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FUNDAMENTALS OF FINANCIAL ACCOUNTING

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WELSCH AND SHORT

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FIFTH EDITION

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# FUNDAMENTALS OF FINANCIAL ACCOUNTING

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Daniel G. Short  
both of the  
College of Business Administration  
The University of Texas at Austin

Fifth Edition  
1987

**IRWIN**

Homewood, Illinois 60430

To  
*Irma, Maryrose,  
Jenni, and Heather*

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# PREFACE

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The fifth edition of this textbook retains all of the features that the numerous faculty who have used the prior editions have regarded favorably. It has been substantially updated to reflect changes in business practice, accounting rules, and the economy. Most chapters have been revised to make them more understandable and interesting to read. This revision reflects both continuity and change.

## TO STUDENTS:

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*Fundamentals of Financial Accounting*, 5th edition, is an introduction to the communication of relevant financial information to investors, creditors, analysts, and other individuals. This book is designed to meet the needs of students who plan to major in accounting as well as those who do not. If you understand the material in *Fundamentals of Financial Accounting*, it will be much easier for you to be successful in subsequent courses. Nonaccounting majors will benefit from their study of this book because they must understand the language of business as well as the uses and limitations of accounting information. Senior business executives often state that they need a better understanding of accounting. Careful study of this text will prepare you for the future. This book is able to meet the needs of both accounting and nonaccounting majors because of its emphasis on concepts. An understanding of the technical aspects of accounting is important for subsequent accounting courses and for the analysis of financial information. The text gives a sound introduction to accounting practice. And with a continuing emphasis on concepts, it clarifies the "why" of each practice. Our discussion of this conceptual framework ties together topics that might otherwise seem unrelated. Also, you will be able to generalize your knowledge and, for example, see similarities between accounting for inventory and property, plant and equipment. Your understanding of these concepts will (1) aid in your study of accounting, (2) permit you to adapt to changes in accounting practice, and (3) help you to appreciate the uses and limitations of accounting information.

This text contains many special features designed to help both the student and the instructor.

## **SPECIAL FEATURES FOR STUDENTS**

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There is a complete package of study aids to help you. Each study aid was prepared by the authors of the text to ensure consistency in terminology, approach, and quality. These aids are:

1. A Study Guide that includes chapter outlines, additional illustrations, and sample exam questions with detailed solutions.
2. Working Papers that include all forms needed for solving homework assignments. The forms contain captions and information that you would otherwise have to copy from the text.
3. A Practice Set that covers the complete information processing cycle. It can be used anytime after Chapter 5 and concluded anytime after Chapter 11.

Each chapter begins with a special introduction that gives you a complete overview of the topics to be covered. The introduction includes a brief statement of purpose and explains how the chapter relates to prior discussions. The introduction also includes broad learning objectives to provide a “road map” for your study of the chapter. Each introduction provides a financial reporting perspective that relates the topics in the chapter to actual financial statements.

Accounting has its own technical language and jargon. The book will help you learn these new words by providing both a comprehensive index and, at the end of each chapter, a list of “important terms used in this chapter”. This list includes the key words, the definition of the word, and the page reference that tells you where the word was first introduced.

A unique format is used in many of the exhibits. To facilitate your study, these exhibits give the illustrative data, analysis, and accounting entries and reporting on a single page.

Each exercise, problem, and case begins with a brief statement of the purpose of the assignment. You will get much more out of homework assignments when you understand your role more clearly.

An actual set of financial statements is included in Special Supplement B (immediately preceding the Index) to help you learn how various accounting issues are handled by a typical company.

The discussions in each chapter have been carefully integrated with other chapters. When we refer to a topic from a prior chapter, a reference is provided to help you locate and review the prior discussion.

## **TO INSTRUCTORS:**

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This textbook is designed to give you maximum flexibility in selecting topics and scheduling. Discussions with a large number of accounting educators have convinced us that there is no single “best” way to teach accounting. We selected topics for this text and organized them in a sound and logical way but we have given you the flexibility to easily include or exclude topics and to rearrange the

organization. Adopters have told us that this text permits them to custom design their courses based on the preferences and needs of their students.

## **SPECIAL FEATURES FOR INSTRUCTORS**

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Several teaching aids are available for instructors:

1. A Comprehensive Teachers Manual that includes answers (with detailed computations) to all questions, exercises, problems, and cases. It also includes suggested course plans, assignment schedules, and instructional ideas.
2. A list of Check Figures for exercises, problems, and cases. This aid is available in quantity for free distribution to students.
3. An extensive Bank of Examination Questions coordinated by chapter and coded by topic, type of question, and level of difficulty. Computest, a computerized test-generating system, is also available.
4. Teaching Transparencies to assist in the preparation and delivery of lectures.
5. A Practice Set that is a complete integrated problem covering the entire information processing cycle. The Practice Set can be introduced after Chapter 5 and concluded anytime after Chapter 11. The section on the Statement of Changes in Financial Position can be completed after Chapter 15.

Most chapters are divided into two parts, an arrangement that permits the instructor to give balanced reading assignments. Also, it provides complete flexibility in selecting topic coverage. With this arrangement each instructor can easily emphasize or eliminate selected topics.

This book includes 17 supplements that discuss either procedural or advanced topics. It is unlikely that any instructor would assign all 17 chapters and 17 supplements. Instead, one objective of the textbook is to provide maximum flexibility in topic selection and to have sufficient additional material available to permit changes based on the objectives of the course.

A brief statement of objectives is given at the start of each exercise, problem, and case. These statements are designed to assist the student, but they can also help the instructor select appropriate assignment material.

This book has an unusually large number of homework assignments. Instructors are able to vary assignments from semester to semester. In addition each chapter contains assignments that have different levels of difficulty. Exercises tend to be applications of a single concept discussed in the chapter; problems are more difficult and may require an understanding of several concepts; cases typically require analysis and judgment. All end-of-chapter material is keyed either to a chapter part or supplement.

Each chapter gives a case based on the Chesebrough-Pond's financial statements included in the book. These cases provide an excellent overview of current accounting practice.

The book places an important emphasis on understanding accounting terminology. Each chapter has at least one exercise on terminology that can be assigned to assess student understanding.

Many faculty members and students have commented that this book is unusually easy to read and understand. We have achieved that objective through careful writing and selection of illustrations. Clarity has not been attained by ignoring or “sliding over” difficult topics. The book discusses a number of advanced topics that are ignored in many other fundamentals textbooks. For example, we include discussions of purchases versus pooling, comprehensive inflation adjustments, and both present and future value concepts. These special topics are organized to facilitate inclusion or exclusion based on the objectives of the instructor.

The list of students and faculty members to whom the authors feel a sense of gratitude for ideas and suggestions is too long to enumerate here. For the 5th edition, we are particularly grateful to the following individuals who devoted considerable time in discussions, reviewing parts of the manuscript, and testing materials:

The following students at The University of Texas at Austin: Vicky Conway, Annick Barton, Jody Daughtler, Melissa Gan, Erica Peters, and Lynette Broders. We recognize the valuable editorial suggestions provided by Petria Sandlin and Kathy Springer. We are especially grateful to Professors Janet Daniels, University of Hartford, Harry Dickinson, University of Virginia, Ralph Drtina, Lehigh University, Sandra and David Byrd, Southwest Missouri State University, Stuart Webster, Lehigh, and LaVern Krueger, University of Missouri, for their valuable suggestions.

Consultation with Kathy Springer was especially valuable in preparing the special supplement on income taxes.

Finally, we express our thanks to numerous users of the prior editions for their valuable suggestions.

Our thanks to the American Institute of Certified Public Accountants, American Accounting Association, Financial Accounting Standards Board, and the authors identified by citations for permission to quote from their publications. To Chesebrough-Pond’s, our special thanks for permission to use its annual reports.

Suggestions and comments on the text and the related materials are invited.

**Glenn A. Welsch**  
**Daniel G. Short**

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# **Fundamentals of Financial Accounting**



## CHAPTER 1 FINANCIAL REPORTING PERSPECTIVES

This chapter introduces financial statements as the means a business uses to communicate economic information to others. Below are selected summary financial data communicated by one large company on its final report. The magnitude of the numbers is interesting.



### Report of Management

The accompanying financial statements, which consolidate the accounts of American Telephone and Telegraph Company and its subsidiaries, have been prepared in conformity with generally accepted accounting principles.

### Summary Data from the 1985 Financial Statements (in millions):

#### Income Statement (Statement of Operations):

Revenues (during 1985) . . . . .	\$34,909.5
Expenses (during 1985) . . . . .	33,352.7
Income (during 1985) . . . . .	<u>\$ 1,556.8</u>

#### Balance Sheet (Statement of Financial Position):

Assets (at end of 1985) . . . . .	\$40,462.5
Liabilities (at end of 1985) . . . . .	24,372.1
Owners' equity (at end of 1985) . . . . .	<u>\$16,090.4</u>

#### Statement of Changes in Financial Position (Cash):

Beginning cash balance (January 1, 1985) . . . . .	\$2,139.9
Sources of cash during 1985 . . . . .	6,756.4
Uses of cash during 1985 . . . . .	(6,682.6)
Ending cash balance (December 31, 1985) . . . . .	<u>\$2,213.7</u>

\*Note: The primary purposes of these "Perspectives" are: (a) to emphasize an important issue discussed in the chapter and (b) to show you how a company resolves that issue.