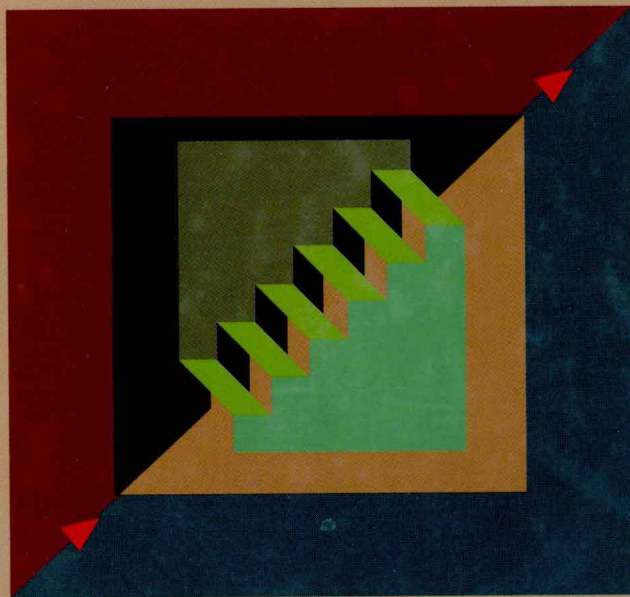


# FINANCIAL ACCOUNTING

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S I X T H E D I T I O N



Larson

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Miller

# FINANCIAL ACCOUNTING

S I X T H E D I T I O N

**Kermit D. Larson**

*University of Texas–Austin*

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*University of Colorado–Colorado Springs*

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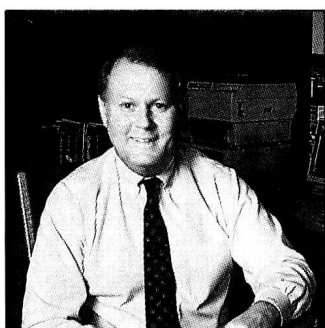
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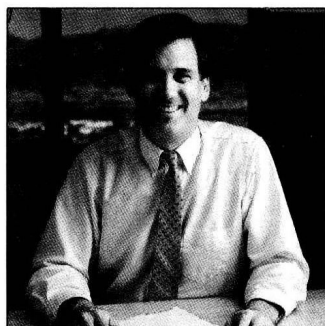
Dedicated to  
Nancy, Julie, Tim, Cindy, Albrecht, and Megan  
and to  
Diana, David, Greg, and Angela

# About the Authors



**Kermit D. Larson** is the Arthur Andersen & Co. Alumni Centennial Professor Emeritus of Accounting at The University of Texas at Austin, where he has been a member of the faculty since 1966. He served as chairman of the UT Department of Accounting from 1971 to 1975 and was Visiting Associate Professor at Tulane University in 1970. His scholarly articles have been published in a variety of journals such as *The Accounting Review*, *Journal of Accountancy*, and *Abacus*. He has also co-authored several books, including *Financial and Managerial Accounting* and *Fundamental Accounting Principles*, published by Richard D. Irwin, Inc.

Kermit's professional activities range from service as chairman of the American Accounting Association's Committee on Concepts and Standards, vice president of the American Accounting Association, Southwest regional vice president of the AAA, and director of the AAA Doctoral Consortium, to member of the Constitutional Drafting Committee of the Federation of Schools of Accountancy and member of the Commission on Professional Accounting Education. He has served on the Accounting Accreditation Committee and on the Accounting Standards Committee of the AACSB and has been an expert witness on cases involving mergers, antitrust litigation, and expropriation of assets by foreign governments. Kermit has served on the board of directors and executive committee of Tekcon, Inc., the Strategic Planning Committee of the American Accounting Association, and the National Accountant's Advisory Board of Safeguard Business Systems, Inc. Presently he serves as president of the Richard D. Irwin Foundation.



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# Preface

This new edition of *Financial Accounting* reflects more extensive changes and improvements than one might expect in a sixth edition. The revision has shifted the focus of the book to include much more attention on the use of accounting information by business owners, lenders, managers, and other parties who are interested in the financial affairs of a business. This is accomplished while maintaining the text's appropriate role of showing students how the information is developed. As a result, *Financial Accounting* (1) develops a general understanding of financial reports and analyses that students will use in their personal and professional affairs, (2) provides a strong foundation for future courses in business and finance, and (3) initiates the course work that would lead to a career in accounting.

This revision has been developed in response to the most intensive and far-reaching input from current and potential adopters in the history of all prior editions. Perhaps the most dominant theme of these criticisms and suggestions has been that the authors should take a more proactive role in limiting the depth and range of topical coverage in the financial accounting course. The clear imperative has been that the text should reverse the trend toward being a complete resource for all possible combinations of topical development. As a result, in close contact with reviewers and other instructors, we have taken numerous steps to avoid technical matters better left to intermediate level courses. In addition, we have deleted topics that have become less relevant in the changing climate of business practices. We discuss these revisions in the following paragraphs.

---

Revised to Limit  
Depth of Coverage  
and Delete Less  
Relevant Topics

## *Expanded Prologue and Limited Focus of Chapter 1*

The first important change in this direction was to prepare an expanded Prologue that now describes the accounting function in the context of other organizational functions such as finance, human resources, research and development, production, marketing, and executive management. The Prologue also explains the work accountants do—including their certifications and the fields within which accountants work—and the pervasive importance of ethics in accounting. This accomplishes two basic improvements. First, as a separate learning unit, the Prologue emphasizes the overall importance of these topics to an understanding of the role accounting plays in providing information to a variety of decision makers. Instructors who want to give more attention to these topics, as suggested by the Accounting Education Change Commission (AECC), will find the Prologue especially appealing.



Second, as a result of the Prologue revision, Chapter 1 is now a much shorter and more manageable learning unit with a clear focus on financial statements. This includes the information contained in the statements, the basic concepts that guide the development and use of accounting information, and the relationship of the statements to the transactions and events in the life of a business.

### *Deletions in Chapters 4 and 5*

Reviewers and adopters have overwhelmingly encouraged limiting the early examples in the book to proprietorships. As a result, the discussion of corporations has been deleted from Chapter 4 and from the illustrations in Chapter 5. Corporations are considered in the early chapters only as necessary to support student interaction with the financial statements at the back of the book and to recognize the existence of alternative forms of business organization.

Work sheets are now presented as an *optional* step in the accounting cycle. However, we also describe other reasons why an understanding of work sheets is useful. In addition, a more concise recognition of the adjusting entry method of accounting for inventories has eliminated the need for a separate appendix at the end of Chapter 5.

### *Discounting Notes Receivable*

The revision of Chapter 7 recognizes the fact that an increasing number of companies routinely convert their receivables into cash without waiting to receive customer payments. In dealing with this modern business practice, the discussion of discounting notes receivable has been replaced with a more general examination of the various ways receivables may be converted into cash.

### *Topics Related to Inventories*

Because perpetual inventory records are rarely maintained on a LIFO basis, LIFO has been deleted from the discussion of perpetual inventories in Chapter 8. Also, the discussion of lower of cost or market has been simplified to avoid the details of considering ceiling and floor concepts when defining market value. Finally, the treatment of markups and markdowns has been eliminated from the discussion of the retail inventory method. Reviewers agree that all three of these topics are better left to intermediate level courses.

### *Topics Related to Property, Plant, and Equipment*

Sum-of-the-years' digits has been deleted from the discussion of accelerated depreciation, as has the matter of apportioning accelerated depreciation between accounting periods. To help students appreciate the differences between financial accounting and tax accounting, we continue to discuss MACRS. However, the discussion has been condensed to exclude the calculations that underlie MACRS tax rate tables. We also eliminated the discussions of plant asset subsidiary records and tax rules that govern plant asset exchanges.

### *Consolidated Financial Statements*

Adopters indicate that the consolidated statements chapter in prior editions was the one they most frequently omitted. Nevertheless, long-term investments are an extremely important financial consideration in evaluating most large companies. By eliminating the details of consolidated statements, we have been able to develop a more balanced set of asset chapters. This involves a new Chapter 10 that completes the asset coverage by discussing natural resources, intangible assets, and long-term investments. The long-term in-

vestments portion naturally concludes with a discussion of investments in international operations.

### *Leases and Deferred Income Taxes Liabilities*

In Chapter 11, the discussion of leases has been significantly shortened. Students learn the differences between capital and operating leases without having to journalize the entries related to capital leases. Also, the appendix on deferred income taxes has been deleted as a technical issue better left to intermediate level courses.

### *Deletion of Cash Flows Appendix and Direct Method Work Sheet*

In explaining cash flows from operating activities in Chapter 14, we first explain the direct method, which is most relevant to managerial evaluations and predictions. However, the direct method work sheet has been deleted. We then explain the indirect method as the dominant method used in financial reporting. This approach avoids the need for a separate appendix dealing with the direct method.

### *Segmental Reporting*

The illustration and discussion of segmental reporting has been eliminated from Chapter 16, based on reviewers suggestions that the topic is better suited for an intermediate level course.

Several important features of this text mark its effectiveness. They include the following:

---

## Special Features

### *Expanded Focus on the Use of Financial Information*

Instructors and reviewers have uniformly called for a new commitment to show students the relevance of accounting information and to teach them how to use the information. We have responded to this in a variety of ways. Most obviously, every chapter now includes a section under the general heading Using the Information. These sections show students how to calculate, interpret, and use information such as:

- Return on equity (Chapter 1)
- Debt ratio (Chapter 2)
- Current ratio (Chapter 3)
- Profit margin ratio (Chapter 4)
- Acid-test ratio (Chapter 5)
- Days' sales uncollected (Chapter 6)
- Accounts receivable turnover (Chapter 7)
- Merchandise turnover and days' stock on hand (Chapter 8)
- Total asset turnover (Chapter 9)
- Return on total assets (Chapter 10)
- Times fixed interest charges earned (Chapter 11)
- Pledged assets to secured liabilities (Chapter 12)
- Dividend yield (Chapter 13)
- Cash flow analyses (Chapter 14)
- Price-earnings ratio (Chapter 15)

In Chapter 16, we review and discuss the relationships between all of these ratios. We also discuss vertical and horizontal analyses and the use of other financial disclosures.



New to this edition are boxed quotations and biographical sketches of persons in business, accounting, and public service. In addition to providing role models for students, these individuals explain how they use accounting information in various decision-making situations.

Numerous sections of the text have been rewritten to explain the accounting issues from the perspective of those who use the information. Also, a large number of the end-of-chapter assignments now require responses that place students in the role of accounting information users. The assignments that require students to compute financial ratios are identified in the text by this symbol:



### *Broad Exposure to Real World Situations*


The text incorporates a variety of features that expose students to real world situations and show the relevance of the material to real world decisions. These features include:

- End-of-chapter questions drawn from the financial statements of Apple Computer, Inc.; Ben & Jerry's Homemade, Inc.; and Federal Expresses Corporation. These financial statements are provided in appendixes to the book.
- Provocative problems at the end of each chapter that call upon students to read and interpret the financial information in Apple Computer's annual report. Also included are many additional provocative problems that are based on real company information.
- A complete rewriting of Chapter 16 that uses the 1993 financial statements of Microsoft Corporation as the basis of the analysis throughout the chapter. The effect is to emphasize the relevance of these issues to real decision situations.
- As a Matter of Opinion inserts that contain brief biographies, pictures, and quotations of persons in business, accounting, and public service. These individuals explain why the material of the chapter is relevant to their business decisions.

### *Integrated Coverage of Mark-to-Market Accounting (SFAS 115)*

The May 1993 issuance of *SFAS 115* represents an accounting milestone in its break from the traditional cost and lower-of-cost-or-market bases of reporting. As a result, we incorporate this new development in several sections of the book. These include short-term investments in Chapter 7, long-term investments in Chapter 10, and alternative valuation methods in Appendix C.

### *An Emphasis on Analytical Thinking and Communication Skills*

The text contains a large number of problems that are identified as analytical essays. Each of them requires students to critically analyze a situation and express their conclusions in writing. Many of the exercises and provocative problems require students to think analytically by working "backward" from outputs to inputs or by analyzing the consequences of errors or omissions. Also, selected chapters include a problem that has as one of its requirements the preparation of a memo, letter, or report to convey information to business colleagues. These promote the development of skills essential for effective business communication. The analytical essays are identified by  and

the business communication problems by 

### *Integrated Coverage of Ethics*

In addition to the discussion of ethics in the Prologue, several chapters contain As A Matter of Ethics cases that relate closely to the technical issues in the chapter. For each of these cases, a provocative problem requires students to analyze the case and express their conclusions in the form of an essay. These problems are identified by this symbol:



### *Group Assignments*

The instructor's F.A.S.T. Edition of the text contains suggested ways of using selected problem assignments as the basis for group projects. Each chapter includes at least one group project suggestion. The purpose of the group projects is to introduce students to the real life activity of working in teams. We also believe the group projects will help encourage more active student participation in the classroom.

### *Effective Use of Visual Aids*

In response to the visual orientation of most students, we have included a wide range of graphical illustrations that convey the logical relationships between important concepts. The transparency overlay presentation of the work sheet in Chapter 4 is especially noteworthy. Our experience indicates that these overlays are very effective in helping students understand the accounting cycle.

### *Appendixes That Are Complete Learning Units*

The appendixes are intended to give instructors maximum flexibility in selecting and organizing the topical coverage of their courses. The topical appendixes are fully supported with learning objectives, summaries, objective review questions, assignment material, and coverage in the study guides and test bank. Thus, each topical appendix is a complete learning unit.

### *Extensive and Diverse Assignment Material*

The assignment material has been thoroughly revised and carefully developed to include a wide variety of questions, exercises, problems, alternate problems, provocative problems, comprehensive problems, and a serial problem. The serial problem in Chapters 2, 3, 4, and 5 involves a single company's operations and may be started after any of those chapters without going back to rework the problem in earlier chapters.

### *Responses to the AECC*

Many of the features discussed in the previous paragraphs are consistent with or responsive to the recommendations of the Accounting Education Change Commission. These include the emphases on using accounting information, analytical or critical thinking, communication skills, integration of ethics, exposure to real world issues and situations, and group project suggestions. Additional features of the text that address the AECC's concerns include the coverage of international issues in Chapters 1 and 10, the deletion of several procedural discussions, the emphasis placed on decision making, and the overriding educational philosophy of maximizing student involvement in the learning process.


## Alternate Problems and Packaging Options

Many instructors have asked that innovative approaches be taken to develop a text that students would want to carry with them to class and to study periods. One way we have responded is to transfer the alternate problems from the text to a separate booklet. The booklet is available in quantity to adopters.

In addition to the hardcover version of the text, a softcover version that includes working papers is available. Various special packaging options are also available depending on the unique needs of each school. Please consult your Irwin representative for details.

## Supplements that Support the Text

*Financial Accounting* is supported by a full range of supplements. They include:

- **Fully Annotated Support for Teaching Edition.** Marginal annotations include Fast Hints, Video Notes, and Check Figures. Fast Hints include Important Points to Remember, Critical Thought Questions, Real World parallels, Relevant Exercises, and Alternative Examples.
- **Solutions Manual.** The solutions manual contains complete solutions for all assignment material.
- **Working Papers.** This volume includes papers for the exercises, the problems or alternate problems, the comprehensive problems, and the serial problem.
- **Study Guide.** For each chapter and appendix, this guide reviews the learning objectives and the summaries, outlines the topical coverage, and provides a variety of problems with solutions.
- **Test Bank.** The test bank contains a wide variety of test questions, including true/false, multiple-choice, quantitative, matching, and essay questions of varying levels of difficulty.
- **Computest.** The extensive features of this test generator program include random question selection based on the user's specification of learning objectives, type of question, and level of difficulty. Users have tremendous flexibility in using the program. They can:
  - Preview selected questions before final acceptance.
  - Edit questions.
  - Add their own questions to the test bank.
  - Scramble questions when printing up to 99 versions of an exam.
  - Scramble multiple choice answers when printing.
  - Insert heading material on the first page.
  - Save and recall exams.
  - Password protect exam files or the entire test bank.
  - Save exams in ASCII format.
- **Teletest.** Irwin is happy to serve those without access to administrative support or a computer system. Simply choose your questions from the Test Bank and call Irwin College New Media.
- **GLAS (General Ledger Applications Software).** This package contains most of the features of commercial accounting software, yet is easily used by students with little or no computer background. A large number of problem assignments are preloaded on the package. These are identified in the text by this symbol:  This software can also be used to

solve any other problem that calls for journal entries. Both DOS and Windows versions are available.

- **SPATS (Spreadsheet Applications Template Software).** This includes Lotus 1-2-3 (or the equivalent) templates for selected problems and exercises from the text. The templates gradually become more complex, requiring students to build a variety of formulas. “What if” questions are added to show the power of spreadsheets and a simple tutorial is included. Both DOS and Windows versions are available. The problems and exercises for which these templates are available are indicated by this symbol:



- **Tutorial Software.** Multiple-choice, true/false, journal entry review, and glossary review questions are randomly accessed by students. Explanations of right and wrong answers are provided and scores are tallied. Both DOS and Windows versions are available.
- **Practice Sets**
  - Barns Bluff Camping Equipment Company.** This manual practice set utilizes business papers. It also covers special journals. It has been extensively revised for the Sixth Edition.
  - Republic Lighting Company.** This is a manual practice set with a narrative of transactions.

Note: Both Barns Bluff and Republic Lighting have their opening balances preloaded on GLAS. They can each be purchased in a version that includes a GLAS disk.

In addition, five computerized practice sets are available, all authored by Leland Mansuetti and Keith Weidkamp of Sierra College:

  - Granite Bay JetSki, Level One**
  - Granite Bay JetSki, Inc., Level Two**
  - Thunder Mountain Snowmobile**
  - Gold Run Snowmobile, Inc.**
  - Wild Goose Marina, Inc.**
- **Solutions Transparencies.** These transparencies are set in large, boldface type to maximize their effectiveness in large classrooms.
- **Financial Accounting Teaching Transparencies.** This set of over 150 color transparencies provides visual support for your complete financial accounting course. A guide for suggested use of each specific transparency with this text is provided.
- **Financial Accounting Video Library.** This video series is designed to strengthen your classroom presentations, grab your students' interest, and add variety to your students' learning process. Topics covered include: Plant and Equipment, Partnerships and Corporations, the FASB's Conceptual Framework, and International Accounting. Each of the 10 videos provides approximately 12 minutes of important topical coverage.
- **Lecture Review Videos.** These videos are prepared by Kirkwood Community College, Cedar Rapids, IA. Selections from this series of lessons can be used to support and reinforce the concepts and procedures found throughout the text. Each lesson runs approximately 15 minutes.

We are grateful for the encouragement, suggestions, reviews, and counsel that have been provided by our students, colleagues, and instructors from across the nation. A tremendous amount of useful information was gained from the participants in the Irwin Accounting Education Seminars. Many others contributed through their responses to the publisher's printed survey and through reviews of various portions of the manuscript. They include:

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**Kermit D. Larson**  
**Paul B. W. Miller**

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