

# PRINCIPLES OF ACCOUNTING

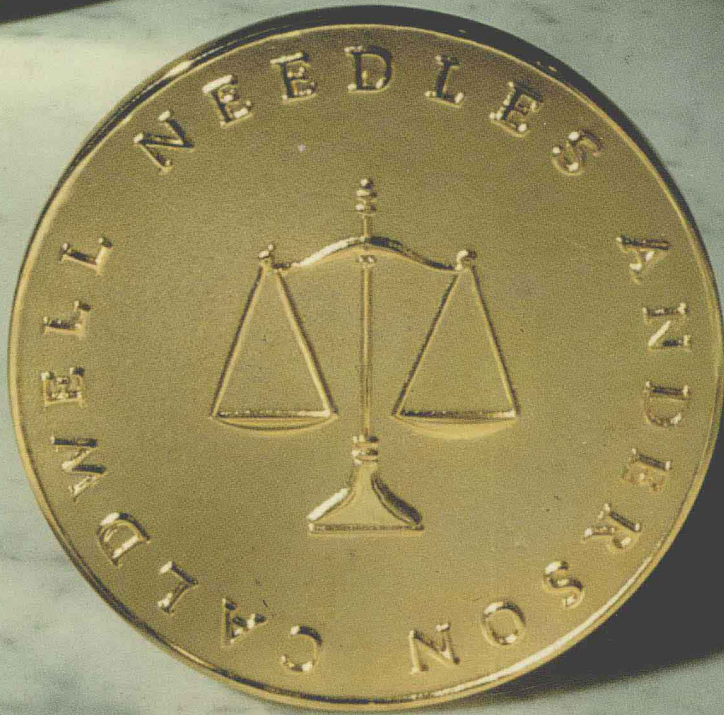
NEEDLES

ANDERSON

CALDWELL

FOURTH EDITION

Chapters 1-21



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# PRINCIPLES OF ACCOUNTING

## FOURTH EDITION

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To Marian Needles, and to Jennifer, Jeff, and Annabelle

To Sue Anderson, and to Deborah and Gregor Shewman, and to Howard, Christine,  
and Nichole Anderson, and to Randy Anderson and Hugh Anderson

To Bonnie Caldwell, and to Stephanie, Susan, and Sharon

This book is written to provide accurate and authoritative information concerning the  
covered topics. It is not meant to take the place of professional advice.

Cover photograph by Ralph Mercer.

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# TO THE STUDENT: HOW TO STUDY ACCOUNTING SUCCESSFULLY

Success in your accounting class depends first on your desire to learn and your willingness to work hard. But it also depends on your understanding of how the text complements the way your instructor teaches and the way you learn. An understanding of how this text is structured will help you to study more efficiently, make better use of classroom time, and improve your performance on exams.

## The Teaching/Learning Cycle<sup>™</sup>

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

**The Teaching Cycle.** Refer to the inner (green) circle in Figure 1, which 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 on the exam.

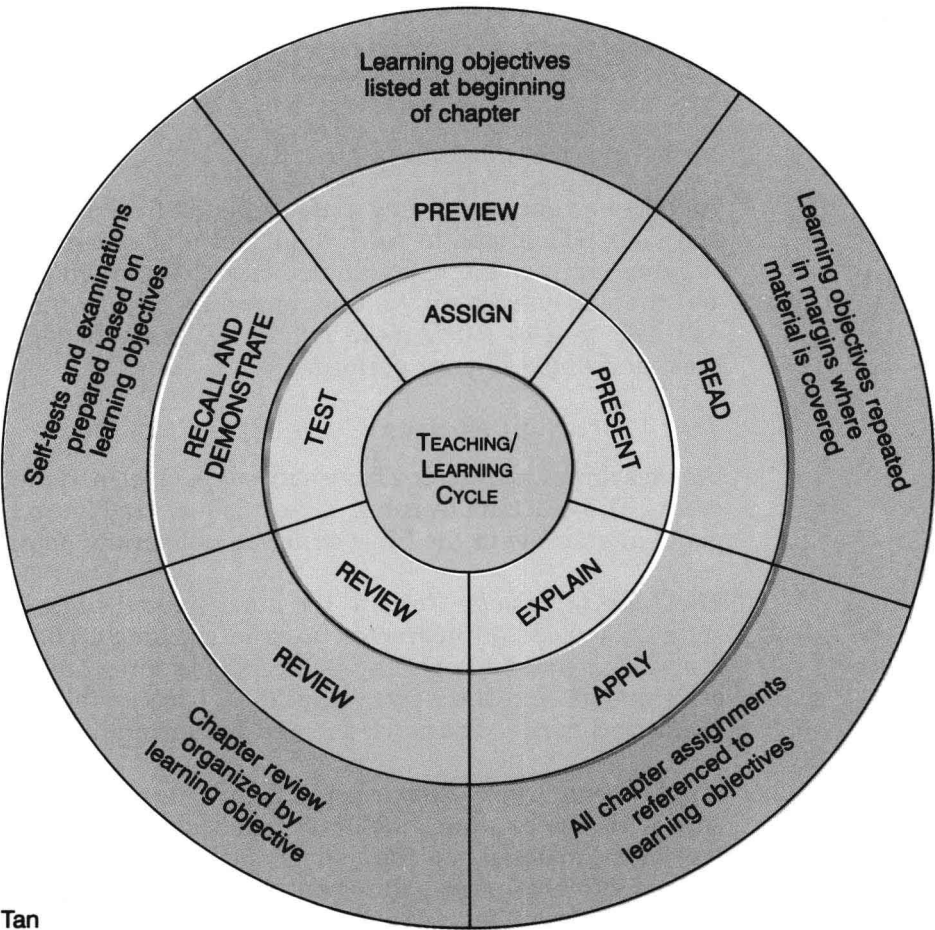
**The Learning Cycle.** Now refer in Figure 1 to the next circle (blue), which shows the steps you should take in studying a chapter. You should *preview* the material, *read* the chapter, *apply* your understanding by working the assignments, *review* the chapter prior to the examination, and *recall* and *demonstrate* your knowledge and understanding of the material on the exam. Your textbook supports these cycles 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.

**Integrated Learning Objectives.** In Figure 1, the outside (red) 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 in reading the material.
3. Every exercise, problem, and case in the chapter assignments shows the applicable learning objective(s) so that 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



Figure 1. Teaching/Learning Cycles with Learning Objectives



Tan  
Green – Teaching cycle  
Blue – Learning cycle  
Red – Learning objectives structure

- problem covering key learning objectives assist you in reviewing each chapter. Your Study Guide, also organized by learning objectives, provides for additional review.
5. Finally, a self-test in each chapter review helps you prepare for the examination that your teacher will give based on the learning objectives assigned and covered in class. The questions, exercises, and problems in the Study Guide also help you prepare for examinations.

**Why Students Succeed.** Students succeed in their accounting course when their personal learning cycle is in phase 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 to be gone over in

class, and reviewing carefully will ultimately achieve their potential on exams. Those who get out of phase with their instructor, for whatever reason, will do poorly or fail. To ensure that you are in phase with your instructor, check your study habits against these suggestions.

### Previewing The Chapter

1. Read the learning objectives at the beginning of the chapter. These learning objectives are specific action statements of what you should be able to do after completing the chapter.
2. Study your syllabus. Know where you are in the course and where you are going. Know the rules of the course.
3. Studying accounting is not like studying history or political science. Each assignment builds on previous ones. If you do poorly in Chapter 1, you may have difficulty in Chapter 2, and be lost in Chapter 3.

### Reading The Chapter

1. As you read each chapter, be aware of the learning objectives in the margins. They will tell you why the material is relevant.
2. Allow yourself plenty of time to read the text. Accounting is a technical subject. Accounting books are condensed and almost every sentence is important.
3. Strive to be able to say "I understand why they do that." 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 page xxxiv of the preface.)

**Red** All learning objectives and references to them are in red, as well as all key terms. Make sure you know their meanings. Remember, they are listed with definitions in the chapter reviews and a comprehensive glossary is located at the end of the book. In addition to learning objectives and key terms, source documents are shown in red.

**Green** All accounting forms and working papers are shown in green.

**Blue** All financial statements, the final product of the accounting process, are shown in blue. In addition, blue is used to emphasize the major headings in each chapter.

**Beige** Selected tables and illustrations use beige to heighten contrasts and aid student understanding. This color is also used in the part openers and comprehensive problems.

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 they do that,” you must also be able to do it yourself by working exercises, problems, and cases. Accounting is a “do-it-yourself” course.
2. Read assignments and the instructions carefully. The wording is precise, and a clear understanding of it will save time and improve your performance.
3. Try to work exercises, problems, and cases without flipping back to the chapter. If you cannot work the 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. Assignments are harder to work and more errors occur when prepared under time pressure.
6. Keep up with your class. Check your answer against the solution presented in class. Find your mistakes. Be sure you understand the correct solution.
7. Note the part of an exercise, problem, or case with which you have difficulty so that you can ask for help.
8. Attend class. Most instructors design class to help you and to answer your questions. Absence from even one class can have a negative effect on 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. Take the chapter self-test and review the learning objective for any question you answered incorrectly.
3. Review all assigned exercises, problems, and cases. Know them “cold!” Be sure you can work these assignments without the aid of the book.
4. Determine the learning objectives for which most of the problems were assigned. These are the topics that your instructor is most likely to emphasize on an exam. Scan the text for these learning objectives and pay particular attention to the examples and illustrations.
5. Look for and scan other similar assignments that cover the same learning objectives. These may be helpful on an exam.
6. Review quizzes. These questions are often similar to longer exams.
7. 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 The Exam

1. Arrive to 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 an element of speed. 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 a homework assignment. 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. Be neat, use good form, and show calculations. These techniques prevent errors.
  7. Relax. If you have followed the above guidelines, your effort will be rewarded.



# Transaction Index

**Note:** This index lists all major transactions and serves as an easy reference to the text discussion and illustration.

Accounts Receivable, Aging of, 392–393  
Accruals, 105–109  
Accumulated Depreciation, 108–109  
**Adjusting Entries, 105–112, 153–154**  
**Admission of New Partner, 576–580**  
**Allowance for Uncollectible Accounts, 388–395**  
Amortization of Premium or Discount on Bond Investments, 860  
Amortizing Bond Discount—Effective Interest Method, 696–698  
Amortizing Bond Discount—Straight-Line Method, 695–696  
Amortizing Bond Premium—Effective Interest Method, 701–702  
Amortizing Bond Premium—Straight-Line Method, 700–701  
Application of Predetermined Overhead Costs, 974–975  
Assets of Low Unit Cost, 507–508  
**Banking Transactions, 290–296**  
Bank Reconciliation Transactions, 295–296  
Bond Interest Expense, Year-End Accrual, 704–706  
**Bond Investment Transactions, 859–862**  
Bond Issue Costs, 692  
Bond Retirement Transactions, 706–707  
Bonds Issued at a Discount, 691  
Bonds Issued at a Premium, 692  
Bonds Issued at Face Value, 690  
**Bonds Payable Transactions, 690–707**  
Bonus to New Partner, 579–580  
Bonus to Old Partners, 578–579  
Brand Name, 542  
Capital Expenditures, 531–532  
Cash Dividends, 613  
**Cash Flows—Worksheet Transactions, 758–762**  
Cash Payments Journal, 253–255  
Cash Receipts Journal, 249–255  
**Closing Entries—Merchandising Company (Adjusting Entry Method), 204–205**  
**Closing Entries—Merchandising Company (Closing Entry Method), 207–208**  
**Closing Entries—Service Company, 153–161**  
Collection of Accounts Receivable, 21  
Collection on Notes Receivable, 402  
Computer Software Costs, 545  
Conversion of Bonds into Common Stock, 707  
Copyright, 542  
Credit Card Sales, 396–397

Death of a Partner, 582–583  
Deferrals, 109–110  
**Definitely Determinable Liabilities, 462–466**  
Depletion, 538–539  
Depreciation Expense, 107–108, 111–112, 498–499  
Depreciation for Partial Year Prior to Disposal, 533  
Depreciation for Partial Years, 510  
Depreciation of Closely Related Plant Assets, 539  
Development and Exploration Costs, 539–540  
Discarded Plant Assets, 533  
Discount on Notes Receivable, 402  
**Disposal of Depreciable Assets, 532–538**  
**Dissolution of Partnership, 576–580**  
**Distribution of Partnership Income and Losses, 570–576**  
Establishing the Petty Cash Fund, 297  
**Estimated Liabilities, 466–469**  
Exchanges of Plant Assets, 534–538  
Exercise of Stock Options, 623–624  
Expenses, 21, 65, 67  
Factory Overhead, 984–986  
Factory Payroll, 983–984  
Factory Purchases, 982–983  
**Financing Activities—Analysis of Transactions, 751–753**  
**Foreign Currency Transactions, 883–886**  
Foreign Purchases, 884  
Foreign Sales, 883  
Formula, 542  
Franchise, 542  
Freight In, 194  
Gain on Sale of Assets in Liquidation of Partnership, 584  
Gain Recognized on the Exchange, 536  
Goodwill, 542  
Government (Fund) Accounting Transactions, D-3  
Group Depreciation, 508  
Group Purchases, 497  
Imputing Interest, A-8  
Income Tax, 466  
Income Taxes Expense, 658–659  
Influential but Noncontrolling Investments, 848–849  
**Intangible Assets Transactions, 540–545**  
Interest Accrual on Notes Receivable, 404  
**Investing Activities—Analysis of Transactions, 747–751**  
Investment of Assets in Partnership, 578  
Issuance of No-Par Stock, 619–620  
Issuance of Par Value Stock, 618–619  
Issuance of Stock for Noncash Assets, 620–621  
**Job Order System Transactions, 981–987**

Just-in-Time Transactions, E-16–E-18  
 Leasehold/Leasehold Improvements, 542  
 Less than 100 Percent Purchase of Stock at Book Value, 854  
 License, 542  
**Liquidation of Partnership, 583–588**  
 Long-Term Investments, 844–850  
 Long-Term Leases, 708–710  
 Loss on Sale of Assets in Liquidation of Partnership, 585  
 Merchandise Inventory, 199–201  
**Merchandising Transactions, 188–196**  
 Mortgages Payable, 708  
**Natural Resources Transactions, 538–540**  
 Net Purchases, 192  
 Noninfluential and Noncontrolling Investments, 845–848  
 Notes Payable, 462–463, 465  
**Notes Receivable Transactions, 402–405**  
**Operating Activities—Analysis of Transactions, 738–747**  
 Owner's Investment, 18, 62  
 Owner's Withdrawals, 22, 66  
**Partnership—Distribution of Income and Losses, 570–583**  
 Partners' Investments, 568–570  
 Patent, 541–542  
 Payment of a Liability, 19, 64  
 Payment of Expenses in Advance, 63  
 Payroll, 476  
 Payroll Register, 475  
 Payroll Taxes, 477  
**Payroll Transactions, 474–477**  
 Pensions, 711–712  
 Percentage of Net Sales Method, 390  
 Periodic Versus Perpetual Inventory System, 437–438  
 Perpetual Inventory System, 437–438  
**Petty Cash Transactions, 296–298**  
 Plant Asset Exchange—Gain Not Recognized, 537  
 Plant Asset Exchange—Gain Recognized, 536  
 Plant Asset Exchange—Loss Not Recognized, 536  
 Plant Asset Exchange—Loss Recognized, 535  
 Plant Assets Sold for Cash, 534  
 Prepaid Expenses, 105–107  
 Prior Period Adjustments, 644  
 Process, 542  
 Process Cost System Transactions, 1024–1028  
 Product Warranty Liability, 467–468  
 Property Taxes Payable, 466–467  
 Purchase of Assets by Incurring a Liability, 19, 64  
 Purchase of Assets with Cash, 18, 63  
 Purchase of Assets with Partial Payment, 63  
 Purchase of Bonds between Interest Dates, 859  
 Purchase of Interest from Partner, 577–578  
 Purchase of Treasury Stock, 649  
 Purchases, 192  
 Purchases Discounts—Gross Method, 193  
 Purchases Discounts—Net Method, 195–196  
 Purchases Journal, 247–249  
 Purchases Returns and Allowances, 192  
 Realized Exchange Gain or Loss, 885  
 Receipt of Notes Receivable, 402  
 Recording a Dishonored Note, 402  
 Recovery of Accounts Receivable Written Off, 395  
 Reimbursing the Petty Cash Fund, 298  
**Retained Earnings Transactions, 643–653**  
 Retirement of Treasury Stock, 651  
 Revenue Expenditures, 531–532  
 Revenue Received in Advance, 65  
 Revenues, 20, 65, 66  
 Revenues from Sales, 188–189  
**Reversing Entries, 159–163**  
 Revision of Depreciation Rates, 506–507  
 Sale of Bonds, 862  
 Sale of Treasury Stock, 650  
 Sales, 188–189  
 Sales and Excise Taxes Payable, 464  
 Sales Discounts, 189  
 Sales Journal Transactions, 242–246  
 Sales of Bonds between Interest Dates, 703–704  
 Sales Returns and Allowances, 189  
 Sales Taxes, 246–247  
**Service Company Transactions, 18–23, 62–67**  
**Short-Term Investments, 385–387**  
**Special-Purpose Journals, 241–257**  
 Standard Costing, Initial Recording, 1143  
**Standard Costing Variance Transactions, 1156–1159**  
 Stock Dividends, 644–647  
**Stock Issuance Transactions, 617–623**  
 Stock Splits, 647–648  
 Stock Subscriptions, 621–623  
 Subsidiary Ledger, 244–245  
 Trademark, 542  
**Treasury Stock Transactions, 648–651**  
**Uncollectible Accounts Expense, 388–393**  
 Uncollectible Account Written Off, 394  
 Unearned or Deferred Revenues, 465  
 Unrealized Exchange Gain or Loss, 885  
 Unrecorded or Accrued Revenues, 110–111  
 Vacation Pay Liability, 468–469  
 Voucher System Transactions, 298–305  
 Withdrawal of Partner by Removing Assets, 582  
 Withdrawal of Partner by Selling Interest, 581–582

# Accounting Format Guide

Headings identify  
1. Name of company  
2. Name of statement  
3. Date or time period

Joan Miller Advertising Agency  
Income Statement  
For the Month Ended January 31, 19xx

Components are indented

## Revenues

Advertising Fees Earned	\$4,400	
Art Fees Earned	<u>400</u>	
Total Revenues		\$4,800

## Expenses

Office Wages Expense	\$1,380	
Utility Expense	100	
Telephone Expense	70	
Rent Expense	400	
Insurance Expense	40	
Art Supplies Expense	500	
Office Supplies Expense	200	
Depreciation Expense, Art Equipment	70	
Depreciation Expense, Office Equipment	<u>50</u>	

Total Expenses		<u>2,810</u>
Net Income		<u><u>\$1,990</u></u>

Totals are aligned with items to which they apply

## Joan Miller Advertising Agency Statement of Owner's Equity For the Month Ended January 31, 19xx

Joan Miller, Capital, January 1, 19xx		—
Add Investments by Joan Miller	\$10,000	
Net Income	<u>1,990</u>	<u>\$11,990</u>
Subtotal		\$11,990
Less Withdrawals		<u>1,400</u>
Joan Miller, Capital, January 31, 19xx		<u><u>\$10,590</u></u>

## Commonly Used Formats

Accounting Records		Statement of Cash Flows	757
T Account	59–60	Special Journals	
General Journal	68–70	Sales Journal	243
General Ledger	70–71	Purchases Journal (single-column)	248
Combined	72	Purchases Journal (multi-column)	249
Work Sheets		Cash Receipts Journal	251
Service Company	150	Cash Payments Journal	254
(Adjusting Entry Method) Merchandising Company	205	Voucher Register	299
(Closing Entry Method) Merchandising Company	208	Check Register	304
		Payroll Register	475
		Service Business	

**Joan Miller Advertising Agency**  
**Balance Sheet**  
**January 31, 19xx**

**Assets**

Cash		\$ 1,720
Accounts Receivable		2,800
Fees Receivable		200
Art Supplies		1,300
Office Supplies		600
Prepaid Rent		400
Prepaid Insurance		440
Art Equipment	→ \$4,200	
Less Accumulated Depreciation	70	4,130
Office Equipment	→ \$3,000	
Less Accumulated Depreciation	50	2,950
Total Assets		→ <u>\$14,540</u>

Dollar signs are used  
1. At tops of columns  
2. After subtotal lines  
3. With totals

**Liabilities**

Accounts Payable	\$3,170
Unearned Art Fees	600
Wages Payable	180
Total Liabilities	← <u>\$ 3,950</u>

Single lines are  
used before subtotals  
and totals

**Owner's Equity**

Joan Miller, Capital, January 31, 19xx	→ 10,590
Total Liabilities and Owner's Equity	← <u>\$14,540</u>

Double lines are  
used after totals

Trial Balance	73	Statement of Cash Flows—Direct Method	753
Income Statement	151	Statement of Cash Flows—Indirect	
Statement of Owner's Equity	152	Method	753
Balance Sheet	152	Manufacturing Business	
Post-Closing Trial Balance	162	Income Statement	939
Merchandising Business		Statement of Cost of Goods Manufactured	924
Income Statement	209	Financial Statement Analysis	
Classified Balance Sheet	338	Comparative Balance Sheet with	
Classified Income Statements	343	Horizontal Analysis	800
Multistep	344	Comparative Income Statement with	
Condensed Formats	344–345	Horizontal Analysis	800
Corporation		Trend Analysis	802
Stockholder's Equity	342	Common-Size Balance Sheet	805
Statement of Retained Earnings	644	Common-Size Income Statement	803
Statement of Stockholder's Equity	355	Summary of Ratios	806
Income Statement	656	Cash Budget	1115

## Preface to PRINCIPLES OF ACCOUNTING, 1–21

PRINCIPLES OF ACCOUNTING, Fourth Edition, Chapters 1–21 is a version of Principles of Accounting that contains all of the financial accounting chapters found in the comprehensive text and includes the following appendices:

- Appendix A: The Time Value of Money
- Appendix B: Future Value and Present Value Tables
- Appendix C: Overview of Income Taxes for Individuals
- Appendix D: Overview of Governmental and Not-for-Profit Accounting

This book has been designed specifically for those schools that offer principles of accounting in a three-semester or three-quarter course sequence in which managerial and cost accounting topics are covered using a separate cost accounting or managerial accounting textbook.

The text contains all of the features contained in the comprehensive version (Chapters 1–28) including integrated learning by objective pedagogy, a five-color design, expanded assignment material, and up-to-date, authoritative coverage of accounting topics. Two features new to the fourth edition, the *Transaction Index* and the *Accounting Format Guide*, are placed at the front of the textbook. A comprehensive and integrated ancillary program is available for instructors and students. The Preface to the fourth edition (page xxxi) contains a complete description of the text and ancillary program.

PRINCIPLES OF ACCOUNTING, Fourth Edition, Chapters 1–21 may also be used as a comprehensive textbook for a one-semester or two-quarter course in financial accounting. It will be an especially appropriate textbook choice if a sole-proprietorship approach is desired for the first part of this course.



# **PREFACE**

PRINCIPLES OF ACCOUNTING, Fourth Edition, is a comprehensive first course in accounting for students with no previous training in accounting or business. It is intended for use in the traditional two-semester or two- and three-quarter sequence. Designed for both majors and nonmajors, the textbook is part of a well-integrated package for students and instructors that includes many manual and computer ancillaries not found in previous editions.

## **Goals of the Fourth Edition**

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We wrote this book believing that integrated learning objectives can significantly improve the teaching and learning of accounting. This system of learning by objective enhances the role of the overall package, and particularly that of the textbook, in achieving good communication between the instructor and the student.

The success of the first three editions of this book has justified our confidence in the principle of learning by integrated objectives. At the same time, several goals guided us in developing and writing PRINCIPLES OF ACCOUNTING, Fourth Edition. Those goals were: (1) to write for the student's first exposure to accounting; (2) to extend learning by objectives to the entire package; (3) to make the content authoritative, practical, and contemporary; (4) to emphasize the role of accounting in decision making; (5) to adhere to a strict system of quality control; and (6) to develop the most complete and flexible package available.

## **The Student's First Exposure to Accounting**

When organizing the text, we specifically focused on the needs of the intended audience, the freshman and sophomore student. First, we carefully paced new concepts and techniques to ensure that students would grasp and retain the material. Second, we limited the number of difficult concepts or practices in each chapter, particularly in the early part of the book. Third, we rigorously provided a clear presentation, a consistent reading level, and a uniform use of terminology throughout the text. Fourth, we focused on understanding, not memorization, believing that concepts acquire meaning when applied and practices become most easily understood when related to those concepts. Fifth, we emphasized concepts and practices useful to students throughout their careers, whether in accounting or not.

### **Integrated Learning by Objectives**

We took a definite pedagogical approach to writing *PRINCIPLES OF ACCOUNTING*, Fourth Edition. We extensively used learning objectives and learning theory. Learning objectives were integrated throughout the text and package from the chapter previews and presentations to the chapter reviews, assignments, study aids, and testing and evaluation material.

### **Authoritative, Practical, and Contemporary**

This book presents accounting as it is practiced and carefully explains the theory underlying those practices. Accounting terms and concepts are defined according to pronouncements of the AICPA, APB, FASB, and CASB. The Statements of Financial Accounting Concepts of the FASB's Conceptual Framework Study form the theoretical underpinning of the book and are used to assess various accounting situations and controversies. In addition, steps were taken to ensure that, to the extent possible within the framework of introductory accounting, the material realistically reflects the way accounting is practiced today.

The topics covered are up to date and correspond with current trends in business and accounting. Ethical considerations in accounting are integrated at appropriate points throughout the book. They are included in the discussions of the auditor's professional responsibilities, financial reporting, managerial accounting, and in a general business context. New appendices have been added on not-for-profit accounting and the just-in-time philosophy in managerial accounting. Complete coverage of the new statement of cash flows is contained in Chapter 18. International accounting is now the primary focus of Chapter 21.

### **Decision-Making Emphasis**

Another of our goals was to present the contemporary business world and the real-life complexities of accounting in a clear, concise, easy-to-understand manner. Accounting is treated as an information system that helps managers, investors, and creditors make economic decisions. In addition to questions, exercises, and problems, the chapter assignments include two decision-oriented features: an "Interpreting Accounting Information" exercise and either a "Financial Decision Case" or a "Management Decision Case." In each situation, the student must extract quantitative information from the exercise or case and make an interpretation or a decision.

### **Quality Control**

Together with our publisher, we developed a system of quality control for all parts of the package to ensure the most technically and conceptually accurate program possible. This system, which utilizes an innovative computer database technology, involved many steps, including thorough reviews by users, visits to and discussions with users by the authors, extensive in-house editorial review, accuracy checking by over forty

introductory accounting teachers, class testing, and finally an audit for technical and conceptual accuracy by the international accounting firm, Ernst & Young.

### **Complete and Flexible Learning System**

We believe that *PRINCIPLES OF ACCOUNTING*, Fourth Edition, represents the most complete and flexible package available for a first course in accounting. All parts of the package fit within the exclusive pedagogical system of integrated learning by objectives established by the authors. This system fits within the framework of the Teaching/Learning Cycle, which is described in detail in the To the Student section at the beginning of this text and in the following sections.

### **Organization of the Fourth Edition**

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The book is organized into seven parts so it may be used by schools on either a semester or quarter sequence. Those using the two-semester or two-quarter sequence may cover three parts during the first term and four parts during the second. Those using the three-quarter sequence may cover two parts in each of the first two quarters and three parts in the last quarter. If a shorter course is required, all or parts of chapters 4, 6, 13, 19, 20, 21, and 24 may be omitted or covered briefly without hindering comprehension of the later chapters. For instructors wanting to introduce students to the present and future value of money, individual income taxes, not-for-profit accounting, or the just-in-time philosophy, appendices on these subjects along with examples and assignments are provided at the end of the text.

### **Focus on Ethics and Communication Skills**

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There is a recognized need in our society for accounting and business students to be exposed in all their courses to ethical considerations and to be better prepared in writing and communication skills. As authors, we feel an obligation to help students achieve these goals. First, we introduce ethical concerns, throughout the text, not only as they apply to auditors but also as they apply to financial and managerial accountants and to business professionals. Second, we have provided ample assignments to enhance student communication skills. All sections of the end-of-chapter material now contain written assignments. The Discussion Questions and Writing Assignments focus on this objective as do the Interpreting Accounting Information and Financial and Management Decision Cases. In addition, selected classroom exercises and A and B problems in each chapter contain writing components. We have found the Interpreting Accounting Information and Financial and Management Decision Cases to be excellent vehicles for the improvement of commu-

nication skills through small group discussion and oral reports. Appropriately structured, these activities take far less time than might be thought and are valuable to the students.

## Textbook Features

### Pedagogical Use of Color

The text uses a five-color design consistently throughout the illustrations to enhance students' understanding of the accounting process. The chart below displays the value of this pedagogical approach to color. First, pedagogical features such as learning objectives, key terms, and emphasized material in the text are printed in red, as are all source documents. Second, green is used to represent accounting forms and working papers, which are part of the ongoing process of accounting. Third, blue is used to emphasize the major headings in the chapter and to highlight the actual financial statements, the final product of the accounting process. Blue is also used to indicate alternative methods that are presented in the text. Beige is used in selected tables and illustrations to heighten the contrasts and aid student understanding. In addition, it helps students locate the three new comprehensive problems.

### Integrated Learning Objectives

Action-oriented objectives at the beginning of each chapter indicate in precise terms what students should be able to do when they complete the chapter. The learning objective is restated in the margin beside pertinent text. All end-of-chapter components—Review of Learning Objectives, Review of Concepts and Terminology, Self-Test, and Review Problem—are clearly referenced to learning objectives, and end-of-chapter assignments are keyed to specific objectives.

