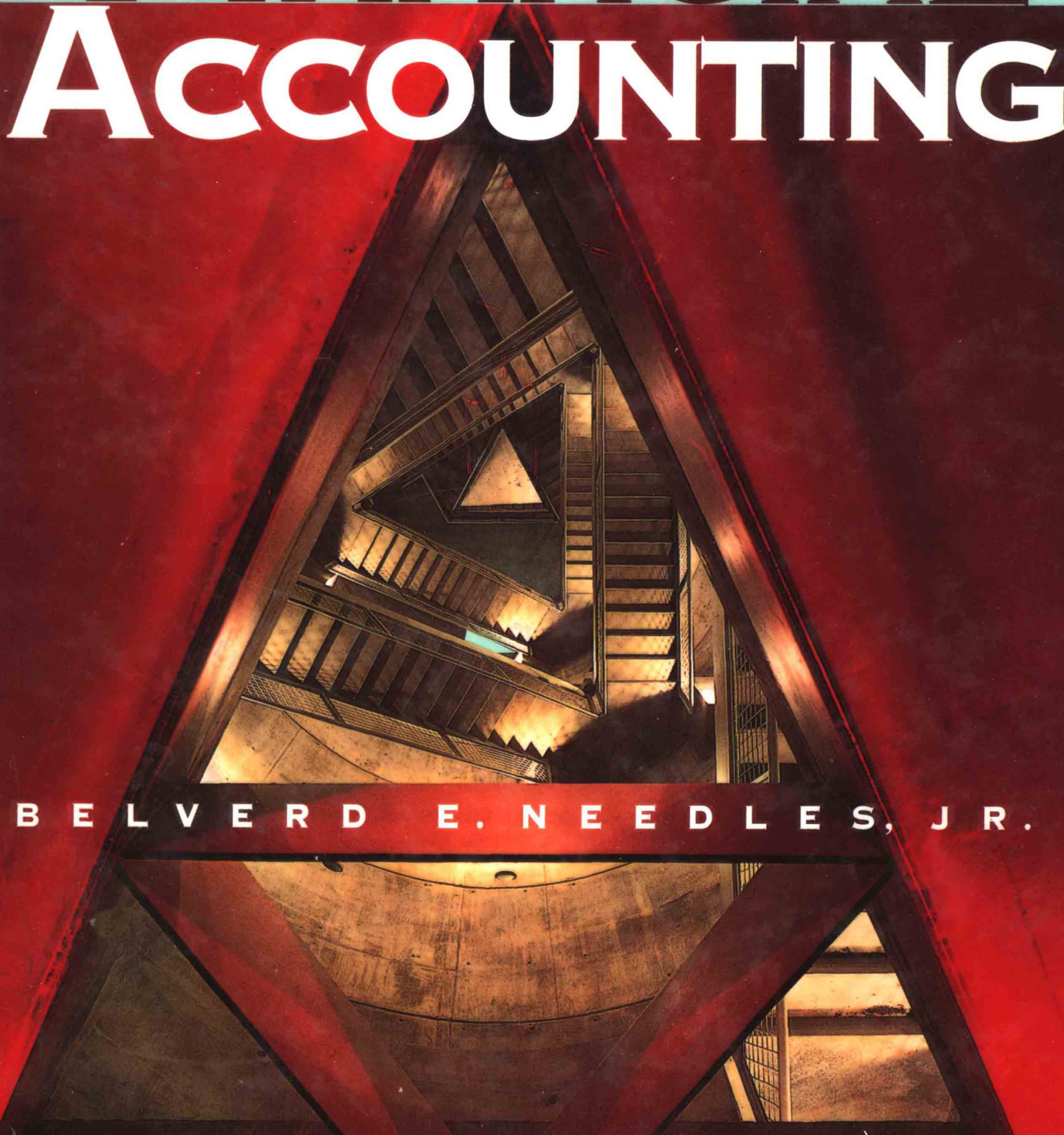


F I F T H E D I T I O N

FINANCIAL Accounting

B E L V E R D E . N E E D L E S , J R .



FIFTH EDITION

Financial Accounting

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*To my wife, Marian,
To my mother, Mrs. Belverd E. Needles, Sr., and
In memory of my father, Mr. Belverd E. Needles, Sr.,
and my grandparents, Mr. and Mrs. Benjamin E. Needles*

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Improvement Model, which encompasses an enlarged set of instructional strategies designed to achieve a broad skill set in students. This model, which includes the Teaching/Learning Cycle™, cognitive levels of learning, output skills, instructional strategies, and evaluation and feedback, is described in the special “Partners in Change” insert in the Instructors’ Edition of this text. Among the goals of the Fifth Edition that result from the application of this model are (1) to develop a much stronger user orientation and reduce the procedural detail, (2) to increase the real-world emphasis, (3) to reorganize and expand the assignment material to develop a broad set of skills, including critical thinking, communication, and financial statement analysis, and (4) to make the book more visually interesting. How these goals are achieved is described in the following sections.

A MUCH STRONGER USER ORIENTATION

Financial Accounting has always emphasized the use of accounting information by external users. The Fifth Edition places additional emphasis on the uses of accounting information by management and on decisions that management makes regarding accounting information.

New Management Sections New sections on management’s use of accounting information appear at or near the beginning of the following chapters:

- Chapter 1 Uses of Accounting Information
- Chapter 5 Accounting for Merchandising Operations
- Chapter 7 Short-Term Liquid Assets
- Chapter 8 Inventories
- Chapter 9 Long-Term Assets
- Chapter 10 Current Liabilities
- Chapter 11 Long-Term Liabilities

Financial Ratios Beginning with Chapter 6, financial analysis ratios are introduced and are integrated in subsequent chapters at appropriate points. These ratios are usually discussed in the “management issues” section at the beginning of the chapters.

Reduced Procedural Detail The first seven chapters have been substantially revised to reduce procedural detail. Unnecessary topics are deleted, and procedures that are not essential to conceptual understanding are treated as supplemental objectives at chapter’s end. The extent of change resulting from increased emphasis on management’s use of accounting information and decreased emphasis on procedural detail throughout the text can be seen in the following detailed descriptions of the revisions in three sample chapters:

- **CHAPTER 1 Uses of Accounting Information and the Basic Financial Statements**
 Rewritten and reorganized to reflect its new title, this chapter contains new material that emphasizes business and management uses of accounting information. All-new illustrations highlight the business goals of profitability and liquidity and the activities of financing, investing, and operating. A new section discusses the use of accounting information in all management functions. The section on the basic financial statements has been rewritten and is accompanied by a new illustration to underscore the interrelationship of the statements. The section on GAAP and organizations that influence GAAP has been moved toward the end of the chapter to smooth the flow of information earlier in the chapter. The section on professional ethics and the accounting profession has been rewritten and, through more concise writing, shortened.

- **CHAPTER 5 Accounting for Merchandising Operations** Rewritten to focus on the merchandising income statement, to provide increased coverage of the perpetual inventory system, and to remove much of the procedural detail usually associated with the topic of merchandising, Chapter 5 now contains a new opening section that focuses on management issues related to merchandising businesses, including the concept of the operating cycle and its relationship to cash flows. The structure of the merchandising income statement is presented early in the chapter, and a new illustration of the components of cost of goods sold is included. The chapter now offers equal and parallel coverage of the periodic and perpetual inventory systems. Since sales discounts and purchases discounts are usually immaterial and add procedural complexity to the problems, these topics have been transferred from the discussion of merchandising transactions to the end of the chapter and treated as a supplemental objective. The merchandising work sheet and closing entries have been moved from the chapter to an appendix at the end of the book.
- **CHAPTER 7 Short-Term Liquid Assets** A new section on the management issues related to short-term liquid assets has been added at the beginning of Chapter 7. It focuses on managing cash needs, setting credit policies, and financing receivables, and introduces two key ratios—receivable turnover and average days' sales uncollected. The discussion of cash and cash equivalents has been updated to incorporate the new topic of banking and electronic funds transfer, and the discussion of short-term investments has been rewritten to incorporate the requirements of SFAS No. 115. The topic of bank reconciliations has been moved to the discussion of cash and cash equivalents. The learning objective that previously covered miscellaneous topics related to accounts receivable has been eliminated, and the topics have been either integrated into the discussion of accounts receivable or omitted in order to reduce procedural detail. One new illustration shows the relationship of the subsidiary ledger to the controlling account, and another illustration contrasts two approaches to estimating uncollectible accounts. The entries for discounting notes receivable and petty cash procedures have been deleted to reduce the procedural detail, and the topic of credit card sales has been made a supplemental objective.

Eliminated Procedural Topics Other examples of eliminated procedural topics are:

- Chapter 9 Sum-of-the-years'-digits method
- Chapter 9 Methods of computing goodwill
- Chapter 9 Accounting for assets of low unit cost
- Chapter 10 Employee payroll records

New or Revised Conceptual and Analytical Topics Examples of new or substantially revised conceptual or analytical topics are:

- Chapter 2 The use of the chart of accounts as a data base for accounting information
- Chapter 3 The relationships of cash flows to accrual accounting
- Chapter 6 Management's responsibility for ethical reporting
- Chapter 6 Components of an annual report (using Toys "R" Us)
- Chapter 8 Parallel presentation of inventory pricing methods for both the periodic and the perpetual inventory systems
- Chapter 9 Integration of the concepts of capital and revenue expenditures into the section on acquisition cost
- Chapter 14 Analysis of cash flows
- Chapter 15 Nature of nonoperating items under quality of earnings
- Chapter 15 Comprehensive illustration of ratio analysis using the financial statements of Apple Computer, Inc.
- Chapter 15 Ratios related to cash flow adequacy

Preface

Sections about accounting for marketable securities in Chapters 7, 14, 15, and the appendix on bond investments have been updated for the effects of SFAS No. 115.

Supplemental Objectives Some topics are treated under supplemental objectives so they can be covered at the instructor's discretion. Exercises and problems that cover supplemental topics are identified and placed at the end of their respective assignment sets. Examples of topics that have been made supplemental objectives include:

- Chapter 3 Relationships of cash flows to accrual accounting
- Chapter 4 The work sheet
- Chapter 4 Reversing entries
- Chapter 5 Sales discounts and purchases discounts
- Chapter 5 Merchandising work sheet and closing entries
- Chapter 7 Credit card sales
- Chapter 8 Valuing inventories by estimation
- Chapter 9 Special problems of depreciating plant assets
- Chapter 14 Workbook approach to statement of cash flows

INCREASE IN REAL-WORLD EMPHASIS

Many steps have been taken to increase the real-world emphasis of the text, including the following:

Decision Points Every chapter contains at least two Decision Points based on real companies. Decision Points present a situation requiring a decision by management or other users of accounting information and then show how the decision can be made using accounting information.

Business Bulletins Also new in this edition are features called Business Bulletins—short items related to chapter topics that show the relevance of accounting in four areas: Business Practice, International Practice, Technology in Practice, and Ethics in Practice.

Other Real-World Topics Information from actual annual reports and articles from such periodicals as *Business Week*, *Forbes*, and the *Wall Street Journal* enhances students' appreciation for the usefulness and relevance of accounting information. In total, more than one hundred publicly held companies have been used as examples. In addition, Chapter 15 demonstrates financial statement analysis using the financial statements of Apple Computer, Inc. Among the real-world topics introduced for the first time in this edition are:

- Chapter 1 Business strategies, goals, and activities
- Chapter 5 Complete and parallel coverage of the perpetual and periodic inventory systems
- Chapter 7 Banking and electronic funds transfer
- Chapter 10 Relationship of interest rates to length of maturities and risk for U.S. Treasury debt and corporate debt
- Chapter 11 Financial leverage
- Chapter 12 Initial public offerings and "tombstone" advertisements
- Chapter 15 The segment information of PepsiCo, Inc.

Real Companies in Assignments The use of real companies in the assignment materials has been greatly increased, as discussed below.

International Accounting In recognition of the global economy in which all businesses operate today, international accounting examples are introduced

in Chapter 1 and integrated throughout the text. Among the foreign companies mentioned in the text and assignments are Takashimaya Co. (Japanese), Wellcome (British), Mitsubishi (Japanese), and Groupe Michelin (French).

Real-World Graphic Illustrations Graphs or tables illustrating how actual business practices relate to chapter topics are presented in most chapters. Many of these illustrations are based on data from studies of 600 annual reports published in *Accounting Trends and Techniques*. Beginning in Chapter 6, most chapters have a new graphic that shows selected ratios for selected industries based on Dun and Bradstreet data. Service industry examples include accounting and bookkeeping and interstate trucking companies. Merchandising industry examples include auto and home supply and grocery store companies. Manufacturing industry examples include pharmaceutical and appliance companies. Most Interpretation Cases from Business are based on the published financial reports of real companies.

Governmental and Not-for-Profit Organizations In recognition of the importance of governmental and not-for-profit organizations in our society, discussions and examples regarding such organizations are included at appropriate points. Among the organizations cited are the city of Chicago and the Lyric Opera of Chicago. An appendix at the end of the book provides an introduction to accounting for governmental and not-for-profit organizations.

REORGANIZED AND EXPANDED ASSIGNMENT MATERIAL TO EMPHASIZE CRITICAL THINKING, COMMUNICATION, AND FINANCIAL STATEMENT ANALYSIS

To accommodate students' need for an expanded skill set and instructors' need for greater pedagogical flexibility, the end-of-chapter assignments and accompanying materials have been reorganized and greatly expanded. My objective has been to provide the most comprehensive and flexible set of assignments available and to include more cases that involve real companies. Because students need to be better prepared in writing and communication skills, I have provided ample assignments to enhance student communication skills. In the new organization, each type of assignment has a specific title and purpose, and has been placed in one of four categories. The end-of-chapter assignments and principal accompanying materials are as follows:

KNOWLEDGE AND UNDERSTANDING

Questions (Q) Fifteen to twenty-four review questions that cover the essential topics of the chapter.

Short Exercises (SE) Ten brief exercises suitable for classroom use that cover the key points of the chapter.

APPLICATION

Exercises (E) Fifteen single-topic exercises that stress the application of all topics in the chapter.

Problem Set A (A) Five more extensive applications of chapter topics, often covering more than one learning objective. Selected problems in each chapter contain writing components.

Preface

Problem Set B (B) An alternative set of problems.

CRITICAL THINKING AND COMMUNICATION

Conceptual Mini-Cases (CMC) Designed so a written solution is appropriate, but usable in other communication modes, these short cases address conceptual accounting issues and are based on real companies and situations.

Ethics Mini-Cases (EMC) In recognition that accounting and business students need to be exposed in all their courses to ethical considerations, every chapter has a short case, often based on a real company, in which students must address an ethical dilemma directly related to the chapter content.

Decision-Making Case (DMC) In the role of decision maker, the student is asked to extract relevant data from a longer case, make computations as necessary, and arrive at a determination. The decision maker may be a manager, an investor, an analyst, or a creditor.

Basic Research Activity (RA) These exercises are designed to acquaint students with the use of business periodicals, annual reports and business references, and the library. Through field activities at actual businesses, students can improve interviewing and observation skills.

FINANCIAL REPORTING AND ANALYSIS

Interpretation Cases from Business (ICB) Short cases abstracted from business articles and annual reports of well-known corporations and organizations such as K-Mart, Sears, IBM, Toys "R" Us, Chrysler, and UAL (United Airlines) require students to extract relevant data, make computations, and interpret the results.

International Company Case (ICC) Short cases similar to the ICBs, but involving companies from other countries.

Toys "R" Us Case (TC) Cases that emphasize the reading and analysis of the actual annual report of Toys "R" Us contained in an appendix at the end of the book.

COMPREHENSIVE PROBLEM

A comprehensive problem covering Chapters 11 and 12 has been added after Chapter 12. Comprehensive stockholders' equity transactions for Sundial Corporation are recorded and a statement of stockholders' equity is prepared.

COMPUTER ASSIGNMENTS

Exercises, cases, and problems that can be solved with Lotus® or General Ledger Software are identified by icons in the text.

MOODY'S COMPANY DATA™ ASSIGNMENT BOOKLET

A series of cases that make use of the Moody's Company Data Base software containing the complete financial records of approximately one-hundred publicly held U.S. companies, keyed to topics in the text.

BUSINESS READINGS

Accompanying the text is a booklet of approximately thirty readings from business and accounting periodicals, such as *Business Week*, *Forbes*, the *Wall Street Journal*, the *Journal of Accountancy*, and *Management Accounting*. These readings, which are coordinated to chapter topics, highlight the relevance of accounting to business issues for real companies. In addition, they address ethical issues, international accounting, not-for-profit applications, and historical perspectives.

FINANCIAL ANALYSIS CASES

Also accompanying the text are a series of comprehensive financial analysis cases that may be integrated throughout the course after Chapter 6 or used as a capstone for the entire course. The first, *General Mills: Decision Case in Financial Analysis*, uses the actual annual report of General Mills, Inc. The other cases, *Heartland Airways, Inc.* and *Richland Home Centers, Inc.*, present complete annual reports for an airline company and a home improvement retailing chain and guide students through a complete financial analysis. These cases may be assigned individually, and provide excellent group assignments, as well. *Soft-Tec, Inc.*, a practice case based on a small merchandising business operating as a corporation, is also available for use after Chapter 5 in the text.

A MORE VISUALLY INTERESTING BOOK

New four-color photographs have been added to every chapter to illustrate the relevance of accounting to business. Bright, lively colors and more contemporary graphics are used throughout. Most illustrations of concepts and relationships have been redrawn for greater clarity, and many new illustrations have been added to enhance comprehension and visual appeal. Examples of the new visual approach in the first five chapters include all illustrations in Chapter 1, the figure depicting the analysis and processing of accounting transactions in Chapter 2, the five figures showing account relationships for adjusting entries in Chapter 3, the figures of the accounting cycle and the closing process in Chapter 4, and the figure illustrating the components of cost of goods sold in Chapter 5.

SUPPLEMENTARY LEARNING AIDS

Study Guide

Business Readings in Financial Accounting

Working Papers for Exercises and A Problems

Blank Working Papers

Check List of Key Figures

Accounting Transaction Tutor

General Ledger Software

Lotus® Templates to Accompany Financial Accounting, with Student Manual

Preface

Moody's Company Data™ Software and Assignment Booklet
Moody's Handbook of Dividend Achievers™—1994 Houghton Mifflin
 Educational Edition
 Student Resource Videos for Chapters 1–4
 Business Bulletin Videos

INSTRUCTOR'S SUPPORT MATERIALS

Instructor's Solutions Manual
 Instructor's Handbook
 Test Bank
 Computerized Test Bank
A.S.S.E.T.: Accounting Software System for Electronic Transparencies
 Solutions Transparencies Boxes 1 & 2
 Teaching Transparencies
 Videodisc
 Master Teacher Video

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Preparing a financial accounting text is a long and demanding project that cannot really succeed without the help of one's colleagues. I am grateful to a large number of professors, other professional colleagues, and students for their many constructive comments on the text. Unfortunately, any attempt to list all who have helped risks slighting some by omission. Nonetheless, some try must be made to mention those who have been so helpful.

I wish to express my deep appreciation to my colleagues at DePaul University, who have been extremely supportive and encouraging.

The thoughtful and meticulous work of Edward Julius (California Lutheran University) is reflected not only in the Study Guide and Test Bank, but also in many other ways. I also would like to thank Marguerite Savage (Elgin Community College) for her work on the Instructor's Handbook, as well as Marion Taube (University of Pittsburgh) for her contribution to the Working Papers.

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cerns, and motives of others. Leadership, supervision, and interviewing skills also facilitate a professional's interaction with others.

Personal/Self Skills Personal/self skills form the foundation for growth in the use of all other skills. To succeed, a professional must take initiative, possess self-confidence, show independence, and be ethical in all areas of life. Personal/self skills can be enhanced significantly by the formal learning process and by peers and mentors who provide models upon which you can build. Financial Accounting is just one course in your entire curriculum, but it can play an important role in your development of the above skills. Your instructor is interested in helping you gain both a knowledge of accounting and the more general skills you will need to succeed in the business world. The following sections describe how you can get the most out of this course.

THE TEACHING/LEARNING CYCLE™

Both teaching and learning have natural, parallel, and mutually compatible cycles. This teaching/learning cycle, as shown in Figure 1 on page xxxii, interacts with the basic structure of learning objectives in this text.

The Teaching Cycle The inner (blue) circle in Figure 1 shows the steps an instructor takes in teaching a chapter. Your teacher *assigns* material, *presents* the subject in lecture, *explains* by going over assignments and answering questions, *reviews* the subject prior to an exam, and *tests* your knowledge and understanding using examinations and other means of evaluation.

The Learning Cycle Moving outward, the next circle (pink) in Figure 1 shows the steps you should take in studying a chapter. You should *preview* the material, *read* the chapter, *apply* your understanding by working the assignments, *review* the chapter, and *recall* and *demonstrate* your knowledge and understanding of the material on examinations and other assessments.

Integrated Learning Objectives Your textbook supports the teaching/learning cycle through the use of integrated learning objectives. Learning objectives are simply statements of what you should be able to do after you have completed a chapter. In Figure 1, the outside (green) circle shows how learning objectives are integrated into your text and other study aids and how they interact with the teaching/learning cycle.

1. Learning objectives appear at the beginning of the chapter, as an aid to your teacher in making assignments and as a preview of the chapter for you.
2. Each learning objective is repeated in the text at the point where that subject is covered to assist your teacher in presenting the material and to help you organize your thoughts as you read the material.
3. Every exercise, problem, and case in the chapter assignments shows the applicable learning objective(s) so you can refer to the text if you need help.
4. A summary of the key points for each learning objective, a list of new concepts and terms referenced by learning objectives, and a review problem covering key learning objectives assist you in reviewing each chapter. Your Study Guide, also organized by learning objectives, provides for additional review.

Why Students Succeed Students succeed in their accounting course when they coordinate their personal learning cycle with their instructor's cycle. Students who do a good job of previewing their assignments, reading the chapters before the instructor is ready to present them, preparing homework assignments before they are discussed in class, and reviewing carefully will ultimately achieve their potential on exams. Those who get out of phase with

2. Allow yourself plenty of time to read the text. Accounting is a technical subject. Accounting books are so full of information that almost every sentence is important.
3. Strive to understand why as well as how each procedure is done. Accounting is logical and requires reasoning. If you understand why something is done in accounting, there is little need to memorize.
4. Relate each new topic to its learning objective and be able to explain it in your own words.
5. Be aware of colors as you read. They are designed to help you understand the text. (See the chart on the back of your textbook.)

Yellow: All source documents and inputs are in yellow.

Aqua: All accounting forms, working papers, and accounting processes are shown in aqua.

Purple: All financial statements, the output or final product of the accounting process, are shown in purple.

Gray: In selected tables and illustrations, gray is used to heighten contrasts and aid understanding.

6. If there is something you do not understand, prepare specific questions for your instructor. Pinpoint the topic or concept that confuses you. Some students keep a notebook of points with which they have difficulty.

APPLYING THE CHAPTER

1. In addition to understanding why each procedure is done, you must be able to do it yourself by working exercises, problems, and cases. Accounting is a "do-it-yourself" course.
2. Read assignments and instructions carefully. Each assignment has a specific purpose. The wording is precise, and a clear understanding of it will save time and improve your performance. Acquaint yourself with the end-of-chapter assignment materials in this text by reading the description of them in the Preface.
3. Try to work exercises, problems, and cases without referring to their discussions in the chapter. If you cannot work an assignment without looking in the chapter, you will not be able to work a similar problem on an exam. After you have tried on your own, refer to the chapter (based on the learning objective reference) and check your answer. Try to understand any mistakes you may have made.
4. Be neat and orderly. Sloppy calculations, messy papers, and general carelessness cause most errors on accounting assignments.
5. Allow plenty of time to work the chapter assignments. You will find that assignments seem harder and that you make more errors when you are feeling pressed for time.
6. Keep up with your class. Check your work against the solutions presented in class. Find your mistakes. Be sure you understand the correct solutions.
7. Note the part of each exercise, problem, or case that causes you difficulty so you can ask for help.
8. Attend class. Most instructors design classes to help you and to answer your questions. Absence from even one class can hurt your performance.

REVIEWING THE CHAPTER

1. Read the summary of learning objectives in the chapter review. Be sure you know all the words in the review of concepts and terminology.
2. Review all assigned exercises, problems, and cases. Know them cold. Be sure you can work the assignments without the aid of the book.
3. Determine the learning objectives for which most of the problems were assigned. They refer to topics that your instructor is most likely to emphasize

on an exam. Scan the text for such learning objectives and pay particular attention to the examples and illustrations.

4. Look for and scan other similar assignments that cover the same learning objectives. They may be helpful on an exam.
5. Review quizzes. Similar material will often appear on longer exams.
6. Attend any labs or visit any tutors your school provides, or see your instructor during office hours to get assistance. Be sure to have specific questions ready.

TAKING EXAMINATIONS

1. Arrive at class early so you can get the feel of the room and make a last-minute review of your notes.
2. Have plenty of sharp pencils and your calculator (if allowed) ready.
3. Review the exam quickly when it is handed out to get an overview of your task. Start with a part you know. It will give you confidence and save time.
4. Allocate your time to the various parts of the exam, and stick to your schedule. Every exam has time constraints. You need to move ahead and make sure you attempt all parts of the exam.
5. Read the questions carefully. Some may not be exactly like your homework assignments. They may approach the material from a slightly different angle to test your understanding and ability to reason, rather than your ability to memorize.
6. To avoid unnecessary errors, be neat, use good form, and show calculations.
7. Relax. If you have followed the above guidelines, your effort will be rewarded.

PREPARING OTHER ASSIGNMENTS

1. Understand the assignment. Written assignments, term papers, computer projects, oral presentations, case studies, group activities, individual field trips, video critiques, and other activities are designed to enhance skills beyond your technical knowledge. It is essential to know exactly what your instructor expects. Know the purpose, audience, scope, and expected end product.
2. Allow plenty of time. "Murphy's Law" applies to such assignments: If anything can go wrong, it will.
3. Prepare an outline of each report, paper, or presentation. A well-done project always has a logical structure.
4. Write a rough draft of each paper and report, and practice each presentation. Professionals always try out their ideas in advance and thoroughly rehearse their presentations. Good results are not accomplished by accident.
5. Make sure that each paper, report, or presentation is of professional quality. Instructors appreciate attention to detail and polish. A good rule of thumb is to ask yourself: Would I give this work to my boss?

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obtaining capital from owners and from creditors, such as banks and suppliers. They also include repaying creditors and paying a return to the owners. Second, each business must engage in **investing activities** to spend the capital it receives in ways that are productive and will help to achieve its objectives. Investing activities include buying land, buildings, equipment, and other resources that are needed in the operation of the business, and selling these resources when they are no longer needed. Third, each business must engage in **operating activities**. In addition to the selling of goods and services to customers, operating activities include such actions as employing managers and workers, buying and producing goods and services, and paying taxes to the government.

FINANCIAL AND MANAGEMENT ACCOUNTING

Accounting's role of assisting decision makers by measuring, processing, and communicating information is usually divided into the categories of management accounting and financial accounting. Although there is considerable overlap in the functions of management accounting and financial accounting, the two can be distinguished by who the principal users of their information will be. **Management accounting** provides internal decision makers who are charged with achieving the goals of profitability and liquidity with information about financing, investing, and operating activities. Managers and employees who conduct the activities of the business need information that tells them how they have done in the past and what they can expect in the future. For example, The Gap needs an operating report on each mall outlet that tells how much was sold at that outlet, and what costs were incurred, and it needs a budget for each outlet that projects the sales and costs for the next year. Financial accounting generates reports and communicates them to external decision makers so that they can evaluate how well the business has achieved its goals. These reports to external users are called **financial statements**. The Gap, for instance, will send its financial statements to its owners (called *stockholders*), its banks and other creditors, and government regulators. Financial statements report directly on the goals of profitability and liquidity and are used extensively both inside and outside a business to evaluate the business's success. It is important for every person involved with a business to *understand financial statements*. They are a central feature of accounting and are the primary focus of this book.

PROCESSING ACCOUNTING INFORMATION

To avoid misunderstandings, it is important to distinguish accounting itself from the ways in which accounting information is processed by bookkeeping, the computer, and management information systems.

People often fail to understand the difference between accounting and bookkeeping. **Bookkeeping** is the process of recording financial transactions and keeping financial records. Mechanical and repetitive, bookkeeping is only a small—but important—part of accounting. Accounting, on the other hand, includes the design of an information system that meets the user's needs. The major goals of accounting are the analysis, interpretation, and use of information.