

Fundamental Finance Accounting Concepts



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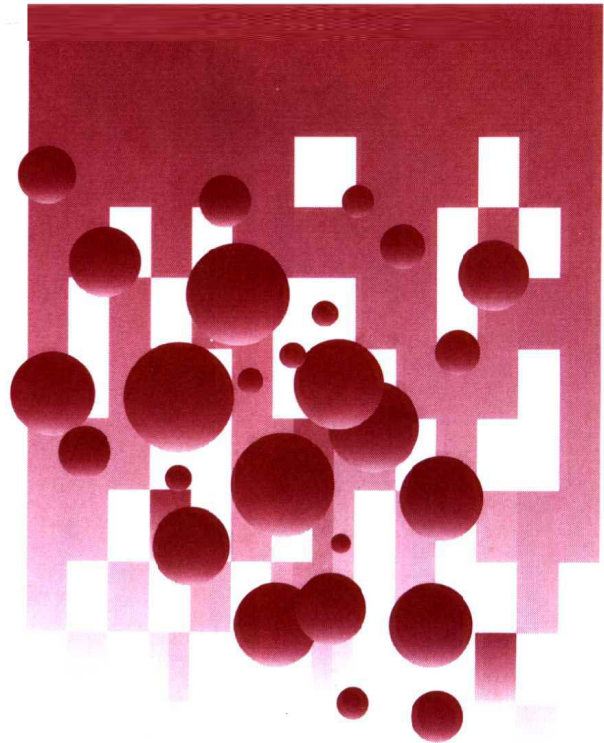
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PREFACE

Conceptual Foundation for Users and Preparers of Financial Statements

This is a **conceptually based / user oriented** book that focuses on the meaningful comprehension of accounting fundamentals as opposed to the rote memorization of recording procedures. What do we mean by a conceptually based book? We mean that the book focuses on the relationships between accounting events and financial statements. The primary objective is to produce students who can explain how an accounting event such as “provided services on account” affects the elements of financial statements. Did the event cause assets to increase, decrease or stay the same? Similarly, what was the effect on liabilities, equity, revenue, expense, gains, losses, net income, and distributions. Further, how did the event affect cash flows? These are the primary questions that are addressed repeatedly as new accounting events are introduced throughout the text.

We believe that an understanding of how accounting events affect financial statements is reinforced by the preparation and use of financial statements. As a result, the text has two secondary objectives: (1) to provide coverage of recording procedures to the extent that they are necessary for students to learn how to organize accounting information for the preparation of financial statements, and (2) to provide a base of analytical tools that enable students to identify meaningful differences in business performance as it is reflected in financial statements. This dual focus is consistent with the goals and objectives of the *Accounting Education Change Commission* as outlined in Position Statement No. Two, which states that the first course in accounting “. . . should be a rigorous course focusing on the relevance of accounting information to decision-making (use) as well as its source (preparation).”

We have **delayed the introduction of recording procedures**, including debit and credit terminology, journal entries, ledger accounts, etc. until Chapter 4. Non-technical terminology (i.e., increase/decrease) is used to discuss the effects of events on the elements of financial statements in the first three chapters of the text. Why bother with debits and credits? In general, students enter business with a sense of debits and credits that is directionally reversed. This phenomenon occurs because businesses speak to customers from the perspective of the business entity, while customers listen from their personal perspective. When a business credits one of its receivable accounts, it reduces the customer’s obligation to the business. Unfortunately, when a customer is told by a business that his/her account is being credited, they develop the erroneous impression that credits act to reduce liabilities. Even non-accounting majors should have opportunity to correct these misconceptions of basic business terminology. More importantly is the fact that some knowledge of the double entry recording scheme facilitates the comprehension of basic concepts by promoting organization and communication skills. As a result, authors disagree with the philosophy that general business majors can ignore recording procedures. Reduce, yes — ignore, no!

Each chapter ends with a discussion entitled **Using Accounting Information**. This section introduces special topics such as the use of ratio analysis, the role of the audit report, the use of management discussion and analysis (MD&A), the importance of footnotes to financial statements, and differential reporting formats. Accordingly, the tools of financial statement analysis are integrated throughout the text. The complete 1993 annual report for Tredegar Industries has been included in Appendix A. The end of chapter material includes a special case that relates the topics covered in each chapter to the Tredegar report.

Unique Features that Facilitate Meaningful Learning

The accounting cycle. We use a *cycles model* which extends the discussion beyond the accounting equation to the financial statements. Other modern textbooks use what is frequently classified as a “horizontal model.” The horizontal model focuses on how events affect the accounting equation. This model should not be confused with a cycles model. The cycles model not only demonstrates the effect of events on the accounting equation but also shows students how the information is presented in a full set of

financial statements (i.e., income statement, statement of changes in equity, balance sheet, and statement of cash flows). In other words, the illustrations end with the presentation of a *full set* of financial statements. The cycles model is used throughout the book. Events, the equation, and the related *financial statements* are shown in virtually every chapter of the text.

Multi-Period Model. We demonstrate the effect of events on financial statements over multiple accounting periods. Indeed, the illustrations in most chapters cover two or more accounting cycles. Eight accounting cycles including eight complete sets of financial statements are presented in the first three chapters alone. The associations between accounting events and financial statements cannot be fully comprehended when only one accounting cycle is presented. Students need to see how depreciation accumulates on the balance sheet over the life of the asset or how a discount account is amortized over the life of a bond. The text is designed to provide a complete picture of the effects of events on financial statements over a series of accounting cycles. You will be amazed at how much clearer this format is to your students.

Statement of Cash Flows. Along with the balance sheet, statement of changes in equity, and the income statement, the *statement of cash flows* is described and illustrated nine times within the first four chapters. Students are taught to create the statement of cash flows under the direct method by analyzing the cash account. Using this approach, coverage of the statement of cash flows is placed on parity with the other primary financial statements which are illustrated throughout the text. Indeed, a full set of financial statements including the statement of cash flows is shown at least once and usually two or three times in virtually every chapter of the textbook. Likewise, many of the exercises and problems require students to prepare a full set of financial statements including the statement of cash flows. We know of no other textbook on the market today that provides a comparable level of coverage of financial statements in general or of the statement of cash flows in particular.

Control of Complexity. Many educators have begun to recognize the detriments of crowded material. Education research suggests that information overload leads to memorization. Very little is accomplished when students are exposed to such a volume of material that they are unable to comprehend the basic concepts. This text seeks to emphasize the comprehension of concepts by reducing the volume of content. For example, one method of estimating uncollectible accounts is sufficient to demonstrate how bad debts affect financial statements. Likewise, you do not need both the net and gross methods to explain how cash discounts affect financial statements. Either method standing alone could be used to demonstrate the critical interrelationships. To heighten the focus on key concepts, this text has eliminated the coverage of many of the alternative recording procedures that are included in traditional textbooks. Some of the topics omitted are: alternative recording procedures for adjusting entries, reversing entries, accounting treatment for discounting an interest bearing note, sum-of-the-years depreciation, accounting for the exchange of like-kind assets, the issue of bonds between interest dates, bond investments, accounting for marketable equity securities, stock subscriptions, and differences in the treatment of large and small stock dividends. While this is not an exhaustive list of the items that have been eliminated, it should serve to make the point that this text represents a serious effort to reduce the problem of information overload in introductory accounting. Indeed, in some instances entire chapters such as accounting for consolidated financial statements, payroll accounting, and partnerships have been omitted. It is important to note that by thinning the material we are not advocating a reduction in rigor. The comprehension of concepts is a far more rigorous learning task than the memorization of arbitrary details.

Emphasis on the Perpetual Inventory Method. The perpetual inventory system is stressed. With the advent of computers, the perpetual system has become the predominant method employed in business practice. It is also the system that is logically consistent with accrual accounting which recognizes events and circumstances as they occur. A strict application of accrual accounting requires product costs to be capitalized in asset accounts until the goods are used (i.e., sold) for the production of revenue. At the time the goods are sold, the product costs should be removed from the asset account and placed in an expense account (i.e., cost of goods sold). The perpetual method of accounting for merchandising transactions is consistent with these concepts because costs are capitalized in the inventory account at the time of acquisition and expensed at the point of sale. In contrast, the periodic method places inventory costs in a temporary account (i.e., a "purchases" account, which is neither an asset nor an expense) at the time of

acquisition. Further, in a periodic system, inventory costs are not expensed as merchandise is sold. Although the objectives of accrual accounting are eventually accomplished through a year-end adjustment, the entries made at the time goods are acquired or sold are logically inconsistent with accrual accounting concepts. Accordingly, students struggling with the comprehension of accrual accounting are likely to find the periodic recording procedures arbitrary. Since arbitrary material cannot be learned meaningfully, students are left with no choice but to memorize. By stressing the perpetual inventory method, this text promotes meaningful learning and more accurately represents contemporary accounting practice.

Real World Relevance. How many companies use sum-of-the-years depreciation versus how many companies use tax tables to compute depreciation? Clearly, tax applications have more real world relevance. This text covers some topics that are not normally found in traditional textbooks, but which are prevalent in business practice. Some examples include the modified accelerated cost recovery system (MACRS) used to compute depreciation for tax purposes, accounting for warranty obligations, accounting for credit card sales, commercial lines of credit, and term loans that require the amortization of principal as well as interest.

Asset/Liability Approach. The Financial Accounting Standards Board (FASB) has consistently favored the measurement of assets and liabilities over the goal of matching in the process of establishing accounting standards. To facilitate the comprehension of present and prospective accounting standards this book has adopted the asset/liability view. Revenues and expense are defined as the by products of the measurement of assets and liabilities. For examples, revenues are defined as increases in assets or decreases in liabilities. Similarly, expenses are defined as decreases in assets or increases in liabilities. Further, in the process of thinning material, favored status was given to the alternatives that focused on the measurement of assets and liabilities. For example, the percent of receivables method was retained and the percent of sales method was discarded in the discussion of bad debts. While the matching concept is discussed, the text emphasizes the measurement of assets and liabilities.

Generic Terminology. This text distinguishes between the different type of business organization in Chapter 11. Prior to this point, the generic term, *equity*, is used to describe the ownership interest in a business. The term equity is subdivided into two categories: contributed capital and retained earnings. These terms are preferable because they describe the two distinct sources of assets. Once the concept of ownership has been fully comprehended, the intricacies of different types of ownership (i.e., proprietorship, partnership, and corporation) are introduced. This approach is consistent with the idea of putting the forest before the trees. Indeed, generic terminology (i.e., assets, liabilities, equity, revenue, expense, net income, cash flow, etc.) is use extensively throughout the text. The theme of the text centers on the comprehension of concepts rather than the memorization of technical terminology.

Ethics Discussion Cases. The end of chapter material for each chapter contains a case that describes an ethical dilemma that may occur in business practice. The unique feature of these cases is that they all concern issues that have a direct bearing on financial statements. The issue under question is always consistent with the topics discussed in the chapter. Students are required to address the impact on financial reporting prior to engaging in a discussion of the ethical implications. This approach provides structure to the discussion and reinforces the relationships between events and financial statements as well as providing a forum for the discussion of ethics.

We believe that this text provides a unique alternative for an introduction to accounting. The primary objective of the text is to provide students with learning experiences that result in the comprehension of the framework of fundamental concepts upon which the accounting discipline is based. Accordingly, the model provides a third alternative to the traditional *preparer*, or the emerging *user*, oriented approaches to introductory accounting. This alternative is a **concepts approach**. Since a conceptual understanding of accounting is essential to the use and preparation of financial statements, it serves general business students as well as those who choose accounting as a major. Indeed, the concepts approach even enhances the appeal of introductory accounting as an elective for non business majors.

A Complete Package of Supplements

The text is supported by a complete package of supplements. Rather than farming the supplements out, we have prepared these material ourselves. Accordingly, you can rest assured that the supplements match the text. The package includes the following items:

Solutions Manual: Prepared by Edmonds, McNair, Milam and Olds: The solutions manual has been prepared by the authors and contains complete answers to all questions, exercises, problems, and cases. The manual has been tested using a variety of quality control procedures to insure accuracy. After the initial preparation of the **solutions**, the problems and exercises were reworked “blind.” The second set of answers were then compared with the previous solutions by an independent reviewer. Any differences were reconciled. After this process, the solutions manual was again proofed and checked for accuracy by the authors. In addition to the quality control measures used by the authors, the material has been class tested at 20 schools by 26 different instructors in 51 independent classroom settings. Any errors found and reported have been incorporated into the review and correction process.

Test Bank: Prepared by Thomas P. Edmonds and Frances M. McNair: The test bank contains a variety of questions and problems. There are between 20 and 30 **multiple choice** questions provided for each chapter. The questions are specifically *designed to test the student's comprehension of accounting concepts*. For example, instead of asking what accounts would be debited or credited, the questions center on how an event affects the elements of the financial statements. Did assets, liabilities, and equity increase, decrease, or stay the same? What happened to net income and cash flow? These are the types of questions addressed in a multiple choice format. Do not let anyone tell you that you cannot use multiple choice questions to test conceptual comprehension. If teaching mass sections has encumbered you with a heavy grading burden, you will be especially appreciative of the high quality of the multiple choice component of this test bank.

The test bank also includes **short discussion** questions that enable you to assess your student's communication skills as well as their accounting knowledge. Even so, the questions can be graded in a relatively short time period. Most of the questions can be answered using one or two words or very short sentences. This format enables the maximum potential for the evaluation of communication skills and accounting knowledge while minimizing the grading task.

Finally, the test bank contains a generous supply of **open-ended problems**. Many of these problems test the student's understanding of financial transactions and their impact on financial statements. The problems allow the instructor to test the student's knowledge of financial statement structure, format, and content. While the majority of problems focus on the evaluation of conceptual comprehension, there are an ample supply of questions that address computational skills and knowledge of recording procedures. Like the textbook, the test bank recognizes the importance of the double entry recording scheme as a mechanism for the organization and communication of accounting information. It is the glue that holds the conceptual relationships together and should not be forgotten in the process of instruction or evaluation.

The test bank is available in *file formats that are compatible with WordPerfect, Microsoft Word, and other word processing software programs*. Accordingly, instructors or their secretaries can easily alter questions using their own word processing programs. There is **no** need to learn how to operate some complicated test generating software.

Study Guide: Prepared by Philip R. Olds: Each chapter of the study guide begins with a brief review and explanation of a set of learning objectives that correspond to the objectives set forth in the textbook. Students are encouraged to accomplish the stated objectives by working a variety of multiple choice problems and short exercises. Unique to this study guide are a series of **articulation problems**. These problems require students to indicate how accounting events affect (i.e., increase, decrease, no effect) the elements of financial statements. They not only reinforce the student's understanding of how events affect statements but also help them understand how the income statement, balance sheet, and statement of cash flows interrelate. Completion of the study guide will enable the student to (1) review their comprehension of the text material, (2) prepare for examinations, and (3) obtain an additional perspective of the course material. The guide contains approximately 200 pages. It includes appropriate work papers and a complete set of solutions.

Work Papers: Prepared by Frances M. McNair and Edward E. Milam: The work papers provide forms that are useful in the completion of both exercises and problems. Work papers for the exercises provide headings and prerecorded example transactions that enable students to get started quickly and to work in an efficient manner. They can be used to shorten the time necessary to complete homework assignments and to provide structure that facilitates the grading task. The forms provided for the problems can be used with either series A or B problems. This set of working papers is of the traditional type in that the shell is provided, but the student must fill in the headings and all other necessary information. The work papers for problems are designed as a companion set to those provided for the exercises. They assume that the student has worked enough exercises to be familiar with the design of the accounting equation and financial statement format. Accordingly, they avoid the fill-in-the-blank mentality that encourages memorization. When using the working papers for problems, students will be required to provide proper headings and to organize information in proper financial statement format. In an effort to control cost the number of pages included in the work paper package has been limited. Only one set of working papers has been provided for both series A and B problems. These working papers can be duplicated by the student if a separate set of papers are needed for each problem series.

Computerized Practice Problem: *Broadway Babies, Inc.* Prepared By Thomas P. Edmonds and Bor-Yi Tsay: Broadway Babies, Inc. is a computerized practice problem. Beginning account balances are presented in a trial balance. Students record accounting events including appropriate **adjusting** entries in general journal format. The software program automatically updates the beginning balances and provides students with an adjusted trial balance. Students use the adjusted trial balance to manually prepare a complete set of financial statements. This is **not** a black box exercise. The problem requires the active participation of the student in the application of debit and credit terminology, the formation of journal entries, and the preparation of financial statements. Accordingly, the student gets a clear picture of how accounting events affect financial statements without getting bogged down in computational and procedural detail. Work papers for statement preparation are included in a booklet that accompanies the software. The problem is designed so that it can be introduced at a point that is approximately two-thirds through the course. This permits a review of a significant portion of the course material while allowing a reasonable amount of time for students to finish the exercise prior to the completion of the course. The software is a DOS based program that is designed to operate on IBM compatible systems using DOS versions of 3.0 or higher. The entire booklet including instructions, transactions and work papers is only fourteen pages long. The program is menu driven. The print function works with any printer without requiring a complicated installation process. Grading effort can be minimized by using a set of multiple choice tests that are provided to instructors upon request. This is truly a hassle free, affordable computing experience for your students.

Manual Practice Problem -- *Mark's Racquets, Inc.* Prepared By Cindy D. Edmonds: Mark's Racquets, Inc. is a manual practice problem. Students record accounting events in general journal format and post transaction data to running balance general ledger accounts. They prepare unadjusted, adjusted, and post-closing trial balances. They use the *information* contained in the adjusted trial balance to prepare an income statement, a balance sheet, a statement of changes in equity and a statement of cash flows. The problem minimizes procedural detail. Special journals, a worksheet, posting references, etc. are not used. The problem is designed so that it can be introduced at a point that is approximately two-thirds through the course. This permits a review of a significant portion of the course material while allowing a reasonable amount of time for students to finish the exercise prior to the completion of the course. The thirty-seven page practice problem booklet contains instructions, transactions, and work papers. Most students are able to complete the problem in less than eight hours. Grading effort can be minimized by using a set of multiple choice tests that are provided to instructors upon request.

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Thomas P. Edmonds
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Edward E. Milam
Philip R. Olds

Contents

PREFACE.....	xiii
---------------------	-------------

CHAPTER 1 Elements of Financial Statements	2
---	----------

Introduction 3 ■ Accounting's Role in Business 3 ■ Financial Statements 5 ■ Elements of Financial Statements 6 ■ Accounting Events and Transactions 8 ■ The New Company Illustration - Events for 19X1 9 ■ Summary of Transactions 12 ■ Elements Presented in Financial Statements 13 ■ The Income Statement 13 ■ Statement of Changes in Equity 14 ■ The Balance Sheet 15 ■ The Statement of Cash Flows 16 ■ Completing the Cycle 17 ■ The New Company Illustration - Events for 19X2 18 ■ Financial Statements for 19X2 19 ■ Using Accounting Information 21 ■ GLOSSARY 24 ■ QUESTIONS 25 ■ EXERCISES 26 ■ PROBLEMS – SERIES A 31 ■ PROBLEMS – SERIES B 36 ■ CASE STUDY 41

CHAPTER 2 Accounting for Accruals	42
--	-----------

Introduction 43 ■ Accrual Accounting Illustrated 43 ■ Effect of Events on the Accounting Equation 44 ■ Summary of Transactions 47 ■ Understanding the 19X1 Financial Statements 47 ■ The Second Accounting Cycle 51 ■ Effect of Events on the Accounting Equation 51 ■ Understanding the 19X2 Financial Statements 53 ■ The Third Accounting Cycle 55 ■ Effect of Events on the Accounting Equation 56 ■ Understanding the 19X3 Financial Statements 58 ■ Using Accounting Information 58 ■ A Review of Core Concepts 63 ■ GLOSSARY 65 ■ QUESTIONS 65 ■ EXERCISES 66 ■ PROBLEMS – SERIES A 72 ■ PROBLEMS – SERIES B 75 ■ CASE STUDY 79

CHAPTER 3 Accounting for Deferrals	82
---	-----------

Introduction 83 ■ Accounting for Deferrals Illustrated 83 ■ Summary of Transactions for 19X4 89 ■ Understanding the 19X4 Financial Statements 89 ■ The Second Accounting Cycle 91 ■ Effect of the 19X5 Transactions on the Accounting Equation and the Financial Statements 91 ■ The Third Accounting Cycle 95 ■ Effect of 19X6 Transactions on the Accounting Equation and the Financial Statements 96 ■ Using Accounting Information 101 ■ GLOSSARY 105 ■ QUESTIONS 105 ■ EXERCISES 106 ■ PROBLEMS – SERIES A 112 ■ PROBLEMS – SERIES B 118 ■ CASE STUDY 124

CHAPTER 4 The Recording Process	126
--	------------

Introduction 127 ■ Debit/Credit Terminology 127 ■ Collins Consultants Case 129 ■ Asset Source Transactions 129 ■ Asset Exchange Transactions 133 ■ Asset Use Transactions 135 ■ Claims Exchange Transactions 137 ■ Adjustments for Accruals 139 ■ Adjustments for Deferrals 141 ■ Overview of Debit and Credit Relationships 144 ■ Summary of T-accounts 144 ■ The Ledger 147 ■ The General Journal 147 ■ Financial Statements 150 ■ Closing Entries 153 ■ Trial Balance 153 ■ Using Accounting Information 153 ■ GLOSSARY 157

■ QUESTIONS 157 ■ EXERCISES 158 ■ PROBLEMS – SERIES A 165 ■ PROBLEMS
– SERIES B 173 ■ CASE STUDY 181

CHAPTER 5 Accounting for Merchandising Businesses

184

Introduction 185 ■ Period Versus Product Cost 185 ■ Allocating Inventory Cost Between
186 ■ Asset and Expense Accounts 186 ■ Recording Inventory Cost 188 ■ The Perpetual
Inventory Method 189 ■ The Effect of Events on the Accounting Equation 189 ■ Journal
Entries and Ledger T-accounts 190 ■ Other Events Affecting Purchases and Sales of Inven-
tory 192 ■ Effect of Events on Accounting Equation 193 ■ Journal Entries and Ledger Ac-
counts 198 ■ Financial Statements 200 ■ The Periodic Inventory Method 202 ■ Schedule
of Cost of Goods Sold 204 ■ Lost, Damaged, or Stolen Merchandise 204 ■ Using Account-
ing Information 206 ■ GLOSSARY 212 ■ QUESTIONS 213 ■ EXERCISES 214 ■
PROBLEMS – SERIES A 220 ■ PROBLEMS – SERIES B 225 ■ CASE STUDY 231

CHAPTER 6 Internal Control and Accounting for Cash

232

Introduction 233 ■ Internal Control in Computer Systems 238 ■ Accounting for Cash 239
■ Controlling Cash 239 ■ Checking Account Documents 241 ■ Reconciliation of Bank
Statement 242 ■ Illustration of the Reconciliation Schedule 246 ■ Petty Cash Funds 249 ■
Using Accounting Information 251 ■ GLOSSARY 257 ■ QUESTIONS 258 ■ EXERCISES
259 ■ PROBLEMS – SERIES A 265 ■ PROBLEMS – SERIES B 272 ■ CASE STUDY
279

CHAPTER 7 Accounting for Accruals – Receivables and Payables

282

Introduction 283 ■ Accounting Events Affecting the 19X1 Period: 284 ■ Journal Entries
and Ledger T-accounts 286 ■ Financial Statements 287 ■ Accounting Events Affecting the
19X2 Period: 288 ■ Journal Entries and Ledger Accounts 290 ■ Analysis of Financial
Statements 292 ■ Recognizing Bad Debts 293 ■ Under the Direct Write-Off Method 293 ■
Accounting for Credit Card Sales 294 ■ Warranty Obligations 296 ■ Accounting for Dis-
count Notes 299 ■ Accounting Events Affecting the 19X2 Period: 302 ■ Using Accounting
Information 304 ■ GLOSSARY 308 ■ QUESTIONS 309 ■ EXERCISES 310 ■ PRO-
BLEMS – SERIES A 315 ■ PROBLEMS – SERIES B 321 ■ CASE STUDY 326

CHAPTER 8 Accounting for Inventories

282

Introduction 329 ■ Inventory Cost Flow Methods 329 ■ Inventory Cost Flow Under a Per-
petual System 331 ■ Inventory Cost Flow When Sales and Purchases Occur Intermittently
337 ■ Inventory Cost Flow in a Periodic System 340 ■ Lower of Cost or Market 341 ■ Es-
timating the Ending Inventory Balance 343 ■ The Effect of Inventory Errors on Financial
Statements 344 ■ Using Accounting Information 347 ■ GLOSSARY 351 ■ QUESTIONS
352 ■ EXERCISES 353 ■ PROBLEMS – SERIES A 359 ■ PROBLEMS – SERIES B
365 ■ CASE STUDY 372

CHAPTER 9 Long-Term Operational Assets 374

Introduction 375 ■ Classifications of Long-Term Operational Assets 375 ■ Methods of Depreciation 378 ■ Income Tax Considerations 388 ■ Revision of Estimates 391 ■ Continuing Expenditures for Plant Assets 392 ■ Natural Resources 394 ■ Intangible Assets 395 ■ Balance Sheet Presentation 398 Using Accounting Information 399 ■ GLOSSARY 402 ■ QUESTIONS 403 ■ EXERCISES 404 ■ PROBLEMS – SERIES A 409 ■ PROBLEMS – SERIES B 415 ■ CASE STUDY 420

CHAPTER 10 Accounting for Debt Transactions 422

Introduction 423 ■ Bond Liabilities 423 ■ Bonds Issued at Face Value 427 ■ Bonds Issued at a Discount 430 ■ The Effect of Semiannual Interest Payments 436 ■ Bonds Issued at a Premium 437 ■ Bond Redemptions 438 ■ Term Loans 439 ■ Line of Credit 443 ■ Using Accounting Information 444 ■ GLOSSARY 449 ■ QUESTIONS 450 ■ EXERCISES 451 ■ PROBLEMS – SERIES A 456 ■ PROBLEMS – SERIES B 461 ■ CASE STUDY 466

CHAPTER 11 Accounting for Equity Transactions 468

Introduction 469 ■ The Formation of Business Organizations 469 ■ Advantages and Disadvantages of 471 ■ Different Forms of Business Organization 471 ■ The Appearance of Capital Structure in 474 ■ Financial Statements 474 ■ Characteristics of Capital Stock 476 ■ Accounting for Stock Transactions on the Day of Issue 480 ■ Stockholder Equity Transactions after the Day of Issue 482 ■ Financial Statement Presentation 487 ■ Using Accounting Information 488 ■ GLOSSARY 492 ■ QUESTIONS 493 ■ EXERCISES 495 ■ PROBLEMS – SERIES A 499 ■ PROBLEMS – SERIES B 503 ■ CASE STUDY 506

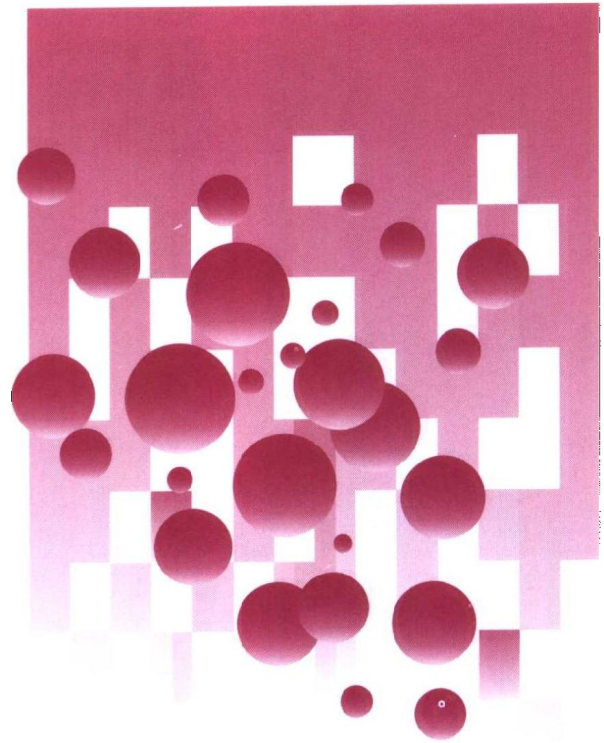
CHAPTER 12 Statement of Cash Flows 508

Introduction 509 ■ The Statement of Cash Flows 509 ■ Reporting Format for Statement of Cash Flows 511 ■ Converting from Accrual to 511 ■ Cash Basis Accounting 511 ■ Operating Activities 512 ■ Investing Activities 516 ■ Financing Activities 516 ■ Comprehensive Example Using the 517 ■ T-account Approach 517 ■ Preparation of the Statement of Cash Flows 517 ■ Cash Flows From Operating Activities 519 ■ Cash Flows from Investing Activities 524 ■ Cash Flows from Financing Activities 526 ■ Presenting Information in the Statement of Cash Flows 527 ■ Statement of Cash Flows 528 ■ Presented Under the Indirect Method 528 ■ Using Accounting Information 529 ■ GLOSSARY 534 ■ QUESTIONS 534 ■ EXERCISES 535 ■ PROBLEMS – SERIES A 539 ■ PROBLEMS – SERIES B 545 ■ CASE STUDY 551

APPENDIX A ANNUAL REPORT FOR TREDEGAR INDUSTRIES.....554

INDEX.....598

Fundamental Financial Accounting Concepts



CHAPTER 1

ELEMENTS OF FINANCIAL STATEMENTS

Learning Objectives:

After completing this chapter you should be able to:

- *State and explain the accounting equation.*
- *Identify the major elements of financial statements.*
- *Identify, describe and explain the four basic financial statements.*
- *Explain how cash transactions affect the financial statements of a business.*
- *Prepare simple financial statements for a business that engages in cash transactions.*
- *Identify the elements of financial statements in a real world annual report.*

INTRODUCTION

People around the world use some form of accounting every day. Consumers account for the money they spend; students have to plan for their educational expenses; and companies use accounting to track the performance of their operating activities. **Accounting** is a diverse and dynamic industry. Much like the fields of medicine or law, accounting is a service based discipline. The accountant's responsibility is to provide reliable and relevant information that is useful in making business decisions. **Users** of accounting information hold either a direct or indirect interest in the companies that issue the accounting reports. Direct users of financial information include investors, managers, creditors, suppliers, and employees. Indirect users advise and influence the direct users of financial information. They include financial analysts, brokers, bankers, government regulators, and reporters. The importance of accounting's role in business is evidenced by the fact that it is frequently referred to as the *language of business*.

Accounting's Role in Business

To understand the importance of accounting in the modern business world, you must know that first and foremost accounting is a **measurement discipline**. There are many different measurement schemes needed in the world of commerce, such as measurements of length, weight and time. Accounting is the measurement of financial results. Exactly what this means cannot be explained in a sentence or even in a page. This entire textbook is devoted to introducing the topic. However, to help explain the importance of understanding financial measurement, consider some of the issues relate to other types of measurement with which you are more familiar.

How long is a *yard*? A yard is .944 of a meter. So, how long is a meter? According to the International System of Units, a meter is the distance traveled by light in a vacuum during $1/299,792,458$ of a second. Now, that is helpful! Is it important to know the precise definition of a meter? No. However, if you wish to communicate the length of a particular object to other people, it is important that both parties agree on a definition of the unit of measure. Imagine the problems that would result if you were to build a house with a carpenter who considered the length of

a foot to be ten inches. Think of your disappointment when you walked into rooms that were much smaller than you expected. The length of a foot is not nearly as important as is the ability to reach agreement on its measurement.

Accounting has similar problems. Many times different definitions could be used to explain an accounting measurement. To facilitate communication, accountants have established rules that business people can use to assure themselves that they are talking about the same thing. For example, suppose a store sells a compact disk player in December to a customer who agrees to pay for it in January. Should the store owner tell people that the sale occurred in December or in January? As will be explained in Chapter 2, accountants operating in the United States have agreed to say it was sold in December. The rule could have been made the other way. There would no problem if everybody reported similar sales in January. However, communication problems may occur if some people report this type of sale in December while others choose to report it in January. Such reporting could preclude meaningful comparisons between companies. Choosing to report in December versus January is not as important as making a rule that facilitates consistency in reporting measurements.

Many people and organizations in our society make decisions based on financial information reported by companies. Therefore, it is important for them to understand how that information was measured. Early in life you learned the length of a yard. Now, when you hear that a quarterback threw a 60 yard pass to win the game, you know what it means. In your business career, if you hear that a company's *earnings are down ten percent while cash flows from operations are about the same*, you need to know what that means as well. The reason business students are required to take this accounting course is to learn the rules of measurement that accountants use.

Why does it take an entire course or two just to get an introduction to the rules of accounting measurement? Because the business activity that accounting is designed to measure is complex. Just think about how many hamburgers McDonald's sells in one day and how many different foreign currencies must be used to account for those sales. Now think about how many different sets of tax rules must be applied to determine the amount of tax due on the income earned from the sale of those hamburgers. In an effort to capture the diversity of business activity, different companies are allowed to use different measurement methods. Even within the same company, it may be necessary to use one measurement method for some financial items and another method for other items.

The diversity in accounting for business activity may appear to contradict the earlier statement that “accountants have established rules that business people can use to assure themselves that they are talking about the same thing.” However, upon further reflection, you can see that this is not a contradiction. Carpenters in Europe may use meters as the measurement unit, while carpenters in the United States use yards. Even so, construction companies operating on both continents can still communicate so long as they agree on the rules governing the length of a yard and a meter. Similarly, one business may record sales when they are made while another business records them in the period that cash is collected. Effective communication can still be accomplished so long as both businesses disclose which measurement method was used to report their sales.

Certainly, communication would be easier if only one measurement method were used to report each type of business activity. Unfortunately, world economies have not yet evolved to the point where it is possible to attain uniformity in financial reporting. Indeed, significant diversity continues to exist even in highly sophisticated countries such as the United States. A well-educated business person must be able to understand and interpret accounting information that has been prepared under a variety of measurement rules. The rules of measurement for accounting used in the United States are called **generally accepted accounting principles**. This textbook is designed to introduce you to these principles so that you will be able to understand business activity as it is presented in accounting reports.

Financial Statements

Which businesses will increase in value? Which companies will fail to pay their debts? Many people are interested in questions such as these. Among others, owners, lenders, employees, customers, suppliers, and regulators seek information about the financial activities of business enterprises. Businesses communicate such information to the public through a process known as financial reporting. The central feature of external financial reporting is a set of **financial statements**. Accordingly, financial statements constitute the principal means of communicating economic information to individuals and institutions residing outside the reporting enterprise.

The four general purpose financial statements used by business enterprises are (1) the income statement, (2) the statement of changes in equity,