

FINANCIAL ACCOUNTING

A Business Perspective 8e



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FINANCIAL ACCOUNTING

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FINANCIAL ACCOUNTING: A BUSINESS PERSPECTIVE

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FINANCIAL ACCOUNTING

A Business Perspective

Eighth Edition

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Accounting Education column for *Management Accounting*. He has held the office of vice president of the American Accounting Association and served on its executive committee. He was also a member of the Institute of Management Accountants, the American Institute of Certified Public Accountants, and the Financial Executives Institute.

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. His wife's name is Dianne, and he has two children, Dana and Susan, both of whom are accounting professors.

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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 was 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. He was inducted into the Ohio State University Accounting Hall of Fame in 2001. His wife's name is Clara, and he has one son, Jim.

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Professor Herrmann (Dr. Don) loves to teach. He especially enjoys teaching his favorite subject - financial accounting. He has received ten teaching awards including the Byron L. Newton Excellence in Teaching Award given to the outstanding teacher in the College of Business, the Business Student Council Faculty Teaching Award, the Golden Key National Honor Society Outstanding Teaching Award, Who's Who Among America's Teachers, and the Mortar Board Top Professor Award.

Prior to a career as a college professor, Dr. Herrmann worked as an auditor for *Deloitte & Touche* in Colorado Springs and holds a Colorado CPA license. His wife's name is Mary, and he has four children: Rachel, David, Nathan, and Micah. When he is not studying financial accounting, he enjoys tennis, camping, running, coaching, and church activities.

Tax Journal, the *Journal of the American Taxation Association*, and the *Journal of International Taxation*. He was awarded two competitive research grants from the Ernst & Young Foundation and coauthored a monograph published by the Ernst & Young Foundation. While Dr. Sellers teaches a wide variety of financial accounting and tax courses, his specialty is financial statement analysis, financial accounting theory and business valuation. In addition to teaching, Dr. Sellers acts as a consultant with companies throughout the U.S. He is a CPA and a member of the National Association of Certified Valuation Analysts. When not teaching or consulting, Dr. Sellers can be found hiking, mountain biking, fishing or snow skiing in the mountains of southwest Colorado with his wife, Felicia, and his two sons, Jacob and Daniel.

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Professor Thomas is a Certified Public Accountant in the state of Oklahoma and enjoys teaching. His primary teaching interests include principles of financial accounting and financial statement analysis. He was awarded the Beta Alpha Psi Outstanding Faculty Award and Business Student Council Faculty Teaching Award and was runner up for the Marvin J. Ashton Award for Excellence in Undergraduate Teaching.

Professor Thomas' hobbies include basketball, golf, tennis, ping pong, running, crosswords, and a variety of church functions. He is married to Julee and has three children, Olivia, Jake and Eli.

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Associate Professor of Accounting at Oklahoma State University – Stillwater. He earned a B.S. and M.B.A. at Northern Illinois University and a Ph.D. at Oklahoma State University. Prior to joining the faculty at Oklahoma State in 1986, he served on the faculty at Northern Illinois.

Professor Wetzel has been involved with Beta Alpha Psi in numerous capacities, including Faculty Advisor, Regional Director, and most recently as a member of the Board of Directors. He is currently on the Board of Directors of the Oklahoma Student Loan Authority and the Association of Specialized and Professional Accreditors.

He has published in *Accounting Horizons* and the *Journal of Accounting Education*. He has experience as

a staff accountant at R. R. Donnelley & Sons, Inc. and has interned at both now PricewaterhouseCoopers and Andersen. He is a member of the American Accounting Association and has served on the Trueblood Committee and several section committees.

He was selected an Outstanding Faculty Advisor by Beta Alpha Psi in 1992 and received numerous teaching awards including the Kenneth D. and Leitner Greiner Undergraduate Teaching Award in the College of Business at Oklahoma State University in 1989. Professor Wetzel is married to the former Mary Ann Santo. They have two daughters Janine and Laura.

Preface

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 Limited, The Home Depot, and Coca-Cola 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) professor 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, and team projects. Each chapter also includes two **Internet projects** in the section titled "Using the Internet—A View of the Real World." For many of these items, you will use written and oral communication skills in presenting your results.

Objectives and Overall Approach of the Eighth 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.¹

One of the purposes of the first course should be to recruit accounting majors. To help accomplish this, the text has

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

a new section preceding each chapter entitled, “Careers in Accounting.”

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.

Approach and Organization

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.

- **“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 Appendix included with this text contains significant portions of the annual report of The Limited, Inc. Many of the real world questions and business decision cases are based on this annual report.
- 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 many companies.

- 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 Appendix and answer certain questions. As stated earlier, this appendix is included with the text and contains the significant portions of the annual report of The Limited, Inc.
- 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.

Pedagogy

Students often come into accounting principles 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.
- 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.
- 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.

Ethics

There is no better time to emphasize high ethical standards to students. This text includes many items throughout the text entitled, "An Ethical Perspective." These items present situations in which students are likely to find themselves throughout their careers. They range from resisting pressure by a superior or a client to do the wrong thing to deciding between alternative corporate behaviors that have environmental and profit consequences.

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. . . ."² 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; (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 back covers of the text. This uniform chart of accounts is used consistently throughout the first 11 chapters. 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.
- Some 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.

²Ibid, p. 2.

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. 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. The Instructor's Resource Guide is provided to adopters on a CD in PDF format.

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, comprehensive review problems, and some group projects. The Solutions Manual is provided to adopters in both hard copy and on a CD in PDF format.

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 contains approximately 4,500 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. The Test Bank is provided to adopters in both hard copy and on a CD in Rich Text Format. A computer test bank version is also available for selecting questions and printing exams.

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. The Study Guide is included on the adopter CD and can be distributed to students free of charge. It is also available on the publisher's website (www.authorsap.com/fabp8e).

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. The Working Papers consist of basic journals, ledgers, and other financial templates rather than being customized for each individual problem. We believe that this enhances the learning process because there is less "spoon feeding" of students. They have to be able to select the correct forms for solving problems. These forms are included on the adopter CD or they can be downloaded from the publisher's website (www.authorsap.com/fabp8e).

Normally the publishers provide the Study Guide and Working Papers in hard copy format which the students are required or encouraged to buy. We provide these items free of charge to students. We see this feature as a significant cost savings to students.

We are indebted to our families who provided needed support and showed great patience during the revision process.

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The development of all eight editions of *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. Recent editions are 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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