



FUNDAMENTAL

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PRINCIPLES

TWELFTH EDITION

KERMIT D. LARSON

Fundamental Accounting Principles

Kermit D. Larson

The University of Texas at Austin

Twelfth Edition

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**Dedicated to Nancy,
and to Julie, Tim, and Cindy**

About the Author



Kermit D. Larson is the Arthur Andersen & Co. Alumni Professor of Accounting at The University of Texas at Austin, where he has been a member of the faculty since 1966. He served as chairman of the U.T. Department of Accounting from 1971 to 1975 and was Visiting Associate Professor at Tulane University in 1970. His scholarly articles have been published in a variety of journals such as *The Accounting Review*, *Journal of Accountancy*, and *Abacus*. He is the author of several books, including *Fundamental Accounting Principles* and *Financial Accounting*, and coauthor of *Advanced Accounting*, all published by Richard D. Irwin, Inc.

Professor Larson's professional activities range from service as chairman of the American Accounting Association's Committee on Concepts and Standards, vice president of the American Accounting Association, Southwest regional vice president of the AAA, and director of the AAA Doctoral Consortium, to member of the Constitutional Drafting Committee of the Federation of Schools of Accountancy and member of the Commission on Professional Accounting Education. He has served on the Accounting Accreditation Committee and on the Accounting Standards Committee of the AACSB and has been an expert witness on cases involving mergers, antitrust litigation, and expropriation of assets by foreign governments. Professor Larson has served on the Board of Directors and Executive Committee of Tekcon, Inc. and presently serves on the Strategic Planning Committee of the American Accounting Association and the National Accountant's Advisory Board of Safeguard Business Systems, Inc.

Preface

Fundamental Accounting Principles and its supplements provide a complete, fully integrated teaching and learning system for the first two-semester accounting course at the college and university level. The objectives of this course generally include: (1) developing a general understanding of financial reports and analyses that students will use in their personal affairs regardless of their fields of specialization, (2) providing a strong foundation for future courses in business and finance, and (3) initiating the course work that leads to a career in accounting. *Fundamental Accounting Principles* serves all of these objectives.

The central focus of *Fundamental Accounting Principles* is to explain the development of accounting information for the use of business managers and other parties who are interested in the financial affairs of a business. Underlying this focus is a primary goal of helping students interpret and use accounting information intelligently and effectively. The concepts and principles that govern accounting processes are explained and persistently emphasized so that students will be able to generalize and apply their knowledge to a variety of new situations.

The early chapters of *Fundamental Accounting Principles* use the single proprietorship to illustrate the accounting cycle. However, corporations are gradually introduced through the first four chapters in a manner that does not interrupt or confuse the discussion of the cycle. As a result, students gain a clear understanding of unincorporated entities and are also prepared for the corporate illustrations of Chapter 5. The assignment material for Chapter 5 is divided equally between corporate and proprietorship businesses so instructors can easily move to full reliance on corporate illustrations or defer an emphasis on corporations until the later chapters in the book.

Learning through Active Student Involvement

The educational philosophy behind the development of *Fundamental Accounting Principles* is that learning occurs most effectively when students are actively involved. Our objective is to have students use as much of their study time as possible in active behavior such as answering questions and solving problems. This means that the use of student time in passive, low-retention behavior such as reading must be held to a minimum. To accomplish this objective, the twelfth edition of *Fundamental Accounting Principles* reflects a concise yet conceptually thorough writing style and provides a rich source of assignment material that includes a wide range of questions, exercises, problems, and provocative problems. In addition, to encourage students to

hold a more active, participative mindset, the twelfth edition has been thoroughly rewritten in a more active voice.

Specific features and changes in the twelfth edition that contribute to this process of learning through active student involvement include the following:

New Introductions. Each part of the book and each chapter opens with a new introduction that invites personal involvement and generally describes the personal benefit that will result from studying the part or chapter.

Careful Integration of Concepts and Applications. Throughout the book, the definitions and explanations of important concepts and principles are presented in close proximity to illustrations and practical applications of those concepts and principles. As a result, students need not hold abstract concepts in limbo before they see how the concepts are applied.

New Diagrams. A variety of new illustrative diagrams are intended to maintain interest and to clarify or summarize the relationships between the concepts under discussion.

New Excerpts of Relevant News Articles. A carefully selected set of news articles has been excerpted from sources such as *The Wall Street Journal* and *Forbes* and included in the text under the common title "As a matter of fact." These items contribute to a higher level of student interest and show the contemporary importance of the material in the business world.

New Chapter Summaries. To help students review their understanding of the topical coverage, each chapter now contains a summary that is organized in terms of the learning objectives.

New Demonstration Problems in Each Chapter. Although the twelfth edition continues its tradition of presenting illustrative problems in close proximity to topical explanations, each chapter also concludes with a demonstration problem and solution. These present integrated examples of how the concepts in the chapter are applied in solving problems.

New Objective Review Questions in Each Chapter. Following each chapter's glossary, the twelfth edition includes a new section called Objective Review. This contains a series of multiple-choice questions related to the learning objectives. To minimize the tendency to look at the answers prior to making a definite choice, the answers are located in Appendix I at the end of the book.

Expanded Assignment Material. There are nearly 750 exercise and problem assignments in the twelfth edition. This expands even further the marked increase in assignment material introduced in the previous edition. All of the assignments have been newly revised, and an increased number are based on facts drawn from real-world companies. A large number have relatively short solution times that give students the positive incentive of quick feedback and frequent encouragement that results from successful completion.

Annotation of Selected Assignments. Brief annotations are provided for the exercises and problems so that students can move quickly to the active process of preparing their solutions.

Unannotated Provocative Problems. The role of the provocative problems is to challenge students with somewhat more complex situations in which they must take greater responsibility for analyzing the problems and structuring their solutions. To facilitate this, annotations are not provided and working papers are not specifically designed for these problems. Nevertheless, the revised working papers booklets now include a variety of extra forms that students can adapt to these problems. Provocative problems can help instructors challenge their best students and demonstrate to the entire class the contemporary relevance of the course.

New Comprehensive Review Problems. To support the integration of topics across several chapters and to provide structured review on a periodic basis, the text now includes four comprehensive assignment problems. They appear after Chapter 4, Chapter 6, Chapter 12, and Chapter 22.

Reorganized Coverage to Increase Flexibility

Several changes in the twelfth edition give the instructor greater flexibility in selecting and organizing topical coverage. For example, the discussions of stock investments, consolidated statements, and international operations have been moved to a separate chapter (Chapter 19). Also, the book now contains ten appendixes. Some of the topics in these appendixes represent expanded coverage and some represent reorganized coverage. Each of the topical appendixes is supported by separate learning objectives, assignment material, coverage in the *Study Guides*, and the examination bank.

- a. Appendix A (after Chapter 3) expands the discussion of adjusting entries to include a clearer treatment of items that are originally recorded in expense and revenue accounts.
- b. Appendix B (after Chapter 4) contains a discussion of reversing entries. This discussion now appears in a more appropriate location in the book and also permits optional coverage of these procedures.
- c. Appendix C (after Chapter 5) gives a thorough explanation of the adjusting entry approach to accounting for merchandise inventories.
- d. Appendix D (after Chapter 7) explains the use of vouchers in a manual accounting system.
- e. Appendix E contains a review of accounting principles and concise coverage of the FASB's conceptual framework. The appendix is located between Chapters 14 and 15 so that it serves as an excellent close to the first half of the book (or opening to the second semester).
- f. Appendix F (after Chapter 18) explains the indirect method of calculating the cash provided (or used) by operating activities.
- g. Appendix G (at the end of the book) supplements the present value discussion in Chapter 10 with an expanded analysis of present and future values.

- h. Given the recent FASB action to make the disclosures on the effect of price changes voluntary, this topic was moved from Chapter 15 to Appendix H.
- i. Appendix I contains the answers to all of the multiple-choice, Objective Review questions in the book. These answers are placed at the end of the book rather than in the chapters so students will avoid the natural tendency to look for the correct answer before making a personal choice.
- j. Appendix J contains all of the financial disclosures that appear in the 1988 annual report of Tyler Corporation.

Other Important Changes that Affect Several Chapters

In addition to the above changes, many specific improvements in the twelfth edition affect several chapters. Some of these are itemized below:

A New Emphasis on Ethics in Accounting. The twelfth edition begins with a new prologue on the importance of ethics in accounting. Thereafter, many chapters include brief cases under the common title "As a Matter of Ethics." These cases are intended to encourage student reflection on the ethical issues confronted by accountants and others who use accounting information. The *Instructor's Resource Manual* includes helpful points for discussion related to each ethical case and copies of the ethical codes adopted by the AICPA and the NAA. Some instructors may use these materials in support of class discussions; others may simply post them or distribute them for student use.

Additional Questions. Approximately 90 additional questions for class discussion address the conceptual issues explained in the text. Approximately 425 questions are now provided.

Expanded Glossaries with Page References. The glossaries now include well over 400 important terms with concise definitions that focus on the conceptual essence of the terms. Where appropriate, the definitions are consistent with the FASB's conceptual framework. Each term in the glossaries is referenced to the pages in the chapter where the term is discussed. The glossaries are located at the end of each chapter so they can be used effectively when students are reviewing the chapter. However, each glossary term is also highlighted in color in the index to the book.

Integrated Learning Objectives. Many of the learning objectives that appear at the beginning of each chapter have been rewritten. To support instructional approaches that focus on learning objectives, the twelfth edition integrates these objectives throughout the text and supporting materials. In the text, they are presented in the margins next to relevant topical coverage and next to related problem assignments. The test bank identifies the learning objectives related to each question and provides for random question selection based on learning objectives.

New Accounting Cycle Illustration with Improved Teaching Features. A new illustration, Jerry Dow, Attorney, is used throughout Chapters 1–4. This new illus-

tration contains several improvements that make the book more teachable and easier to understand. For example, all of the financial statements introduced in Chapter 1 (including the statement of cash flows) are drawn from this illustration. Also, Chapter 3 presents the unadjusted trial balance, the adjustments, and the adjusted trial balance in a manner that better prepares students for the Chapter 4 discussion of the work sheet. And in Chapter 4, a series of overlay transparencies are used to show much more clearly the process of developing a work sheet. Throughout these chapters, special care has been taken to ensure that problem requirements never precede a thorough explanation of the issues.

Descriptive Titles of Illustrations. Many new illustrations have been added to the text. Also, descriptive titles have been given to the illustrations whenever this adds clarity.

New Treatment of Dividends. Dividends are now recorded in a Dividends Declared account to make the corporate procedures parallel to the withdrawals accounts used in unincorporated businesses.

New Real-World Examples. All of the exercises, problems, and provocative problems have been revised, and the real-world examples and problems were newly selected for the twelfth edition. These have been drawn primarily from the published financial reports of corporations such as American Can Company, Bell & Howell Company, Caterpillar Inc., Chrysler Corporation, The Clorox Company, Dycom Industries Inc., H. J. Heinz Company, W. R. Grace & Co., Textron Inc., and Tyler Corporation.

Problem Assignments Solvable with New Computer Packages. A large number of the exercises, problems, provocative problems, and three of the comprehensive problems in the text can be solved using newly developed software packages that accompany the text. Those that can be solved using *General Ledger Applications Software (GLAS)* are identified in the margin with the



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

Many additional exercises, problems, and provocative problems can be solved using *Spreadsheet Applications Template Software (SPATS)* developed by Will Garland of Coastal Carolina College. *SPATS* contains innovatively designed templates based on Lotus® 1-2-3® and includes a very effective tutorial for Lotus® 1-2-3®. The exercises and problems solvable with *SPATS* are identified in the margin of the text with the following symbol.



Expanded Use of Color to Enhance Learning. The use of color in the twelfth edition has been carefully designed to support and encourage student learning. Financial reports that are the output of the accounting process are identified by their blue background. A bold blue is used to emphasize key terms, titles of statements, and items of special importance in illustrations. Textual headings require a “hot”, bold color to draw attention. These are printed in red, which also is used to emphasize alternative points of special importance in illustrations. A noninterruptive, cream color softly highlights the end-of-chapter material where student involvement in the learning process is greatest. Cream also serves as a background for illustrations.

Improvements in Specific Chapters

Most of the chapters in this edition reflect specific improvements in addition to those described above. These include the following:

- Chapter 1 contains expanded coverage of the institutional environment of financial reporting and its relationship to standards setting. Also, more attention is given to professional certifications in accounting.
- Chapter 3 reflects an improved conceptual discussion of the realization and matching principles and of accrual versus cash basis accounting.
- Overlay transparencies are used in the work sheet illustrations of Chapter 4 to present more effectively the sequence of steps in the preparation of a work sheet.
- New illustrations in Chapter 7 highlight the principles of internal control and diagram the flow of business papers related to purchases when a voucher system is used. The concept of asset liquidity is also explained in this chapter.
- A new discussion of short-term investments and lower of cost or market is provided in Chapter 8.
- The discussion in Chapter 10 has been reorganized to clarify the concept of cost recovery through depreciation and to place less emphasis on accelerated depreciation methods. Also, the discussion of the Modified Accelerated Cost Recovery System has been updated.
- The tax method of accounting for asset exchanges is more precisely explained in Chapter 11.
- In Chapter 12, the criteria for classifying leases as capital or operating leases are more clearly explained.
- Chapter 15 includes a new discussion and illustration of corporate management structures. Also, a reorganized discussion of preferred stock places less emphasis on participating stock and better illustrates dividends to cumulative stock.
- The material on reporting income and retained earnings items is now presented in Chapter 16, as is the explanation of earnings per share. This reorganization provides a more logically connected set of topics in this chapter and makes room for the separate chapter on stock investments, consolidations, and international operations (Chapter 19). Chapter 16 also introduces the now widely used statement of changes in stockholders' equity.

- The statement of cash flows is explained in Chapter 18. The direct approach (recommended by the FASB) is explained in the chapter and the indirect approach is explained in an appendix. Both the T-account and working paper approaches to preparing the statement are explained.
- The discussion of financial statement ratios in Chapter 20 has been reorganized, and includes new coverage of profit margin, total asset turnover, and their relationship to return on total assets. The calculations of all ratios are reviewed at the end of the chapter.
- Several new diagrams are used in Chapter 21 to support improved explanations of product costs versus period costs, the flow of product costs in manufacturing companies, and the relationship between overhead items, the manufacturing statement, and the income statement.
- Chapter 22 contains an improved explanation of over- or underapplied overhead and new diagrams that show the flow of materials in job order manufacturing processes and in process manufacturing operations.
- The revised discussion in Chapter 23 better reflects the use of computers in accounting and provides clearer explanations of controllable versus uncontrollable costs and the financial statement effects of joint cost allocations.
- Just-in-time inventory systems are now explained in Chapter 25, which also reflects a reorganized discussion of the benefits from budgeting.
- The discussion of variances in Chapter 26 has been revised to include algebraic or formula approaches to explaining variances, a better discussion of overhead variances, and a new diagram that clearly shows the cause of a volume variance. The new chapter also includes more complete illustrations of the entries to record standard costs in the accounts.
- Chapter 28 now includes a surprisingly clear introduction to the most important concepts embodied in *SFAS 96*, the FASB's new accounting requirement for income taxes. The revision also reflects all relevant changes in the federal income tax laws.

Supplements to the Text

For the Instructor

The support package for *Fundamental Accounting Principles* includes many items to assist the instructor. The instructor's support items are:

- The *Instructor's Integrated Teaching System*, which includes the entire 28-chapter text in a three-ring binder. This system allows the instructor to prepare class presentations that combine text, teaching transparencies, solutions transparencies, and relevant material from the *Instructor's Resource Manual* in a self-contained binder.
- Two *Solutions Manuals* that have more extensive supporting calculations in this edition.
- *Solution Transparencies* that include all exercises and all problems. These transparencies are now printed in boldface in a new, exception-

ally large typeface so that visibility from a distance is strikingly improved.

- An expanded set of *Teaching Transparencies*, many of which are now in color.
- *Computerized Teaching Transparencies* that are designed to support teaching the course using a computer, data display, and an overhead projector.
- *Video tapes* that are available upon adoption. The tapes reinforce important topics and procedures. They may be used in the classroom or media lab.
- *Spreadsheet Applications Template Software (SPATS)*, a new software package developed for use with the text by Will Garland of Coastal Carolina College. SPATS includes a Lotus® 1-2-3® tutorial and innovatively designed templates that may be used with Lotus® 1-2-3® to solve many of the exercises and problems in the text. Upon adoption, this package is available to instructors for classroom or laboratory use.
- *Peachtree® Complete III™*. The leading business accounting software is available for site license. The General Store, Inc. and World of Sports practice sets are available with templates that permit their use with Peachtree® Complete III™.
- *Computerized Tutorials for Chapters 1–14 and Chapters 15–28*, by Leland Mansuetti. These software packages include true/false and multiple-choice questions with explanations for both correct and incorrect answers by students. Upon adoption, these computerized tutorials are available to instructors for classroom or laboratory use.
- A dramatically expanded test bank to accompany the twelfth edition. The new bank includes a much greater variety of multiple-choice and true/false questions. In addition, the new bank contains at least 100% more exercise-type problems. The printed *Examination Materials I and II* booklets now contain a complete copy of the computer test bank plus the solutions to the achievement tests.
- *Computest III*, an improved test generator program that allows editing of questions, provides up to 99 different versions of each test, and allows question selection based on type of question, level of difficulty, or learning objectives.
- *Teletest*, which is a system for obtaining laser-printed tests by telephoning the publisher and specifying the questions to be drawn from the test bank.
- *Achievement Tests, Series A, B, and C*. These examinations come in packages of 30 copies each and are free to adopters. Each series is made up of five examinations plus one final examination for Chapters 1–14 and five examinations plus one final examination for Chapters 15–28.
- *The Instructor's Resource Manual* includes sample course syllabi, suggested homework assignments, a series of lecture outlines, demonstration problems, suggested points for emphasis, and background materials for discussions of ethics in accounting.

For the Student

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

- The *Student Integrated Learning System—Chapters 1–14* (Volume I) and *Chapters 14–28* (Volume II). This option allows students to purchase either Chapters 1–14 or Chapters 14–28 of the text with the related working papers and study guides in a 3-ring binder. Students benefit by having all three course-related items in a single package and by obtaining a significant cost savings. The text is also available in the conventional 28-chapter hardcover format.
- *Working Papers, Chapters 1–14* and *Chapters 14–28*. These include working papers for the problems, alternate problems, and comprehensive problems, with additional forms that may be adapted for the exercises and provocative problems. To support flexibility of course design, both volumes include working papers for Chapter 14.
- *Study Guides, Chapters 1–14* and *Chapters 14–28*. These volumes, which provide a basis for independent study and review, have been expanded to include multiple-choice and true/false questions as well as several additional problems with solutions for each chapter and appendix. Coverage of Chapter 14 and Appendix E is reproduced in both volumes.
- *Class Notes*, for use with the computerized teaching transparencies. These are designed to help students be actively involved and take effective notes when the computerized transparencies are used to teach the course.
- *Check Figures* for the problems and alternate problems.
- *World of Sports*, a manual, single proprietorship practice set with business papers that may be assigned after Chapter 6.
- *The General Store, Inc.*, a manual practice set that may be assigned after Chapter 8.
- *Freewheel Corporation*, a manual practice set by Christie Johnson that may be assigned after Chapter 20.
- *NewTech Incorporated*, a manual practice set with a narrative of transactions for a manufacturing corporation. This may be assigned after Chapter 21.
- *Kellogg Business Systems, Inc.*, an extended corporate practice set that may be assigned after Chapter 20. Like the other computerized items for students, it can be ordered on either 5¼ or 3½ inch disks.
- *General Ledger Applications Software (GLAS)*, newly developed software that can be used with the text to solve a large number of the exercises, problems, and three of the comprehensive problems. This software can also be used to solve the first two manual practice sets. *GLAS* may be ordered with the textbook, or with the *Student Integrated Learning System*, or as a separate item.

- *ESP—Electronic Spreadsheet Program*, a computerized spreadsheet package by John Wanlass and Kermit Larson that can be used to solve many of the problems in the text and is also broad enough to be used in a separate computer accounting course.

Several items listed earlier under the heading “For the Instructor” are intended for student use at the option of the instructor. They include:

- *Spreadsheet Applications Template Software (SPATS)*.
- *Peachtree® Complete III™*.
- *Computerized Tutorials for Chapters 1–14*.
- *Computerized Tutorials for Chapters 15–28*.

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