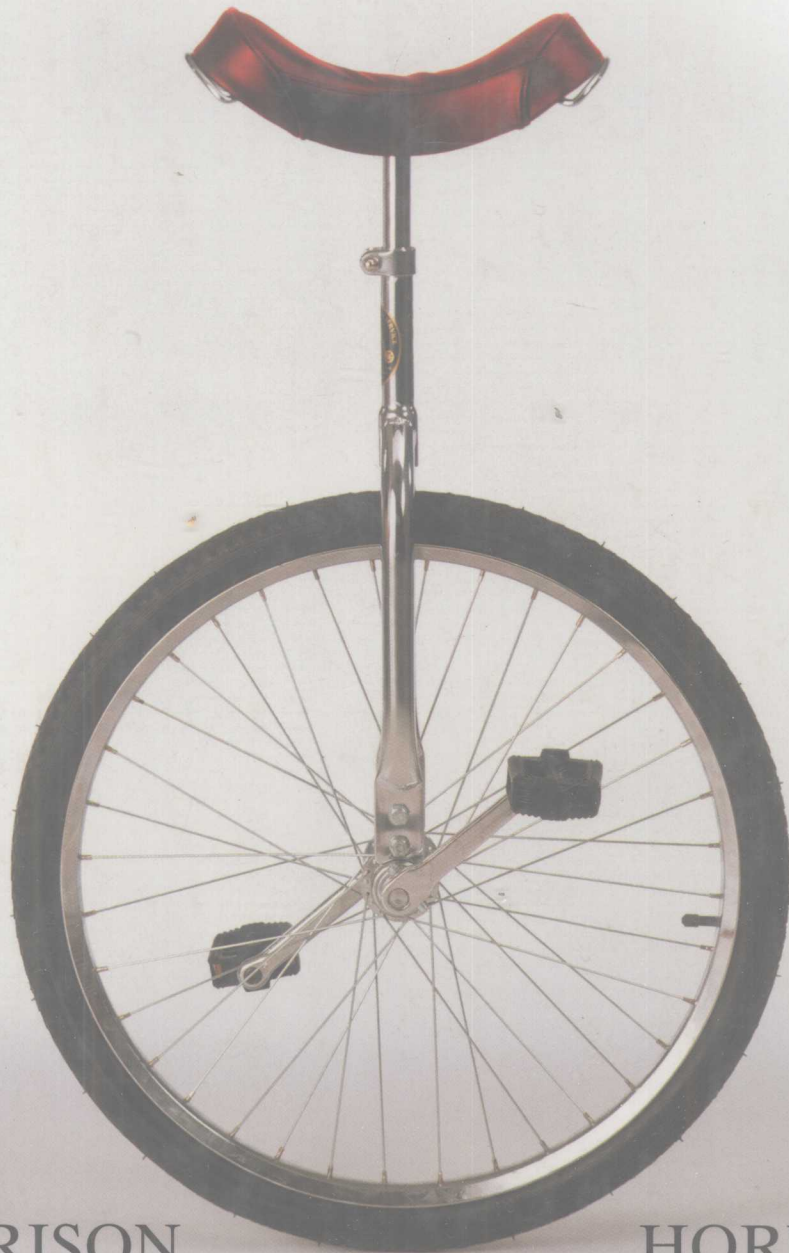


FINANCIAL ACCOUNTING

s i x t h e d i t i o n



HARRISON

HORNGREN



Financial

Accounting

SIXTH EDITION

Walter T. Harrison Jr.

Baylor University

Charles T. Horngren

Stanford University

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Preface

The Accounting Cycle: Key To Success

Note to the Instructor: This financial accounting course builds on the first three chapters, which focus on accounting fundamentals and the accounting cycle. You've told us that mastering these chapters will guarantee your students' success as they move through the course. For this reason, *Financial Accounting, 6th edition* is focused on students' success in learning accounting basics and mastering the mechanics so that they are motivated to excel throughout the course.

Review the inside front cover to see exactly what we are offering your students.

New In-Chapter Learning Tools

- **Accounting Alerts!** Boxes in each chapter focus on issues that can affect accounting decisions or on pitfalls to watch out for.
- **Taking Action:** Immediately after they learn a concept, students are asked to make a business decision. Their ability to make this decision with the information provided gives them an immediate application of the concept and allows them to check their understanding of the material.
- **Making Managerial Decisions:** This feature presents a specific situation that needs a decision, along with the accounting guidelines to use in making the decision, in an easy-to-use table format.
- **Focus on Financials: YUM! Brands.** Yum! Brands, Inc. financial statements are used in case exercises at the end of each chapter. Selected excerpts from YUM! statements also appear throughout the text where appropriate to assist learning. The full statements appear in Appendix A.
- **Focus on Analysis: Pier 1 Imports.** Pier 1 Imports financial statements are used in an additional case exercise focused on analysis that appears at the end of each chapter. The full statements appear in Appendix B.

Learning Approach: Focus On Practice and Performance

Student success and "practice, practice, practice," go hand in hand. That's why we increased quizzing opportunities for you and self-guided practice for your students.

In-Text Practice Material

- **Chapter Review Quiz:** At the end of chapter, these multiple-choice questions include answers for quick self-assessment.
- **Practice Quiz:** Multiple-choice questions in the end-of-chapter assignments section have answers in the Check Figures appendix at the end of the book.

Practice Quiz

Test your understanding of the financial statements by answering the following questions. Select the best choice from among the possible answers given.

PQ1-1 The primary objective of financial reporting is to provide information

- a. To the federal government.
- b. About the profitability of the enterprise.
- c. On the cash flows of the company.
- d. Useful for making investment and credit decisions.

PQ1-2 Which type of business organization provides the least amount of protection for bankers and other creditors of the company?

- a. Corporation
- b. Partnership
- c. Proprietorship
- d. Both b and c

PQ1-3 Assets are usually reported at their

- a. Appraised value
- b. Historical cost
- c. Current market value
- d. None of the above _____

Online Practice and Homework Material

- **Practice Material:** An open-access online practice environment enables students to master chapter material. Selected end-of-chapter problems are available for all learning objectives in Chapters 1-3. The problems (a) are algorithmic, giving students a chance to practice until they have mastery; (b) provide immediate feedback, giving students a chance to see how well they are doing right away; (c) mirror those in the book, giving students a chance to practice before doing “the real thing.”
- **Homework and Quiz Material:** Prentice Hall Grade Assist (PHGA)

PHGA is an online homework and quizzing environment that allows instructors to completely customize homework and quiz options for their classes.

Selected end-of-chapter (even-numbered) exercises and (A) problems from the text are available. Instructors can post assignments and receive grades. All questions are algorithmically generated so each student session offers different problems and answers while providing immediate feedback and scoring for instructors and their students.

Special Section for Current Users

Thank you for your continued use of Harrison Financial Accounting in your classroom. To ease your transition, here are highlights of chapter changes for the 6th edition.

Chapter 1. The Financial Statements

New feature company for the book, YUM! Brands

New Accounting Alert: We Need an Audit to Validate the Financial Statements

Accounting Cycle Tutorial

Chapter 2. Transaction Analysis

New chapter opener about Apple Computer
 New Accounting Alert: Single-Entry Accounting Doesn't Cut It
 New section on Transaction Analysis
 New formatting of exhibits for better pedagogy
 Streamlined coverage of journalizing transactions
 Accounting Cycle Tutorial

Chapter 3. Using Accrual Accounting to Measure Income

New chapter opener on Callaway Golf Company
 New Accounting Alert: Cash Basis Accounting Doesn't Cut It, Either
 New exhibit on How Transactions Affect the Ratios
 Accounting Cycle Tutorial

Chapter 4. Internal Control & Cash

New chapter opener on Merrill Lynch & Co.
 New section on the Sarbanes-Oxley Act
 New Accounting Alert: Are Outside Auditors Really Independent?
 New Accounting Alert: Three Faces of Internal Control
 Streamlined coverage and new exhibit for Internal Control over Cash Receipts
 Streamlined coverage and new exhibit for Internal Control over Cash Payments

Chapter 5. Short-Term Investments & Receivables

New chapter opener on Ford Motor Company
 New "road-map" exhibit for classifying investments
 Expanded coverage of realized gain on sale of investments
 Revamped section on Accounting for Uncollectible Receivables
 New Accounting Alert: Is That Investment Really a Current Asset?
 New Accounting Alert: Shifting Sales into the Current Period

Chapter 6. Merchandise Inventory & Cost of Goods Sold

New chapter opener on Pier 1 Imports
 Revamped chapter: Clearer distinction between sale price and cost of a unit of inventory
 Cost of Goods Sold Model moved to the end of the chapter
 New coverage of Perpetual Inventory System
 New diagrams to illustrate cost flows under FIFO, LIFO, and Average Costing
 New coverage of FIFO, LIFO, and Average Costing using T-accounts to replace old Exhibit 6-6
 Deleted section on Materiality
 New illustration of inventory write-down under lower of cost or market
 New exhibit comparing Pier 1 Imports, May Co. Department Stores, and Wal-Mart
 New Accounting Alert: Cooking the Books to Increase Reported Income

Chapter 7. Plant Assets, Natural Resources & Intangibles

New chapter opener on eBay and United Parcel Service (UPS)
 New Accounting Alert: Is That Cost Really an Asset?

Chapter 8. Current & Long-Term Liabilities

New chapter opener comparing AMR (American Airlines) and UAL (United Airlines)
 New coverage of unearned revenue
 New Accounting Alert: Are All Your Liabilities Reported on the Balance Sheet?

Chapter 9. Stockholders' Equity

New chapter opener on IHOP (International House of Pancakes)
 New summary of the components of stockholders' equity on the balance sheet
 New Accounting Alert: Stock Issuance for Other Than Cash

Chapter 10. Long-Term Investments & International Operations

New chapter opener on General Electric
 New exhibit summarizing the accounting rules for long-term investments
 New Accounting Alert: When Should We Sell That Investment in HP (Hewlett Packard) Stock?

Chapter 11. Income Statement & Statement of Stockholders' Equity

New chapter opener on Best Buy
 New Accounting Alert: Watch Out for Voluntary Accounting Changes that Increase Reported Income
 New Accounting Alert: Beware of Pro Forma Earnings
 Deleted sections: Using the P/E Ratio and Restrictions on Retained Earnings

Chapter 12. Statement of Cash Flows

New Accounting Alert: Telltale Signs of Financial Difficulty

Chapter 13. Financial Statement Analysis

Return to feature company, YUM! Brands, for evaluation and analysis
 New Stop & Think section focused on YUM! Brands
 Streamlined Common Size Statements section
 Streamlined Benchmarking section
 New Accounting Alert: The Limitations of Ratio Analysis
 New Accounting Alert: Red Flags in Financial Statement Analysis

Teaching And Learning Support

For Instructors**At a Glance Supplements Grid**

	Instructor's Manual	Test Item File	Instructor Solutions Manual	Interactive Solution PowerPoints	PH Accounting Excel Tips	PH Grade Assist	One Key	Companion Website	Accounting Cycle Tutorial
Print	√	√	√		√				
Online	√	√	√	√	√	√	√	√	X
IRCD	√	√	√	√					

Instructor's Resource Center www.prenhall.com/accounting This password-protected site is accessible from the catalog page for *Financial Accounting, 6e* and hosts the following resources:

- **New! Interactive Solution PowerPoints**, by Robert Bauman: These Powerpoints provide instructors with tools for presenting one worked-out electronic solution for an end-of-chapter exercise based on each chapter learning objective. They simplify classroom preparation by providing teaching and learning tips.
- Instructor's Manual
- Test Item File

- TestGen EQ for PC
- Image Library: Access to most of the images and illustrations featured in the text.
- Peachtree and QuickBooks Computer Workshops (Software NOT included): These Workshops (beginning at the end of Chapter 2) enable instructors to integrate the latest release of Peachtree and/or QuickBooks Software in order to solve specific accounting problems in a real-world company setting.
- General Ledger and Excel Spreadsheet Templates: Use these templates to complete homework assignments. These problems are designated by an icon in the text.
- Excel Application Problems: These problems show when, why, and how people use the accounting guidelines in order to make business decisions. Students can apply the Making Managerial Decisions guidelines to a realistic situation and use the power of Excel to determine a solution.
- Essentials of Excel, by Drs. L. Murphy Smith and Katherine T. Smith: This section introduces students to the fundamental tools and techniques available in Microsoft Excel. Students will learn through experience by following directions and creating the example worksheets shown.
- **Solutions Manual**, by Tom Harrison (ISBN: 0-13-149969-6): This manual contains the fully worked-out and accuracy-checked solutions for every question, exercise, and problem in the text.

Instructor's Manual by Angela Sandberg, Jacksonville State University (ISBN: 0-13-149959-9): Each chapter of this comprehensive resource consists of a list of the student learning objectives, a narrative overview of main topics, an outline with teaching tips, a suggested assignment grid for all end-of-chapter questions, problems, and exercises, and an integration grid that contains the list of exercises and problems available in PH Grade Assist, Microsoft Excel, and General Ledger.

Test Item File by Anne Wessley, St. Louis Community College (ISBN: 0-13-149960-2): This section features over 1,800 questions written specifically for the 6th edition. Multiple-choice, true/false, conceptual and quantitative questions, critical thinking problems, and exercises are organized by level of difficulty and include the corresponding learning objective number.

Instructor's Resource CD (ISBN 0-13-149961-0): This CD-ROM now has a new interface and searchable database. It contains all the supplements that are hosted on our online Instructor's Resource Center, including all the book line art. The CD-ROM also provides the **NEW** interactive Solution PowerPoints that provide an instructor with one worked-out electronic solution for an end-of-chapter exercise based on each chapter learning objective for in-class discussion and student learning and comprehension.

Solutions Transparencies (ISBN: 0-13-149962-9): Every page of the solutions manual has been reproduced in acetate form for use on an overhead projector.

PH Accounting Excel Tips (ISBN: 0-13-149965): A laminated resource useful for every B-School course, these tips cover basic tasks, navigation keys, shortcuts, productivity tips, and new features of Microsoft Excel 2003. Ask your local representative about FREE Value Pack options.

PHGA-Instructor Access Card (ISBN: 0-13-149951-3): This card is available for instructors to set up PH Grade Assist, an online homework assessment system available through our OneKey.

OneKey CourseCompass, WebCT and BlackBoard for Financial Accounting
Prentice Hall's OneKey site is all that instructors and students need for anytime online access to interactive materials that enhance this text.

OneKey WebCT, Financial Accounting by Walter T. Harrison © 2006 (ISBN: 0-13-149966-1), Electronic Book, Estimated Publication 07/01/2005: Prentice Hall's OneKey site is all instructors and students need for anytime online access to interactive materials that enhance this text. Premium Resources that are hosted on OneKey include: PH Grade Assist and Interactive Solution PowerPoints.

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For Students

MASTERING THE ACCOUNTING CYCLE

<http://www.prenhall.com/harrison>

Open Access (no registration or password needed) Companion Website that provides you with:

- Accounting Cycle Tutorial: For practice on material from Chapters 1–3
- Online Practice Environment with algorithmic questions for Chapters 1–3
- Accounting Cycle Pocket Guide: Reference tool that walks you through each step of the accounting cycle
- Interactive study guide for all chapters of the book

OneKey CourseCompass, Student Access Kit, Financial Accounting

ISBN: 0-13-149955-6

OneKey WebCT, Student Access Kit, Financial Accounting

ISBN: 0-13-149957-2

OneKey BlackBoard, Student Access Kit, Financial Accounting

ISBN: 0-13-149958-0

PHGA-Student Access Card

ISBN: 0-13-149952-1

Note: All Mastering the Accounting Cycle material can be found within OneKey courses previously listed.

PRINT STUDY AIDS

Study Guide by Alan Campbell, Saint Leo University Center for Online Learning (ISBN: 0-13-149953-X): This chapter-by-chapter learning aid helps you learn financial accounting and get the maximum benefit from study time. Each chapter contains

a Chapter Overview and Review, a Featured Exercise that covers all of the most important chapter material, and Review Questions and Exercises with Solutions that test your understanding of the material.

Working Papers by L. Murphy Smith, Texas A&M University and Katherine T. Smith (ISBN: 0-13-149950-5): Available in traditional printed format and also online (in OneKey) as downloadable Excel files.

Acknowledgments

In revising this edition of *Financial Accounting*, we had the help of instructors from across the country who have participated in online surveys, chapter reviews, and focus groups. Their comments and suggestions for both the text and the supplements have been a great help in planning and carrying out the revision, and we thank them for their contributions.

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Prologue

ACCOUNTING CAREERS: MUCH MORE THAN COUNTING THINGS

What kind of career can you have in accounting? Almost any kind you want. A career in accounting lets you use your analytic skills in a variety of ways, and it brings both monetary and personal rewards. According to the 2002 Jobs Rated Almanac, "accountant" was the fifth best job in terms of low stress, high compensation, lots of autonomy, and tremendous hiring demand.¹

Look at what these accountants do:

- Jeffrey S. Sallet is a CPA at the FBI who investigates the financial side of criminal activities. He conducts interviews, surveillance, and crime scene investigations as well as reviewing financial documents and testifying in court. "I have conducted numerous organized crime, public corruption and terrorism investigations," Sallet says. "While conducting these investigations I have applied traditional investigative techniques and forensic accounting. My efforts have resulted in the conviction of members and associates of Organized Crime and Union Officials."²
- Alan Friedman loves music. He plays guitar in a band and knows the industry inside and out. As a CPA, he helps music store retailers, musicians, and independent recording labels with accounting and tax services. "My clients appreciate the fact that we are intimately familiar with the product they sell, the suppliers they deal with and the ever-changing condition of the music retailing marketplace," Friedman says. There are 9,000 music retailers in the United States, and while most of them already have a CPA, chances are that they do not have one who's an expert in the music business. Friedman found his niche by combining his hobby with his work.³
- Jane Cozzarelli, CPA, is vice president of internal audit at Battelle Memorial Institute, a \$1 billion research and development enterprise. She helps Battelle evaluate the risks of multi-million-dollar deals such as joint ventures and acquisitions. "By measuring your risks, you can direct capital to them more efficiently. You also are better able to understand the upside and downside of undertaking a risk," Jane says.⁴
- Regine Metellus, CPA, is the CFO for the Germantown Settlement, a charity that empowers over 195,000 elderly and low-to-moderate income residents in Philadelphia. "Germantown needed someone to organize their records and put in place policies and procedures and help improve the financial reporting," Regine says. By making the charity's financial operations more efficient, she helps Germantown Settlement put more money back into the community and truly "make a difference."⁵
- After doing auditing work at KPMG and serving as a controller for a venture-capital-backed firm, David Kupferman started his own CPA practice. He specializes in serving high-net-worth individuals and businesses looking for sound

advice along with technology ventures. Day to day, Kupferman provides taxation advice, litigation support, business valuation, complex business modeling, and CFO-like financial consulting for early stage companies. He has a particular interest in bringing foreign technology companies to the United States and works with clients from Australia, Spain, Hungary, England, France, Byelorussia, Singapore, and Japan.⁶

- Mark Denton, an accountant at NASA's Marshall Space Flight Center, is helping to implement NASA's Core Financial Project. The project is an agencywide effort to provide timely, consistent, and reliable financial information to managers making program budget decisions. "This project will be a good thing, enabling NASA to operate more like a business," Denton says. "I love working with money," he adds, "but, more importantly, I love working with people."⁷

And then there is the opportunity for flexible work arrangements:

"I'm probably one of the first people who stayed in public accounting because of quality-of-life advantages," says Eileen Garvey, an audit partner at Ernst & Young in New York. Garvey works a 3-day-a-week schedule. The mother of two, she made partner as a part-timer. Flexibility works for men, too: Carl Moilienkamp, a manager with a firm in Chicago, took a summer leave to pursue his other career as a chef.

Where Accountants Work

Where can you work as an accountant? There are four kinds of employers.

Public Practice

You can work for a public accounting firm, which could be a large international firm such as one of the Big Four where Eileen Garvey works, or a small CPA firm such as Alan Friedman's. Within the CPA firm, you can specialize in areas such as tax, audit, or consulting. In this capacity, you'll be serving as an external accountant to many different clients. Most CPAs start their career at a large CPA firm. From there, they can find themselves in a variety of situations:

- Josh Young's first consulting engagement found him on the site of the Northridge earthquake outside Los Angeles. One of his clients was a supermarket chain with 150 damaged stores. Young needed to visit the actual site to determine how much damage had occurred to help prepare the insurance claims.
- Jennifer Tufer is a Deloitte & Touche senior manager on assignment in Moscow. As she looks through her incoming mail, she finds a request from a U.S. manufacturer interested in expanding into Russia. "The company wants to know how they would be taxed," she says.

The highest career level in a CPA firm is partner—becoming a part owner of the firm. Only 2% to 3% of accountants in a Big Four CPA firm make partner.⁸

Deloitte & Touche	Employees: 29,000	Offices: 97
Ernst & Young	Employees: 103,000	Offices: 670
KPMG	Employees: 100,000	Offices: 103
PricewaterhouseCoopers	Employees: 122,000	Countries Served: 139

Managerial Accounting

Instead of working for a wide variety of clients, you can work within one corporation or nonprofit enterprise. Your role within the organization is to analyze financial information and communicate that information to managers, who use it to plot strategy and make decisions. You may be called upon to make recommendations on how best to allocate corporate resources or improve financial performance. For example, you might do a cost-benefit analysis to help management decide whether to acquire a company or build a factory; or you might describe the financial implications of choosing one strategy over another. You might work in areas such as internal auditing, financial management, financial reporting, treasury management, and tax planning. The highest position in management accounting is the CFO position, with some CFOs rising all the way to the top to become CEOs.

Phil Knight, CEO of Nike, and Arthur Blank, cofounder of Home Depot, are CPAs.

Government

You can also work as an accountant for the government, be it at the federal, state, or local level. Like your counterparts in public accounting and business, your role as an accountant in government includes responsibilities in the areas of auditing, financial reporting, and management accounting. You'll evaluate how government agencies are being run and advise decision makers in allocating resources to promote efficiency. You might find yourself working for the IRS, the Securities and Exchange Commission, the Department of Treasury, or even the White House.

WORKING FOR THE GAO

Government Accountability Office (GAO)—formerly called the General Accounting Office—is an agency that works for Congress and the American people. Congress asks GAO to study federal government programs and expenditures. GAO studies how the federal government spends taxpayer dollars and advises Congress and the heads of executive agencies (such as the Environmental Protection Agency, Department of Defense, and Health and Human Services) about ways to make government more effective and responsive. GAO evaluates federal programs, audits federal expenditures, and issues legal opinions.

Within the GAO, you can work in an area such as health care. Much of this work focuses on the ability of these federal programs to provide access to quality care while paying appropriately for that care. Accountants in health care also examine the activities of federal public health agencies, including the National Institutes of Health, the Food and Drug Administration, and the Centers for Disease Control and Prevention. They examine not only the achievement of program goals but also the management, information systems, human capital, and financial operations of these agencies.

Education

Finally, you can work at a college or university or a professional school of accountancy, advancing the thought and theory of accounting and teaching future generations of new accountants. On the research side of education, you might study how companies use or misuse accounting to further their goals, or you might develop new ways of categorizing financial flows, or study accounting practices in different countries. You then publish your ideas in journal articles and books and present them to your colleagues at meetings around the world. On the education side, you can help others learn about accounting and give them the tools they need to be their best.

Did you know that 15% of FBI new hires in 2004 were CPAs?⁹ In fact, 1,400 of the FBI's special agents are accountants, and the number 3 man at the FBI, Assistant Director Thomas Pickard, is a CPA.¹⁰

CPA: THREE LETTERS THAT SPEAK VOLUMES

When employers see the CPA designation, they know what to expect about your education, knowledge, abilities, and personal attributes. They value your analytic skills and extensive training. Your CPA credential gives you a distinct advantage in the job market and instant credibility and respect in the workplace. It's a plus when dealing with other professionals such as bankers, attorneys, auditors, and federal regulators. In addition, your colleagues in private industry tend to defer to you when dealing with complex business matters, particularly those involving financial management.¹¹

The Hottest Growth Areas in Accounting

Recent legislation, such as the Sarbanes-Oxley Act of 2002, has brought rising demand for accountants of all kinds. In addition to strong overall demand, certain areas of accounting are especially hot.¹²

Sustainability Reporting

Sustainability reporting involves reporting on an organization's performance with respect to health, safety, and environmental (HSE) issues. As businesses take a greater interest in environmental issues, CPAs are getting involved in reporting on such matters as employee health, on-the-job accident rates, emissions of certain pollutants, spills, volumes of waste generated, and initiatives to reduce and minimize such incidents and releases. Utilities, manufacturers, and chemical companies are particularly affected by environmental issues. As a result, they turn to CPAs to set up a preventive system to ensure compliance and avoid future claims or disputes or to provide assistance once legal implications have arisen.

Corporate social responsibility reporting is similar to HSE reporting but with a broadened emphasis on social matters such as ethical labor practices, training, education, and diversity of workforce and corporate philanthropic initiatives. Here's a sampling of companies across industries that provide corporate social responsibility reports: