

# FINANCIAL ACCOUNTING

## A BUSINESS PERSPECTIVE

SEVENTH EDITION

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Roger H. Hermanson

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SEVENTH EDITION

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### FINANCIAL ACCOUNTING: A BUSINESS PERSPECTIVE

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Regents Professor of Accounting and Ernst & Young–J. W. Holloway Memorial Professor at Georgia State University. He received his doctorate at Michigan State University in 1963 and is a CPA in Georgia. Professor Hermanson taught and later served as chairperson of the Division of Accounting at the University of Maryland. He has authored or coauthored numerous articles for professional and scholarly journals and has coauthored numerous editions of several textbooks, including *Accounting Principles*, *Financial Accounting*, *Survey of Financial and Managerial Accounting*, *Auditing Theory and Practice*, *Principles of Financial and Managerial Accounting*, and *Computerized Accounting with Peachtree Complete III*. He also has served on the editorial boards of the *Journal of Accounting Education*, *New Accountant*, *Accounting Horizons*, and *Management Ac-*

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Professor Hermanson has been awarded two excellence in teaching awards, a doctoral fellow's award, and a Distinguished Alumni Professor award; and he was selected as the Outstanding Faculty Member for 1985 by the Federation of Schools of Accountancy. He has served as a consultant to many companies and organizations. In 1990, Professor Hermanson was named Accounting Educator of the Year by the Georgia Society of CPAs.

### **Professor James Don Edwards, Ph.D., CPA**

J. M. Tull Professor of Accounting in the Terry College of Business at the University of Georgia. He is a graduate of Louisiana State University and has been inducted into the Louisiana State University Alumni Federation's Hall of Distinction. He received his M.B.A. from the University of Denver and his Ph.D. from the University of Texas and is a CPA in Texas and Georgia. He has served as a professor and chairman of the Department of Accounting and Financial Administration at Michigan State University, a professor and dean of the Graduate School of Business Administration at the University of Minnesota, and a Visiting Scholar at Oxford University in Oxford, England.

Professor Edwards is a past president of the American Accounting Association and a past national vice president and executive committee member of the Institute of Management Accountants. He has served on the board of directors of the American Institute of Certified Public Accountants and as chairman of the Georgia State Board of Accountancy. He was an original trustee of the Financial Accounting Foundation, the parent organization of the FASB, and a member of the Public Review Board of Arthur Andersen & Co.

He has published in *The Accounting Review*, *The Journal of Accountancy*, *The Journal of Accounting Research*, *Management Accounting*, and *The Harvard Business History Review*. He is also the author of *History of Public Accounting in the United States*. He has served on various American Institute of Certified Public Accountants committees and

boards, including the Objectives of Financial Statements Committee, Standards of Professional Conduct Committee, and the CPA Board of Examiners. He was the managing editor of the centennial issue of *The Journal of Accountancy*.

In 1974, Beta Alpha Psi, the National Accounting Fraternity, selected Professor Edwards for its first annual Outstanding Accountant of the Year award. This selection is made from industry, government, and educational leaders. In 1975, he was selected by the American Accounting Association as its Outstanding Educator.

He has served the AICPA as president of the Benevolent Fund, chairman of the Awards Committee, member of the Professional Ethics Committee and Program for World Congress of Accountants. He is on the Education Standards Committee of the International Federation of Accountants and the Committee on Planning for the Institute of Management Accountants. He was the director of the Seminar for Management Accountants–Financial Reporting for the American Accounting Association. He is also a member of the Financial Executives Institute.

He received the 1993 AICPA Gold Medal Award, the highest award given by the Institute. A Doctor Honoris Causa (Honorary Doctorate) from the University of Paris was awarded to him in 1994. He is the first accountant to receive this distinction in France. The Academy of Accounting Historians awarded him the 1994 Hourglass Award which is the highest international honor in the field of Accounting History.

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# PREFACE

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## PHILOSOPHY AND PURPOSE

Imagine that you have graduated from college without taking an accounting course. You are employed by a company as a sales person, and you eventually become the sales manager of a territory. While attending a sales managers' meeting, financial results are reviewed by the Vice President of Sales and terms such as gross margin percentage, cash flows from operating activities, and LIFO inventory methods are being discussed. The Vice President eventually asks you to discuss these topics as they relate to your territory. You try to do so, but it is obvious to everyone in the meeting that you do not know what you are talking about.

Financial accounting principles courses teach you the "language of business" so you understand terms and concepts used in business decisions. If you understand how accounting information is prepared, you will be in an even stronger position when faced with a management decision based on accounting information.

We wrote this text to give you an understanding of how to use accounting information to analyze business performance and make business decisions. The text takes a business perspective. We use the annual reports of real companies to illustrate many of the accounting concepts. You are familiar with many of the companies we use, such as The Coca-Cola Company, The Home Depot, and Colgate-Palmolive Company.

Gaining an understanding of accounting terminology and concepts, however, is not enough to ensure your success. You also need to be able to find information on the Internet, analyze various business situations, work effectively as a member of a team, and communicate your ideas clearly. This text was developed to help you develop these skills.

## CURRICULUM CONCERNS

Significant changes have been recommended for accounting education. Some parties have expressed concern that recent accounting graduates do not possess the necessary set of skills to succeed in an accounting career. The typical accounting graduate seems unable to successfully deal with complex and unstructured "real world" accounting problems and generally lacks communication and interpersonal skills. One recommendation is the greater use of active learning techniques in a reenergized classroom environment. The traditional lecture and structured problem solving method approach would be supplemented or replaced with a more informal classroom setting dealing with cases, simulations, and group projects. Both inside and outside the classroom, there would be two-way communication between (1) profes-

sor and student and (2) student and student. Study groups would be formed so that students could tutor other students. The purposes of these recommendations include enhancing students' critical thinking skills, written and oral communication skills, and interpersonal skills.

One of the most important benefits you can obtain from a college education is that you "learn how to learn." The concept that you gain all of your learning in school and then spend the rest of your life applying that knowledge is not valid. Change is occurring at an increasingly rapid pace. You will probably hold many different jobs during your career, and you will probably work for many different companies. Much of the information you learn in college will be obsolete in just a few years. Therefore, you will be expected to engage in life-long learning. Memorizing is much less important than learning how to think critically.

With this changing environment in mind, we have developed a text that will lend itself to developing the skills that will lead to success in your future career in business. The section at the end of each chapter titled, "Beyond the Numbers—Critical Thinking," provides the opportunity for you to address unstructured case situations, the analysis of real companies' financial situations, ethics cases, team projects, and Internet projects. For many of these items, you will use written and oral communication skills in presenting your results.

## OBJECTIVES AND OVERALL APPROACH OF THE SEVENTH EDITION

The Accounting Education Change Commission (AECC) made specific recommendations regarding teaching materials and methods used in the first-year accounting course. As a result, significant changes are taking place in that course at many universities. The AECC states:

The first course in accounting can significantly benefit those who enter business, government, and other organizations, where decision-makers use accounting information. These individuals will be better prepared for their responsibilities if they understand the role of accounting information in decision-making by managers, investors, government regulators, and others. All organizations have accountability responsibilities to their constituents, and accounting, properly used, is a powerful tool in creating information to improve the decisions that affect those constituents.<sup>1</sup>

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<sup>1</sup>Accounting Education Change Commission, *Position Statement No. Two*, "The First Course in Accounting" (Torrance, CA, June 1992), pp. 1–2.

In making the transition from primarily a preparer's focus to a balanced preparer's and user's focus, in the seventh edition we eliminated chapters on special journals and partnerships and appendixes on (1) payroll and taxes and (2) inflation accounting. We also eliminated the following topics: the net price method for purchases of merchandise, the alternative closing method for a merchandising company, the voucher system, the direct write-off method for receivables, discounting notes receivable, recording capital stock issuances by subscription, and long-term bond investments. The coverage of certain other topics was shortened considerably or relegated to a chapter appendix. For instance, the work sheet for a merchandising company was placed in a chapter appendix.

We retained a solid coverage of accounting that serves business students well regardless of the majors they select. Those who choose not to major in accounting, which is a majority of those taking this course, will become better users of accounting information because they will know something about the preparation of that information.

## REVISION APPROACH AND ORGANIZATION

Changes were made in every chapter in this seventh edition, but certain changes deserve special mention.

In Chapter 7, Measuring and Reporting Inventories, we have split the coverage into a section on periodic inventory procedure and a section on perpetual inventory procedure. Some users indicated that they wished to deemphasize the coverage of periodic inventory procedure because of the almost exclusive use of perpetual inventory procedure in accounting software packages. The separation of these topics in Chapter 7 now permits the deemphasis of periodic inventory procedure.

Many users indicate that they desire to have their students engage in *more group (team) projects*. In the sixth edition we had only one group project per chapter. We have added two new group projects per chapter in the seventh edition.

The Internet is expanding daily and contains much information that is useful to accountants. Students need to be knowledgeable about using the Internet, and many of them have used the Internet for purposes other than accounting. We have included *two Internet projects* in each chapter to give students some experience in using the Internet to acquire information pertaining to accounting. We have identified many of the most useful accounting websites (e.g., all of the websites of the Big-Six accounting firms) that students can use, not only for the specific projects assigned, but in later courses and in their working careers. One word of caution is in order. Some entities create websites but either do not revise them to make them current or cancel them. The websites we have selected are ones that we believed would be retained and updated periodically. However, if an Internet project is assigned that involves a website which no longer contains the required information or has been canceled, the student should simply select another Internet project.

The seventh edition contains three types of marginal annotations to help students study the materials. *Notes to the*

*Student* contain examples to illustrate key concepts and alternative presentations of ideas. *Reinforcing problems* indicate which exercises, problems, and cases reinforce coverage of a particular topic. **Real World Examples** give interesting and relevant information about the business world. We hope students and instructors will find these annotations helpful.

A list of check figures is now included at the end of the book. Check figures give key amounts for the problems, business decision cases, other "Beyond the Numbers" items, and comprehensive review problems in the text.

## Business Emphasis

Without actual business experience, business students sometimes lack a frame of reference in attempting to apply accounting concepts to business transactions. We seek to involve the business student more in real world business applications as we introduce and explain the subject matter.

- Each part opens with "**A Manager's Perspective,**" which features interviews with managers at The Coca-Cola Company. These opening vignettes provide insight into how managers in various areas in business (marketing, HR, finance, manufacturing, etc.) use accounting information to make decisions.
- "**An Accounting Perspective: Business Insight**" boxes throughout the text provide examples of how companies featured in text examples use accounting information every day, or they provide other useful information.
- "**Accounting Perspective: Uses of Technology**" boxes throughout the text demonstrate how technology has affected the way accounting information is prepared, manipulated, and accessed.
- Some chapters contain "**A Broader Perspective.**" These situations, taken from annual reports of real companies and from articles in current business periodicals such as *Accounting Today*, and *Management Accounting*, relate to subject matter discussed in that chapter or present other useful information. These real world examples demonstrate the business relevance of accounting.
- Real world questions and real world business decision cases are included in almost every chapter.
- The Annual Report Booklet included with this text contains significant portions of the 1996 annual reports of The Coca-Cola Company, John H. Harland Company, The Limited, Inc., and the Maytag Corporation. Many of the real world questions and business decision cases are based on these annual reports.
- Numerous illustrations adapted from *Accounting Trends & Techniques* show the frequency of use in business of various accounting techniques. Placed throughout the text, these illustrations give students real world data to consider while learning about different accounting techniques.
- Throughout the text we have included numerous references to the annual reports of over 75 companies. In fact, Chapter 17 and most of Chapter 16 are based

- on the 1996 annual report of the Colgate-Palmolive Company.
- Most of the chapters contain a section entitled, “Analyzing and Using the Financial Results.” This section discusses and illustrates a ratio or other analysis technique that pertains to the content of the chapter. For instance, this section in Chapter 4 discusses the current ratio as it relates to a classified balance sheet.
- Most of the chapters contain end-of-chapter questions, exercises, or business decision cases that require the student to refer to the Annual Report Booklet and answer certain questions. As stated earlier, this booklet is included with the text and contains the significant portions of the 1996 annual reports of four companies: The Coca-Cola Company, Maytag Corporation, The Limited, Inc., and John H. Harland Company.
- Each chapter contains a section entitled, “Beyond the Numbers—Critical Thinking.” This section contains business decision cases, annual report analysis problems, writing assignments based on the Ethical Perspective and Broader Perspective boxes, group projects, and Internet projects.
- Key terms are printed in another color for emphasis. End-of-chapter glossaries contain the definition and the page number where the new term was first introduced and defined. Students can easily turn back to the original discussion and study the term’s significance in context with the chapter material. A “New Terms Index”—an alphabetical list of all key terms in the text with page numbers—is included at the end of the text.
- Each chapter includes a “Self-Test” consisting of true-false and multiple-choice questions. The answers and explanations appear at the end of the chapter. These self-tests are designed to determine whether the student has learned the essential information in each chapter.
- In the margin beside each exercise and problem, we have included a description of the requirements and the related Learning Objective(s). These descriptions let students know what they are expected to do in the problem.
- Throughout the text we use examples taken from everyday life to relate an accounting concept being introduced or discussed to students’ experiences.

## Pedagogy

Students often come into financial accounting courses feeling anxious about learning the subject matter. Recognizing this apprehension, we studied ways to make learning easier and came up with some helpful ideas on how to make this edition work even better for students.

- Improvements in the text’s content reflect feedback from adopters, suggestions by reviewers, and a serious study of the learning process itself by the authors and editors. New subject matter is introduced only after the stage has been set by transitional paragraphs between topic headings. These paragraphs provide students with the reasons for proceeding to the new material and explain the progression of topics within the chapter.
- The Introduction contains a section entitled “How to Study the Chapters in This Text,” which should be very helpful to students.  
Each chapter has an “Understanding the Learning Objectives” section. These “summaries” enable the student to determine how well the Learning Objectives were accomplished. We were the first authors (1974) to ever include Learning Objectives in an accounting text. These objectives have been included at the beginning of the chapter, as marginal notes within the chapter, at the end of the chapter, and in supplements such as the Test Bank, Instructors’ Resource Guide, Computerized Test Bank, and Study Guide. The objectives are also indicated for each exercise and problem.
- Demonstration problems and solutions are included for each chapter, and a different one appears for each chapter in the Study Guide. These demonstration problems help students to assess their own progress by showing them how problems that focus on the topic(s) covered in the chapter are worked before students do assigned homework problems.

## End-of-Chapter Materials

Describing teaching methods, the AECC stated, “Teachers . . . should place a priority on their interaction with students and on interaction among students. Students’ involvement should be promoted by methods such as cases, simulations, and group projects. . . .”<sup>2</sup> A section entitled “**Beyond the Numbers—Critical Thinking**” at the end of every chapter is designed to implement these recommendations. **Business Decision Cases** require critical thinking in complex situations often based on real companies. The **Annual Report Analysis** section requires analyzing annual reports and interpreting the results in writing. The **Ethics Cases** require students to respond in writing to situations they are likely to encounter in their careers. These cases do not necessarily have one right answer. The **Group Projects** for each chapter teach students how to work effectively in teams, a skill that was stressed by the AECC and is becoming increasingly necessary for success in business. The **Internet Projects** teach students how to retrieve useful information from the Internet.

A team approach can also be introduced in the classroom using the regular exercises and problems in the text. Teams can be assigned the task of presenting their solutions to exercises or problems to the rest of the class. Using this team approach in class can help reenergize the classroom by creating an active, informal environment in which students learn from each other. (Two additional group projects are described in the Instructor’s Resource Guide. These projects are designed to be used throughout the semester or quarter.)

We have included a vast amount of other resource materials for each chapter *within* the text from which the instructor may draw: (1) one of the largest selections of end-of-chapter questions, exercises, and problems available;

<sup>2</sup>Ibid, p. 2.

(2) several comprehensive review problems that allow students to review all major concepts covered to that point; and (3) from one to three business decision cases per chapter. Other key features regarding end-of-chapter material follow.

- A uniform chart of accounts appears on the inside covers of the text. This uniform chart of accounts is used consistently throughout the first 11 chapters. The use of general ledger applications software with this edition necessitated the creation of a uniform chart of accounts. We believe students will benefit from using the same chart of accounts for all homework problems in those chapters.
- A comprehensive review problem at the end of Chapter 4 serves as a mini practice set to test all material covered to that point.
- Many of the end-of-chapter problem materials (questions, exercises, problems, business decision cases, other “Beyond the Numbers” items, and comprehensive review problems) have been revised. Each exercise and problem is identified with the learning objective(s) to which it relates.
- All end-of-chapter exercises and problems have been traced back to the chapters to ensure that nothing is asked of a student that does not appear in the book. This feature was a strength of previous editions, ensuring that instructors could confidently assign problems without having to check for applicability. Also, we took notes while teaching from the text and clarified problem and exercise instructions that seemed confusing to our students.
- Many of the problems, comprehensive review problems, and business decision cases in the text can be solved using software. Those problems that can be solved using *General Ledger Applications Software (GLAS)*, developed by Jack E. Terry of ComSource Associates, are identified in the margin with the symbol below.



This software package can also be used to solve the first two manual practice sets.

Many other exercises, problems, and business decision cases can be solved using *Spreadsheet Applications Template Software (SPATS)* developed by Jack Terry. The exercises and problems solvable with *SPATS* are identified in the margin of the text with the following symbol:



## SUPPLEMENTS FOR THE INSTRUCTOR

A complete package of supplemental teaching aids contains all you need to efficiently and effectively teach the course.

**Instructor’s Resource Guide, Chapters 1–17** This guide contains sample syllabi for both semester- and quarter-based

courses. Revised for this edition, each chapter contains: (1) a summary of major concepts; (2) learning objectives from the text; (3) space for the instructor’s own notes; (4) an outline of the chapter with an indication of when each exercise can be worked; and (5) detailed lecture notes that also refer to specific end-of-chapter exercise and problem materials illustrating these concepts. Also included are (6) a summary of the estimated time, learning objective(s), level of difficulty, and content of each exercise and problem that is useful in deciding which items to cover in class or to assign as homework; and (7) teaching transparencies masters. The Instructor’s Resource Guide for Chapter 17 contains a case study based on Hasbro, Inc. This company is the world’s leading manufacturer and marketer of toys, games, puzzles, and infant care products. You may want to assign this case as a special project to individuals or to teams. The results of the analysis, with recommendations, could then be presented to the class.

**Solutions Manual, Chapters 1–17** The solutions manual contains suggested discussion points for each ethics case as well as detailed answers to questions, exercises, two series of problems, business decision cases, most “Beyond the Numbers” items, and comprehensive review problems.

**Solutions Transparencies** Acetate transparencies of solutions to all exercises and *all* problems with excellent clarity are available free to adopters. These transparencies, while useful in many situations, are especially helpful when covering problems in large classroom settings.

**Test Bank, Chapters 1–17** The test bank, *revised in this edition*, contains questions and problems to choose from in preparing examinations. This test bank contains true-false questions, multiple-choice questions, and short problems for each chapter. Questions and problems are *classified by the learning objective* to which they relate.

**Computest 4** This improved microcomputer version of the Test Bank allows editing of questions; provides up to 99 different versions of each test; and allows question selection based on type of question, level of difficulty, or learning objective. Computest 4 is available on 3.5” disks.

**Teletest** Teletest is an in-house testing service that will prepare your exams within 72 working hours after you phone the publisher.

**Videos** The Irwin/McGraw-Hill Financial Accounting Video Library covers special topics such as the accounting cycle, merchandising, ethics, and international accounting. The subject matter lends itself well to a visual approach in the classroom. A video guide is also provided.

*The following items are intended for student use at the option of the instructor.*

**General Ledger Applications Software (GLAS)** Many problems, business decision cases, and comprehensive review problems in the text can be solved using this software.



GLAS is available on 3.5" disks and can be ordered with the text or as a separate item.

**Spreadsheet Applications Template Software (SPATS)** Many additional exercises, problems, and business decision cases can be solved using SPATS. It contains innovatively designed templates based on Excel. SPATS is available on 3.5" disks. SPATS can be ordered with the text or as a separate item.

**Peachtree® Complete™** This leading business accounting software is available for site license by contacting your Irwin/McGraw-Hill representative. The version you will receive is the actual "full-featured" commercial software being sold to many U.S. companies.

**Windows-based Computerized Tutorials** These software packages by Leland Mansuetti of Sierra College include true-false and multiple-choice questions with explanations for both correct and incorrect answers. Upon adoption, these computerized tutorials are available to instructors for classroom or laboratory use. Tutorials are available on 3.5" disks and can be ordered with the text or as a separate item.

## SUPPLEMENTS FOR THE STUDENT

In addition to the text, the package of support items for the student includes the following:

**Study Guides, Chapters 1–17** Included for each chapter are learning objectives, a reference outline, a chapter review, and an additional demonstration problem and solution. If students use the study guide throughout the course, their knowledge of accounting will be enhanced significantly. The study guide is a valuable learning tool in that it includes matching, true-false, and multiple-choice questions, completion questions, and exercises. Solutions to all exercises and questions are also included.

**Working Papers, Chapters 1–17** A set of working papers is available for completing assigned exercises, problems, business decision cases, other "Beyond the Numbers" items, and comprehensive review problems. In many instances, the working papers are partially filled in to reduce the "pencil

pushing" required to solve the problems, yet the working papers are not so complete as to reduce the learning impact.

**Manual Practice Sets** Four manual practice sets are available.

- *Dominion Lighting Company* illustrates special journals and includes a work sheet for a retailing company. This practice set can be used anytime after Chapter 9.
- *Aspen Mountain Camping Equipment Company* illustrates the use of business papers for a retailing company. It can be used anytime after Chapter 9.
- *Rocky Mountain Clothes Company, Inc.*, illustrates special journals and includes a work sheet for a retailing company. It can be used anytime after Chapter 9. This practice set is also available on our General Ledger Applications Software (GLAS).

**Computer Supplements** The following computer supplements are available on 3.5" disks:

- *Granite Bay Jet Ski, Level One*, Second Edition, by Leland Mansuetti and Keith Weidkamp, both of Sierra College, is a computerized simulation that can be used with any Principles of Accounting text using a single proprietorship approach. Level One is intended for use after coverage of the accounting cycle and accounting for cash (Chapter 8).
- *Granite Bay Jet Ski, Inc., Level Two*, Second Edition, by Leland Mansuetti and Keith Weidkamp, both of Sierra College, adds a corporate dimension to the business presented in Level One. It is intended for use after coverage of (1) plant assets and (2) current and long-term liabilities (Chapter 15).

We are indebted to many individuals for reviewing the manuscript of this edition. In addition to those listed on the acknowledgment pages, we are especially indebted to colleagues and students at our respective universities for their helpful suggestions. Our families also provided needed support and showed great patience during the revision process.

**Roger H. Hermanson**  
**James Don Edwards**

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The development of the seventh edition of *Financial Accounting: A Business Perspective* was an evolving and challenging process. Significant changes are taking place in the first course in accounting in schools across the country, and the authors and publisher worked hard throughout the development of this text to stay on top of those changes. The seventh edition is the product of extensive market research including interviews with adopters and nonadopters and comprehensive reviews by faculty. In particular, we are grateful to the following individuals for their valuable contributions and suggestions.

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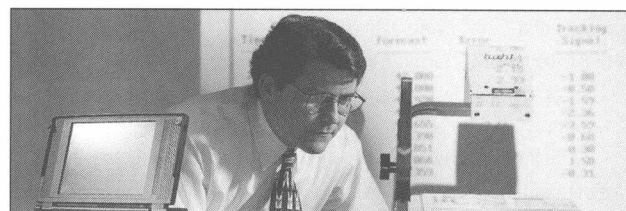
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