

SECOND
EDITION

FINANCIAL ACCOUNTING

THE IMPACT ON DECISION MAKERS

129967 \$52.00



GARY A. PORTER
CURTIS L. NORTON

FINANCIAL ACCOUNTING

THE IMPACT ON DECISION MAKERS

SECOND EDITION

GARY A. PORTER

Loyola University Chicago

CURTIS L. NORTON

Northern Illinois University



The Dryden Press

Harcourt Brace College Publishers

Fort Worth Philadelphia San Diego New York Orlando Austin San Antonio
Toronto Montreal London Sydney Tokyo

Publisher George Provol
Executive Editor Mike Reynolds
Acquisitions Editor Sara Tenney
Product Manager Craig Johnson
Developmental Editor Craig Avery
Project Editor Jim Patterson
Art Director Jeanette Barber
Production Manager Lois West

Credits appear on page C-1, which constitutes a continuation of the copyright page.
Cover illustration: Andrew Judd/Masterfile

ISBN: 0-03-020483-6
Library of Congress Catalog Card Number: 97-65089

Copyright © 1998, 1995 by Harcourt Brace & Company

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission in writing from the publisher.

Requests for permission to make copies of any part of the work should be mailed to: Permissions Department, Harcourt Brace & Company, 6277 Sea Harbor Drive, Orlando, Florida 32887-6777.

Some material in this work previously appeared in *FINANCIAL ACCOUNTING: THE IMPACT ON DECISION MAKERS*, Alternate Edition, copyright © 1996 by Harcourt Brace & Company.

Address for orders:
The Dryden Press
6277 Sea Harbor Drive
Orlando, FL 32887-6777
1-800-782-4479

Address for editorial correspondence:
The Dryden Press
301 Commerce Street, Suite 3700
Fort Worth, TX 76102

Web site address:
<http://www.hbcollege.com>

The Dryden Press, Dryden, and the Dryden Press logo are registered trademarks of Harcourt Brace & Company.

Printed in the United States of America

8 9 0 1 2 3 4 5 6 032 9 8 7 6 5 4 3 2

The Dryden Press
Harcourt Brace College Publishers

ABOUT THE AUTHORS

The Porter/Norton Story

When the first edition of *Financial Accounting: The Impact on Decision Makers* was published in 1995, an unparalleled success story was created. The authors' own teaching experiences and observations, combined with extensive research by The Dryden Press, culminated in a new entry into the accounting market and a fresh approach to teaching. This approach was simple: deemphasize procedures, focus on introductory accounting concepts, and teach financial accounting from a financial statement user—rather than preparer—perspective. The Porter/Norton story was born.

Now, with the second edition, a great book has been made even better. Gary Porter and Curt Norton listened to users of the first edition who suggested three things: emphasize key concepts, eliminate unnecessary procedural detail, and engage the student even more in subject material.

The changes have resulted in a more streamlined, less procedural, and more student-friendly textbook—a book based on four guiding philosophies: (1) today's introductory accounting students must learn how to interpret and use financial statements; (2) students need practice relating the fundamental accounting concepts to real-world statements; (3) students should focus on the “why” instead of the “how” in using accounting information to make decisions; and (4) students do not all learn the same, nor do professors teach in the same way.

The authors invite you to share these philosophies in the second edition, as they have in their own classrooms and professional lives.

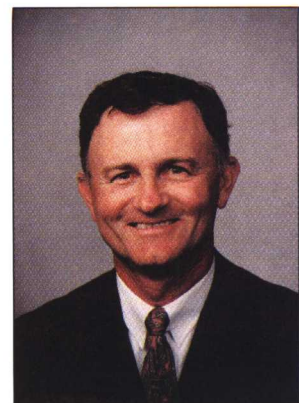
Gary A. Porter, CPA, is Professor of Accounting at Loyola University Chicago. He earned Ph.D. and M.B.A. degrees from the University of Colorado and his B.S.B.A. from Drake University. He has published in the *Journal of Accounting Education*, *Journal of Accounting, Auditing & Finance*, and *Journal of Accountancy*, among others and has conducted numerous workshops on the subject of introductory accounting education.

Dr. Porter's professional activities include membership on the Illinois CPA Society's Innovations in Accounting Education Grants Committee, experience as a staff accountant with Deloitte & Touche in Denver, and a participant in KPMG Peat Marwick Foundation's Faculty Development Program.

He has won an Excellence in Teaching award from the University of Colorado and an Outstanding Professor award from San Diego State University. Dr. Porter has served on the steering committee of the midwest region of the American Accounting Association and is currently on the board of directors of the Chicago chapter of the Financial Executives Institute.

Curtis L. Norton is Deloitte & Touche Professor of Accountancy at Northern Illinois University in DeKalb, Illinois. He earned his Ph.D. from Arizona State University, his M.B.A. from the University of South Dakota, and his B.S. from Jamestown College, North Dakota. His extensive list of publications includes articles in *Accounting Horizons*, *The Journal of Accounting Education*, *Journal of Accountancy*, *Journal of Corporate Accounting*, *Journal of the American Taxation Association*, *Real Estate Review*, *The Accounting Review*, *CPA Journal*, and many others. In 1988–89, Dr. Norton received the University Excellence in Teaching Award, the highest university-wide teaching recognition at NIU. He is also a consultant and has conducted training programs for governmental authorities, banks, utilities, and other entities.

Dr. Norton is a member of the American Accounting Association and a member and officer of the Financial Executives Institute.



PREFACE

To the Instructor

It is our goal in writing this textbook that students gain a thorough understanding of introductory concepts in accounting as well as the powerful ability to make the transition from textbook concepts to the real world, an ability that is important in any business career. This textbook offers the flexibility of teaching a conceptual and real-world approach to financial accounting.

Throughout the development of the second edition, we were continually reminded by adopters and reviewers of the demands in accomplishing the above goal in the classroom. We were also reminded of the need to emphasize key concepts, eliminate unnecessary procedural details, and find ways to engage students in the material. In writing the second edition, we have responded to such feedback while utilizing four guiding philosophies:

1. Today's introductory accounting students must learn to interpret and use financial statements. Our original two introductory chapters, "Accounting as a Form of Communication" and "Financial Statements and the Annual Report," have been retained, given their great success in launching a financial statement focus in the course. We have taken greater steps to incorporate information that will allow students to gain the necessary knowledge of the uses and interrelationships of financial statements:

- To increase our emphasis on how to read and understand financial statements, we have **reduced the number of preparer-oriented topics**. We continue to link transactions and journal entries to the financial statements by way of the accounting equation.
- A **new cash flows exhibit** found in Chapters 6 through 12 relates the material presented in each chapter to the statement of cash flows.
- Our **end-of-chapter problems and cases** have been revised to add **more thought-provoking questions and more practice** in interpreting financial statements.

Our approach to accounting topics is to provide very clear concepts, examples, and terminology for students. As in the first edition, we have taken great efforts to ensure we clearly explain difficult concepts. Additionally,

- **Chapter 2, "Financial Statements and the Annual Report," is considerably streamlined** by substituting the statements of only one company, Starbucks, for numerous companies' statements found in the first edition. We retained the parallel coverage of simple statements of our hypothetical company, Dixon Sporting Goods, with that of Starbucks.
- **ALTERNATE TERMS** in every chapter have been **expanded** to address the varying use of terminology that can roadblock a student's learning. We have also made

FOCUS ON FINANCIAL STATEMENTS

certain that new terms are defined as they are introduced and that the vocabulary in each chapter is not overwhelming.

- **End-of-chapter exercises, problems, and cases** have been carefully checked to ensure that they fully conform to and adequately test the content of the chapter. Further, the test bank has also been developed in parallel with the end-of-chapter material to ensure maximum pedagogical value.

REAL-COMPANY FOCUS



2. **Students need practice relating fundamental accounting concepts to real-world statements.**

- We continue to use **Ben & Jerry's** as a “flagship company.” Its straightforward and entertaining annual report is packaged with new copies of the textbook, and its financial statements and notes are reprinted in an appendix at the back of the book.
- Each **chapter-opening company** has been **more fully integrated into the chapter text** and additionally as sidebars, in the chapter-ending statement of cash flows exhibit, in end-of-chapter materials, and onto our Web site. In many instances, financial statement items are compared and contrasted with other companies. Integrating the chapter-opening company into the chapter allows students to gain more familiarity with the company and its numbers, allowing them to more fully analyze the company, its industry conditions, and business strategies.
- A number of **new companies** have been added to this edition—both in the text and in the end-of-chapter materials—to stimulate student interest and identification with the topic. Companies with a similar appeal to Ben & Jerry's, such as Ride, Inc., a snowboard manufacturer, are used to illustrate key concepts.

DECISION EMPHASIS

3. **If students have a concrete understanding of the “why” instead of the “how,” they will be much better able to use accounting information to make decisions.** As in the first edition, we continue to incorporate a decision-making emphasis, adding new material such as the uses of **time-value of money** concepts and the **choice of stock versus bond financing alternatives**. Additionally,

- **ACCOUNTING FOR YOUR DECISIONS** boxes were a unique feature of the first edition that placed the student in a role-playing situation as a user of financial information. In the second edition, we have **significantly increased** the number of these in-text, role-playing scenarios (from two to four in most chapters), so they can also be used as a form of **self-study problem**. We have also **broadened their focus** to include both business decisions and financial decisions students might make.
- The **end-of-chapter material** has been expanded to include more questions that **ask the student to analyze, evaluate, and make decisions or recommendations** regarding specific material.
- The accompanying **Interactive Decision Cases for Financial Accounting CD-ROM** additionally reinforces practice in making decisions based on real company information.

PEDAGOGY AND STUDENT APPEAL

4. **Not all students learn in the same way, nor do their professors teach in the same way.** For the *professor*,

- Our textbook provides instructors with flexibility, allowing them to emphasize either journal entries or the accounting equation as a way to understand transactions.
- We have retained the organization of the first edition in which the first two chapters give a big picture overview, followed by an introduction to the accounting model and sections on assets, liabilities, and owners' equity items. We believe this **transactions-based approach to financial accounting** provides a highly logical, structured approach to understanding the composition of financial statements and how they can be used in making decisions.

- We have also retained the 15-chapter organization of the first edition, which gives instructors the option of covering later chapters if desired.
- We **eliminated unnecessary procedural details**, and you will find such changes worth noting in the “Content Changes” section below.

For the *student*, we have added an **international perspective** throughout the text, serving the increasing need for students to have global business awareness and outlining conceptually interesting aspects of international accounting. Also, throughout the book we have attempted to engage the student in a variety of ways to learn other than simply the printed word:

- **STUDY LINKS** at the beginning of each chapter review the previous chapter, introduce the current chapter, and look forward to the following chapter. This gives the student an integrated perspective on the text.
- **Photos and captions** have been revised and expanded to **better explain or elucidate** text material.
- **Exhibits** have been enhanced and added wherever possible to be more visually appealing to students and make it **easier to learn**.
- **Captions are used in selected real financial statements** to allow students to focus their attention on a specific reporting issue and not become bogged down with the complexities of the statements. Wherever financial statement information appears in text, it has been highlighted with a green border to distinguish it from other tabular material.

Content Changes

In **Chapter 1**, “Accounting as a Form of Communication,” we have revised the exhibit that explains articulation of the financial statements to make it easier to understand. A new section was added to interest students in accounting as a career, focusing on both the opportunities and salaries in the profession. The section in the chapter on standard setting is enhanced with a discussion of the role of the International Accounting Standards Committee (IASC).

Chapter 2, “Financial Statements and the Annual Report,” serves as an overview of the various elements in the annual report by comparing the statements of a hypothetical company, Dixon Sporting Goods, with those of a real company. The coverage in this chapter has been streamlined considerably from the first edition, most noticeably by substituting the statements of only one company, Starbucks, for the numerous company statements presented in the first edition. An international perspective has been added following the conceptual framework section of the chapter by introducing the efforts of the IASC in this area.

We have streamlined the coverage of the accounting cycle in **Chapter 3**, “Processing Accounting Information” and **Chapter 4**, “Income Measurement and Accrual Accounting,” by eliminating procedural topics such as reversing entries, finding errors in the trial balance, and post-closing trial balances. The emphasis of the chapters is on accounting as an information system; therefore, topics such as posting from the journal to the ledger are still covered, but not in as much procedural detail as in the first edition.

We have made similar changes in **Chapter 5**, “Merchandise Accounting and Internal Control.” Only the gross method of accounting for sales and purchases discounts is covered, and the appendix on worksheets and closing entries for a merchandiser has been eliminated. The coverage of internal control in the body of the chapter focuses on the fundamental concepts, with the material on document flow for a merchandiser moved to an appendix.

Chapter 6, “Inventories and Costs of Goods Sold,” has been enhanced with a discussion of how companies in other countries account for inventory and the stance of the IASC. The section on analyzing the management of inventory turnover has been enhanced, and a new exhibit has been added to compare inventory turnover for Circuit

City and Safeway. Coverage of both the retail inventory method and the lower-of-cost-or-market rule have been streamlined. As mentioned earlier, beginning in this chapter and continuing through Chapter 12, two new exhibits have been added to each chapter to illustrate how key financial statement items are reported on the statement of cash flows.

Chapter 7, “Cash and Receivables,” has been revised to focus sharper attention on the key reporting and control issues for cash and receivables. To do this, we have eliminated the coverage of bad debt recoveries and significantly shortened the discussion of discounting notes receivable.

Chapter 8, “Operating Assets: Property, Plant, and Equipment, Natural Resources, and Intangibles,” has been simplified by eliminating much of the discussion of the capitalization of interest and by deleting the sum-of-years’ digits depreciation method. The chapter has been enhanced by a new exhibit and explanation of the factors that management should consider in choosing a depreciation method. The cash flow consequences of depreciation and other transactions affecting long-term assets is illustrated for the opening vignette company.

A new exhibit has been added to **Chapter 9**, “Current Liabilities, Contingent Liabilities, and the Time Value of Money,” to compare the current and quick ratios of six real-world companies. A new section has been added to explain more fully why the time value of money is important in both personal and accounting decisions. The discussion of contingent liabilities has been revised, and an exhibit illustrating the cash-flow impacts of current liabilities has been added.

Chapter 10, “Long-Term Liabilities,” has been simplified by reducing the discussion of amortization of bond discounts and premiums to one method, the effective interest method. A new exhibit has been added to illustrate how to read bond listings in *The Wall Street Journal*. The chapter utilizes the real-world statements of both Coca-Cola and PepsiCo to allow instructors to compare two companies within the same industry. Finally, the section on analysis of long-term liabilities has been moved toward the end of the chapter.

Chapter 11, “Stockholders’ Equity,” contains a new section on comparing stock and debt as financing alternatives. Detail has been removed by eliminating the topic of stock subscriptions, much of the material on retirement of stock, and a portion of the material on treasury stock. The chapter introduces the real-world financial statements of both Ford and Chrysler and presents a new exhibit on the dividend payout ratios of the companies in the auto industry.

The focus of **Chapter 12**, “Analysis of Retained Earnings and Stockholders’ Equity,” has been altered to emphasize additional aspects of retained earnings and stockholders’ equity, and the chapter title reflects the new focus. A section was added to stress the role of retained earnings as a link between the income statement and balance sheet, and a new exhibit illustrates this important concept graphically. Much of the discussion of appropriations of retained earnings has been eliminated, and the section on the statement of stockholders’ equity has been reduced.

In **Chapter 13**, “Additional Reporting Issues: Intercompany Investments and Foreign Currency,” we have added a new exhibit on foreign exchange rates to help students understand how to read foreign currency quotes in the newspaper. We have also added an excerpt from the statement of cash flows of Intel to augment the section on how companies reflect investments in their cash flows statement.

Chapter 14, “The Statement of Cash Flows,” and **Chapter 15**, “Financial Statement Analysis,” allow the instructor the maximum flexibility. In Chapter 14, instructors can emphasize either the concepts of cash flows or the preparation of the cash flows statement, or both, or they can defer the chapter to a later course. Chapter 15 consolidates the coverage of ratios that was integrated into the chapters, allowing instructors to teach financial statement analysis throughout the course, only in this chapter, or in another course. Thus we have made only minimal changes to these well-received chapters.

An extensive listing of chapter-by-chapter changes can be found on our Web site.

Supplements and Teaching Materials

A key contributor to the success of the first edition was a supplements package that was flexible, functional, innovative, and fully integrated with the goals and pedagogy of the text. For the second edition, we have once again listened to instructors' and students' needs in the new classroom and study environment and created a teaching and learning package to meet those needs.

For the Instructor

Solutions Manual (by the text authors), contains solutions to questions, exercises, problems, cases, and "From Concept to Practice" boxes for each chapter. (Suggested solutions for research cases appear on the book's Web site.) End-of-chapter items have been independently solved by two instructors (David Malone of Texas Tech University and Michael Claire of the College of San Mateo) to assure solution accuracy. *Also available in Word 6.0 for Windows files.*

Instructor's Resource Kit (by Patricia Doherty, Boston University) is a complete toolbox for instructors who teach a more financial statement user-oriented, interactive course. Containing chapter outlines, projects and activities, and a bibliography of readings, the Instructor's Resource Kit will provide ideas, suggestions, and resources for a variety of classroom styles. Numerous activities throughout are based on annual report exhibits, supporting the approach taken in the text. *Also available in Word 6.0 for Windows files.*

Test Bank (by Diane L. Tanner, University of North Florida, and Kevin Feeney, Southern Connecticut State University) has been thoroughly revised to increase its flexibility. Now containing more test items (approximately 150 questions per chapter), the Test Bank for the second edition has a greater variety of types of problem material to choose from, including multiple choice, short problems, matching, fill in the blanks, new cross-out the incorrect answer, new true-or-false questions, and new essay questions. It has been thoroughly error-checked and compared with the end-of-chapter material in the textbook for maximum pedagogical value.

EXAMASTER+ Computerized Test Bank (Windows) allows instructors to customize their tests by selecting items according to their individual teaching preferences. In addition, RequesTest service allows instructors to call a toll-free number to order custom test masters. A fax service is also available. RequesTest service is available Monday through Friday from 9 A.M. to 4 P.M. (Central Standard Time). Your sales representative can supply details.

Solutions Transparencies for selected exercises, problems, and cases are available in large type in acetate form. Transparency masters are available for all remaining solutions.

Teaching Transparencies contain a variety of visual tools for lecture enhancement taken largely from the text and based on the Lectures in PowerPoint. Includes text charts and graphs, reproductions of selected financial statements, lecture outlines, and additional lecture aids.

Lectures in PowerPoint (by Sandra Devona, Northern Illinois University) have been extensively revised for easier use for the second edition. More concise and focused on key topics and visual learning styles, *Lectures in PowerPoint* slides feature charts and graphs from the text as well as real-world financial statements.

Lecture Launching Videos provide a fuller view of selected chapter-opening companies, their strategic concerns, and recent financial decisions.

Classroom Guide to the Interactive CD-ROM (by Karen Walton, John Carroll University) contains classroom suggestions on the use of the student Interactive Decisions CD-ROM.



Software Support is available by calling 1-800-447-9457 Monday–Friday from 7 A.M. to 6 P.M. (Central Standard Time). Technical support is available twenty-four hours every day by fax or Internet. Users may access the fax-on-demand service at 1-800-352-1680. Users may contact the Technical Support Center at <http://www.hbtechsupport.com>

For the Student

Study Guide (by Mary Nisbet, University of California at Santa Barbara) contains study aids that let students better review chapter topics on their own, including a review of key concepts by learning objective with integrated Test Your Understanding questions and answers and a greater variety of self-test items.

Student Lecture Mate (by Sandy Devona, Northern Illinois University) contain printed versions of all the Lectures in PowerPoint slides in one handy booklet so that students can follow along during PowerPoint lectures and concentrate on the lecture rather than on taking notes.

Working Papers for every end-of-chapter exercise, problem, and case allow students to complete their assignments with a minimum of scratch work. Where possible, given data and repetitive or nonessential information has been pre-completed so that students can better concentrate on developing their problem-solving skills.

Guide to Understanding and Using Annual Reports (by Angela Bell, Floyd W. Kirby, and Elise M. Gantt, all of Jacksonville State University) contains a series of structured assignments in financial statement analysis, using World Wide Web and traditional research techniques outlined in the case, culminating in groupwork, decision-making scenarios, and writing exercises. The case is designed to foster business skills in systematic data gathering, understanding, analyzing, presenting, and making decisions using financial information. It is available with an Excel/Lotus spreadsheet disk.

Interactive Decision Cases for Financial Accounting CD-ROM (by Guided Explorations LLC) consist of eight cases linked to important financial accounting topics. This CD-ROM allows the student to play the role of an internal or external user of accounting information. Actual company financial statements as well as video and news clips, internal corporate correspondence, and other critical information are available to aid the student in making financial accounting decisions. Each case uses information pertaining to real-life companies such as Whirlpool, Kmart, or Dell Computer.

Bridge Software is tutorial software covering procedures no longer included in many user-oriented introductory accounting courses.

Tax Supplement (by Anita Feller, University of Illinois) contains essential coverage of corporate and individual taxation issues, complete with assignment material. (Instructor's solutions to assignment material are available free to adopters.)

Computerized Practice Set is a brief practice set containing reduced procedures and flexible, user-friendly general ledger software.

Procedural Review Software is based on the first edition's printed Procedural Review supplement. This software is designed to provide extra practice for procedures covered in the text, freeing class time for other activities.

Key Figures contain check figures for selected end-of-chapter assignments. It is available to adopters individually or in class bundles of 30.

Porter/Norton Web site. The Dryden Press has developed a Web site (<http://www.dryden.com>) to help instructors and students use the wealth of financial information available on the World Wide Web. The student can obtain financial statements, current news, SEC filings, and stock quotes for every company found in the text. The instructor can obtain all the above plus view and download many of the ancillaries to the text. As a special feature, the Porter/Norton Web site presents an Online Case Company to parallel the use of Ben & Jerry's annual report in the text. We have selected IBM's online annual report for its ease of use and instructional value. The student is challenged to read and interpret IBM's annual report by our **online "FROM CONCEPT TO PRACTICE" exercises and online chapter cases.**



<http://www.dryden.com/account/porter>

Acknowledgments

To develop, write, and publish a book to meet the changing needs of students and instructors truly requires a team effort. We appreciate the sincere and devoted work of all those who have contributed to our book.

Reviewers and Focus Group Participants for the First Edition:

Diana Adcox
University of North Florida
Saul Ahlaria
SUNY at Buffalo
Mike Akers
Marquette University
Marcia Anderson
University of Cincinnati
David Angelovich
San Francisco State University
Alana Baier
Marquette University
Amelia A. Baldwin-Morgan
Eastern Michigan University
Bobbe M. Barnes
University of Colorado at Denver
Maj. Curt Barry
U.S. Military Academy
Peter Battell
University of Vermont
Paul Bayes
East Tennessee State University
Mark Bettner
Bucknell University
Frank Biegbeder
Rancho Santiago Community College
Francis Bird
University of Richmond
Karen Bird
University of Michigan
Eddy Birrer
Gonzaga University
Michelle Bissonnette
California State University–Fresno
John Blahnik
Lorain County Community College
Ed Bresnahan
American River College
Sarah Brown
University of North Alabama
Philip Buchanan
George Washington University
Rosie Bukics
Lafayette College

Carolyn Callahan
University of Notre Dame
Linda Campbell
University of Toledo
Jim Cashell
Miami University
Charles Caufield
Loyola University Chicago
Gyan Chandra
Miami University
Mayer Chapman
California State University at Long Beach
Alan Cherry
Loyola Marymount University
Mike Claire
College of San Mateo
David C. Coffee
Western Carolina University
David Collins
Eastern Kentucky University
Judith Cook
Grossmont College
John C. Corless
California State University–Sacramento
Dean Crawford
University of Toledo
Shirley J. Daniel
University of Hawaii at Manoa
Alan Davis
Community College of Philadelphia
Henry H. Davis
Eastern Illinois University
Lyle E. Dehning
Metropolitan State College–Denver
Patricia Doherty
Boston University
Margaret Douglas
University of Arkansas
Kathy Dunne
Rider College
Kenneth Elvik
Iowa State University
Anette Estrada
Grand Valley State University

Ed Etter
Syracuse University
Alan Falcon
Loyola Marymount University
Charles Fazzi
Robert Morris College
Anita Feller
University of Illinois
Howard Felt
Temple University
David Fetyko
Kent State University
Richard File
University of Nebraska–Omaha
Ed Finkhauser
University of Utah
Jeannie M. Folk
College of DuPage
J. Patrick Forrest
Western Michigan University
Patrick Fort
University of Alaska–Fairbanks
Diana Franz
University of Toledo
Tom Frecka
University of Notre Dame
Gary Freeman
University of Tulsa
Veronique Frucot
Rutgers University–Camden
Joe Gallo
Cuyahoga Community College
Michelle Gannon
Western Connecticut State University
Will Garland
Coastal Carolina University
John Gartska
Loyola Marymount University
Roger Gee
San Diego Mesa College
Cynthia Van Gelderen
Aquinas College
Linda Genduso
Nova University

Don E. Giacomino
Marquette University
 Claudia Gilbertston
Anoka Ramsey Community College
 Lorraine Glascock
University of Alabama
 Larry Godwin
University of Montana
 Lynn Grace
Edison Community College
 Marilyn Greenstein
Lehigh University
 Paul Griffin
University of California-Davis
 Leon Hanouille
Syracuse University
 Joseph Hargadon
Widener University
 Robert Hartwig
Worcester State College
 Jean Hatcher
University of South Carolina at Sumner
 Donna Sue Hetzel
Western Michigan University
 Thomas F. Hilgeman
St. Louis Community College-Meramec
 Robert E. Holtfreter
Ft. Hays State University
 Kathy Horton
University of Illinois, Chicago
 Bruce Ikawa
Loyola Marymount University
 Danny Ivancevich
University of Nevada-Las Vegas
 Janet Jackson
Wichita State University
 Sharon Jackson
Auburn University at Montgomery
 Randy Johnston
Pennsylvania State University
 William Jones
Seton Hall University
 Naida Kaen
University of New Hampshire
 Manu Kai'ama
University of Hawaii at Manoa
 Jane Kapral
Clark University
 Marcia Kertz
San Jose State University
 Jean Killey
Midlands Technical College
 Ronald King
Washington University
 William Kinsella
Loyola Marymount University
 Jay LaGregs
Tyler Junior College
 Michael Lagrone
Clemson University
 Lucille E. Lammers
Illinois State University
 Ellen Landgraf
Loyola University Chicago
 Horace Landry
Syracuse University
 Kristine Lawyer
North Carolina State University

Terry Lease
Loyola Marymount University
 Susan Lightle
Wright State University
 Tom Linsmeier
University of Iowa
 Chao-Shin Liu
University of Notre Dame
 Bruce Lubich
Syracuse University
 Catherine Lumbattis
Southern Illinois University
 Patsy Lund
Lakewood Community College
 Raymond D. MacFee, Jr.
University of Colorado
 David Malone
University of Idaho
 Janice Mardon
Green River Community College
 Mary D. Maury
St. John's University
 Al Maypers
University of North Texas
 John C. McCabe
Ball State University
 Nancy McClure
Lock Haven University
 Margaret McCrory
Marist College
 Christine McKeag
University of Evansville
 Thomas D. McLaughlin
Monmouth College
 Laura McNally
Black Hills State College
 Mallory McWilliams
San Jose State University
 E. James Meddaugh
Ohio University
 Cynthia Miller
GM Institute
 William Mister
Colorado State University
 Tami Mittelstaedt
University of Notre Dame
 Perry Moore
David Lipscomb University
 Barbara Morris
Angelo State University
 Mike Morris
University of Notre Dame
 Theodore D. Morrison
Valparaiso University
 Howard E. Mount
Seattle Pacific University
 Rafael Munoz
University of Notre Dame
 Mary J. Nisbet
University of California-Santa Barbara
 Curtis L. Norton
Northern Illinois University
 Priscilla O'Clock
Xavier University
 Phil Olds
Virginia Commonwealth University
 Michael O'Neill
Gannon University

Janet O'tousa
University of Notre Dame
 Rimona Palas
William Paterson College of New Jersey
 Beau Parent
Tulane University
 Paul Parkison
Ball State University
 Sue Pattillo
University of Notre Dame
 Ron Pawliczek
Boston College
 Donna Philbrick
Portland State University
 Gary A. Porter
Loyola University Chicago
 Harry V. Poynter
Central Missouri State University
 Joseph Ragan
St. Joseph's University
 Mitchell Raiborn
Bradley University
 Ann Riley
American University
 Mary Rolfes
Mankato State University
 Leo A. Ruggle
Mankato State University
 Victoria Rymer
University of Maryland
 George Sanderson
Moorhead State University
 Karen Saurlander
University of Toledo
 Warren Schlesinger
Ithaca College
 Edward S. Schwan
Susquehanna University
 Don Schwartz
National University
 Richard Scott
University of Virginia
 Richard Sherman
St. Joseph's University
 Ray Slager
Calvin College
 Amy Spielbauer
St. Norbert College
 Charles Stanley
Baylor University
 Catherine Staples
Virginia Commonwealth University
 Anita Stellenwerf
Ramapo College
 Stephen Strange
Indiana University at Kokomo
 Linda Sugarman
University of Akron
 Kathy Sullivan
George Washington University
 Jeanie Sumner
Pacific Lutheran University
 Judy Swingen
Rochester Institute of Technology
 Tim Tancy
University of Notre Dame
 Bente Villadsen
Washington University

Alan K. Vogel
Cuyahoga Community College–Western
 Vicki Vorell
Cuyahoga Community College–Western
 Phil Walter
Bellevue Community College
 Ann Watkins
Louisiana State University
 Judy Wenzel
Gustavus Adolphus College
 Charles Werner
Loyola University Chicago

Michael Werner
University of Miami
 Paul Wertheim
Pepperdine University
 Shari Wescott
Houston Baptist University
 T. Sterling Wetzel
Oklahoma State University
 Steven D. White
Western Kentucky University
 Samuel Wild
Loyola Marymount University

Jack Wilkerson
Wake Forest University
 Lyle Wimmergren
Worcester Polytechnic Institute
 Carol Wolk
University of Tennessee
 Steve Wong
San Jose City College
 Robert Zahary
California State University at Los Angeles
 Thomas L. Zeller
Loyola University Chicago

Survey Respondents for the Second Edition:

Ray Bainbridge
Lehigh University
 Dorcas Berg
Wingate University
 Bruce Bolick
University of Mary Hardin Baylor
 Frank Bouchlers
North Carolina State University
 Thomas Brady
University of Dayton
 Bob Brill
St. Bonaventure University
 Sarah Brown
University of North Alabama
 David Brunn
Carthage College
 Gary Bulmash
American University
 Brian Burks
Harding University
 Judith Cadle
Tarleton State University
 John E. Coleman
University of Massachusetts at Boston
 Carrie Cristea
Augustana College, South Dakota
 Fred Current
Furman University
 Jim Davis
Clemson University
 Les Dlabay
Lake Forest College
 Patricia Douglas
Loyola Marymount University
 Joan Friedman
Illinois Wesleyan University
 Sharon Garvin
Wayne State College
 Art Goldman
University of Kentucky
 Bud Granger
Mankato State University
 Jack Grinnell
University of Vermont
 Al Hannan
College of Notre Dame
 Suzanne Hartley
Franklin University

Donna Hetzel
Western Michigan University
 Nathan Hindi
Shippensburg University of Pennsylvania
 Betty Horn
Southern Connecticut State University
 Fred Ihrke
Winona State University
 Patricia Johnson
Canisius College
 Becky Jones
Baylor University
 Don Kellogg
Rock Valley College
 Rita Kiugery
University of Delaware
 Paul Kleichman
University of Richmond
 George Klersey
Birmingham Southern College
 Lynn Koshiyama
University of Alaska
 Bobby Kuhlmann
Chaffey College
 James Kurtenbach
Iowa State University
 Jay LaGregs
Tyler Junior College
 Laurie Larson
Valencia Community College
 Chao Liu
Tarleton State University
 Gina Lord
Santa Rosa Junior College
 George Macklin
Susquehanna University
 Jim Martin
University of Montevallo
 Laurie McWhorter
University of Kentucky
 Paul Mihalek
University of Hartford
 Charles Milliner
Glendale Community College
 Marcia Niles
University of Idaho
 Mary Ellen O'Grady
Ramapo College

Bruce Oliver
Rochester Institute of Technology
 Paul Parkison
Ball State University
 Victor Pastena
SUNY Buffalo
 Charles A. Pauley
Gannon University
 Chris Pew
Galivan College
 Al Rainford
Greenfield Community College
 Keith Richardson
Indiana State University
 Joseph Rue
Syracuse University
 Rick Samuelson
San Diego State University
 Gail Sanderson
Lebanon Valley College
 Richard Sathe
University of St. Thomas
 Ron Singer
University of Wisconsin–Parkside
 David Smith
Metropolitan State University
 David Smith
University of Dayton
 Kim Sorenson
Eastern Oregon State University
 Jens Stephan
University of Cincinnati
 David Struheck
Indiana University NW
 Larry Tartaligno
Cabrillo College
 Dewey Ward
Michigan State University
 Jennifer Wells
University of San Francisco
 Paul Wertheim
Pepperdine University
 Jill Whitley
Sioux Falls College
 Jane Wiese
Valencia Community College
 David Willis
Illinois Wesleyan University

Reviewers and Focus Group Participants for the Second Edition:

Angela Bell
Jacksonville University
 Bryan Burks
Harding University
 Judith Cook
Grossmont Community College
 Rosalind Cranor
Virginia Polytechnic Institute
 Les Dlabay
Lake Forest College
 Jaime Doran
Muhlenberg College
 Alan Doyle
Pima Community College East
 Alan Drebin
Northwestern University
 Dean Edmiston
Emporia State University
 Leo Gabriel
Bethel College
 Lorraine Glasscock
University of North Alabama
 Bonnie Hairrell
Birmingham Southern
 Sharon Jackson
Auburn University, Montgomery
 Stanley Jenne
University of Montana

Mary Keim
California State University–Bakersfield
 Anne Marie Keinath
Indiana University Northwest
 Robert Kelly
Corning Community College
 Charles Konkol
University of Wisconsin–Milwaukee
 Frank Korman
Mountain View College
 James Kurtenbach
Iowa State University
 Tom Lee
Winona State University
 Alan Lord
Bowling Green State University
 Bruce Lubich
American University
 Jim Martin
University of Montevallo
 Daniel O'Mara
Quinnipiac College
 John Osborn
California State University–Fresno
 Prakash Pai
Kent State University
 John Rhode
University of San Francisco

Marilyn Sagrillo
University of Wisconsin–Green Bay
 Karen Sedatole
Stephen F. Austin
 John Sherman
University of Texas, Dallas
 Richard Silkoff
Quinnipiac College
 Jill Smith
Idaho State University
 Donna Street
James Madison University
 Martha Turner
Bowling Green State University
 Karen Walton
John Carroll University
 Dewey Ward
Michigan State University
 Michael Welker
Drexel University
 Jane Wells
University of Kentucky
 Betty Wolterman
St. John's University, MN
 Steven Wong
San Jose City College
 Gail Wright
Bryant College

We wish to thank Donna Street (James Madison University) for her suggestions leading to the inclusion of international accounting issues. Jeannie Folk (College of DuPage) and Donna Hetzel (Western Michigan University) provided invaluable help in revising end-of-chapter problem material and the Solutions Manual. We also wish to thank Sylvia Ong (Paradise Valley Community College), Les Dlabay (Lake Forest College), Stuart Weiss, and Karen Hill for their help in revising the features in the text.

The following supplement reviewers have aided us in the development of the package: Sarah Brown (University of North Alabama), Jennifer Wells (University of San Francisco), Laurie Larson, (Valencia Community College), Richard Silkoff (Quinnipiac College), Mary Houser (Western Michigan University) Steven Wong (San Jose City College), Suzanne Hartley (Franklin University).

We wish to thank O'Donnell and Associates, in particular Carrie O'Donnell and Karen Mislser, for their many efforts in this project, its research, and its supplements. We also wish to thank Michael Mueller, our webmaster, as well as Archipelago Productions, for their initiatives on the book's Web site.

We are grateful to the editorial, marketing, and production team at The Dryden Press for their invaluable efforts: Mike Reynolds, Sara Tenney, Craig Avery, Laura Hayes, Craig Johnson, Jennifer Langer, Jim Patterson, Lois West, Jeanette Barber, and Annette Coolidge.

**Gary A. Porter
 Curtis L. Norton**

BRIEF CONTENTS

Preface ix

PART I The Accounting Model 1

- Chapter 1** Accounting as a Form of Communication 2
- Chapter 2** Financial Statements and the Annual Report 52
- Chapter 3** Processing Accounting Information 102
- Chapter 4** Income Measurement and Accrual Accounting 146
- Appendix 4A** Accounting Tools: Work Sheets and Reversing Entries 175

PART II Accounting for Assets 215

- Chapter 5** Merchandise Accounting and Internal Control 216
- Appendix 5A** Accounting Tools: Internal Control for a Merchandising Company 236
- Chapter 6** Inventories and Cost of Goods Sold 262
- Appendix 6A** Accounting Tools: Inventory Costing Methods with the Use of a Perpetual Inventory System 287
- Chapter 7** Cash and Receivables 312
- Chapter 8** Operating Assets: Property, Plant, and Equipment, Natural Resources, and Intangibles 360

PART III Accounting for Liabilities and Owners' Equity 405

- Chapter 9** Current Liabilities, Contingent Liabilities, and the Time Value of Money 406
- Appendix 9A** Accounting Tools: Payroll Accounting 436
- Chapter 10** Long-Term Liabilities 462
- Chapter 11** Stockholders' Equity 508
- Appendix 11A** Accounting Tools: Unincorporated Businesses 532
- Chapter 12** Analysis of Retained Earnings and Stockholders' Equity 558

PART IV Additional Topics in Financial Reporting 601

- Chapter 13** Additional Reporting Issues: Intercompany Investments and Foreign Currency 602
- Chapter 14** The Statement of Cash Flows 664
- Appendix 14A** Accounting Tools: A Work-Sheet Approach to the Statement of Cash Flows 700
- Chapter 15** Financial Statement Analysis 732

Appendix: Financial Statements for Ben & Jerry's Homemade, Inc. A-1

Index of "From Concept to Practice" Assignments B-1

Glossary G-1

Photo Credits C-1

Company Index I-1

Subject Index I-3

CONTENTS

Preface ix

PART I The Accounting Model 1

Chapter 1 Accounting as a Form of Communication 2

Focus on Financial Results: Ben & Jerry's Homemade Inc. 2

Ben & Jerry's: The Need to Make Financial Decisions 4

Forms of Organization 5

Business Entities 6

Nonbusiness Entities 6

Organizations and Social Responsibility 7

The Nature of Business Activity 8

Financing Activities 8

Investing Activities 8

Operating Activities 9

What Is Accounting? 9

Users of Accounting Information and Their Needs 10

Internal Users 10

External Users 10

Financial Statements: How Accountants Communicate 11

The Accounting Equation and the Balance Sheet 12

The Income Statement 12

The Statement of Retained Earnings 14

Accounting for Your Decisions: You Are a Potential Stockholder 14

The Statement of Cash Flows 19

Accounting for Your Decisions: You Are the Banker 19

Relationships among Ben & Jerry's Financial Statements 20

The Conceptual Framework: Foundation for Financial Statements 21

Accounting for Your Decisions: You Are the Supplier 22

Accounting as a Social Science 22

Who Determines the Rules of the Game? 22

The Accounting Profession 23

Employment by Private Business 23

Employment by Nonbusiness Entities 24

Employment in Public Accounting 24

Accountants in Education 25

Accounting as a Career 26

Accounting for Your Decisions: You Are a Student 27

Accountants and Ethical Judgments 27

Focus on Users: Using Financial Data to Make Career Decisions 28

A Final Note about Ben & Jerry's 29



Ben & Jerry's Homemade Inc., like all companies in this book, uses its annual report to communicate the year's financial performance.

Each chapter contains the following material:

Review Problem, Solution to Review Problem, Chapter Highlights, Key Terms Quiz, Alternate Terms, Questions, Exercises, Problems, Alternate Problems, Cases, Solutions to Key Terms Quiz



Starbucks Corporation has an ambitious growth plan, and by reading and understanding its financial statements, users can see how that growth can be sustained in the future.



Ride Inc. had multimillion-dollar sales in snowboard equipment in its first year, and spectacular growth by year 3—due in part to the strength of an accounting system that lets its managers make smart decisions based on accurate and timely information.

Chapter 2 Financial Statements and the Annual Report 52

Focus on Financial Results: Starbucks Corporation 52

Objectives of Financial Reporting 54

- The Primary Objective: Provide Information for Decision Making 54
- Secondary Objective: Reflect Prospective Cash Receipts to Investors and Creditors 54
- Secondary Objective: Reflect Prospective Cash Flows to the Enterprise 55
- Secondary Objective: Reflect Resources and Claims to Resources 55

What Makes Accounting Information Useful? Qualitative Characteristics 55

Understandability 56

Accounting for Your Decisions: You Are the Stockholder 56

- Relevance 56
- Reliability 57
- Comparability and Consistency 57
- Materiality 58
- Conservatism 59

Financial Reporting: An International Perspective 59

The Classified Balance Sheet 60

What Are the Parts of the Balance Sheet? Understanding the Operating Cycle 60

Current Assets 61

Noncurrent Assets 61

Accounting for Your Decisions: You Are a Student 62

- Current Liabilities 62
- Long-Term Liabilities 63
- Stockholders' Equity 63

Using a Classified Balance Sheet 63

- Working Capital 63
- Current Ratio 65
- Debt-to-Equity Ratio 65

The Balance Sheet for Starbucks Corporation 66

The Income Statement 68

- What Appears on the Income Statement? 68
- Format of the Income Statement 69
- Using a Multiple-Step Income Statement 71

The Income Statement for Starbucks Corporation 72

The Statements of Retained Earnings and Stockholders' Equity 72

The Statement of Cash Flows 74

The Cash Flow Statement for Dixon Sporting Goods 74

Other Elements of an Annual Report 75

- Report of Management and Report of Independent Auditors 75
- The Ethical Responsibility of Management and the Auditors 75
- Management Discussion and Analysis 76
- Notes to Consolidated Financial Statements 77

Accounting for Your Decisions: You Are the Customer 78

Summary of Selected Financial Data 78

Chapter 3 Processing Accounting Information 102

Focus on Financial Results: Ride Inc. 102

Economic Events—The Basis for Recording Transactions 104

- External and Internal Events 104
- The Role of Source Documents in Recording Transactions 104
- Analyzing the Effects of Transactions on the Accounting Equation 105
- Balance Sheet and Income Statement for the Health Club 108