begins by linking the vignette with the major topics of the chapter. It then gives a graphic outline of major topics and subtopics that will be discussed. This narrative and visual preview gives you a mental framework upon which to arrange the information you are learning.

PREVIEW OF CHAPTER 2

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

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



The **Chapter-Opening Vignette** is a brief story that helps you picture how the chapter topics relate to the real worlds of accounting and business. Throughout the chapter, references to the vignette will help you put new ideas in context, organize them, and remember them. Most vignettes end with the **Internet address** of the company cited in the story.

SECTION 1 OBJECTIVES OF FINANCIAL REPORTING

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

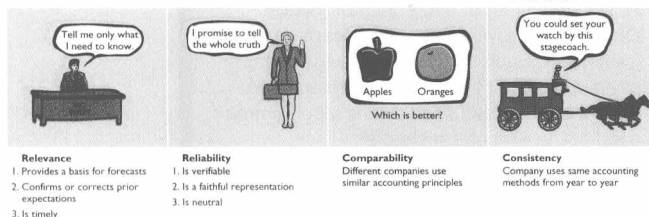


Illustration 2-1
Characteristics of useful information

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

CONSTRAINTS IN ACCOUNTING

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

MATERIALITY

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

Key terms that represent essential concepts of the chapter topic are printed in blue where they are first explained in the text. They are listed and defined again in the end-of-chapter glossary.

STUDY OBJECTIVE

Identify two constraints in accounting.

Study Objectives reappear in the margins at each point that the topic is discussed. End-of-chapter exercises and problems are keyed to study objectives.

Helpful Hints in the margins help clarify concepts being discussed.

Illustration 2-5 Current assets section

The Coca-Cola Company

THE COCA-COLA COMPANY Balance Sheet (partial) (in millions)

Current assets	
Cash and cash equivalents	\$1,648
Short-term investments	159
Trade accounts receivable	1,666
Inventories	890
Prepaid expenses and other assets	2,017
Total current assets	\$6,380

Financial statements appear regularly throughout the book. Those from real companies are identified by a logo or related photo. Often, numbers or categories are highlighted in colored type to draw your attention to key information.

A company's current assets are important in assessing its short-term debt-paying ability, as explained later in the chapter.

Alternative Terminology notes present synonymous terms that you may come across in practice.

Alternative Terminology
Long-term investments are often referred to simply as investments.

LONG-TERM INVESTMENTS

Long-term investments are generally investments in stocks and bonds of other corporations that are normally held for many years. In Illustration 2-4 Franklin Corporation reported long-term investments of \$7,200 on its balance sheet. Yahoo! Inc. reported long-term investments in its balance sheet as shown in Illustration 2-6.

FREIGHT COSTS

The sales invoice indicates whether the seller or the buyer pays the cost of transporting the goods to the buyer's place of business. When the buyer pays the transportation costs, these costs are considered part of the cost of purchasing inventory. As a result, the account Merchandise Inventory is increased. For example, if upon delivery of the goods on May 6, Sauk Stereo pays Haul-It Freight Company \$150 for freight charges, the entry on Sauk's books is:

May 6	Merchandise Inventory	150	
	Cash		150
	(To record payment of freight on goods purchased)		

$$A = L + SE$$

$$+150$$

$$-150$$

Accounting equation analyses appear in the margin next to key journal entries. They will help you understand the impact of an accounting transaction on the financial statements.