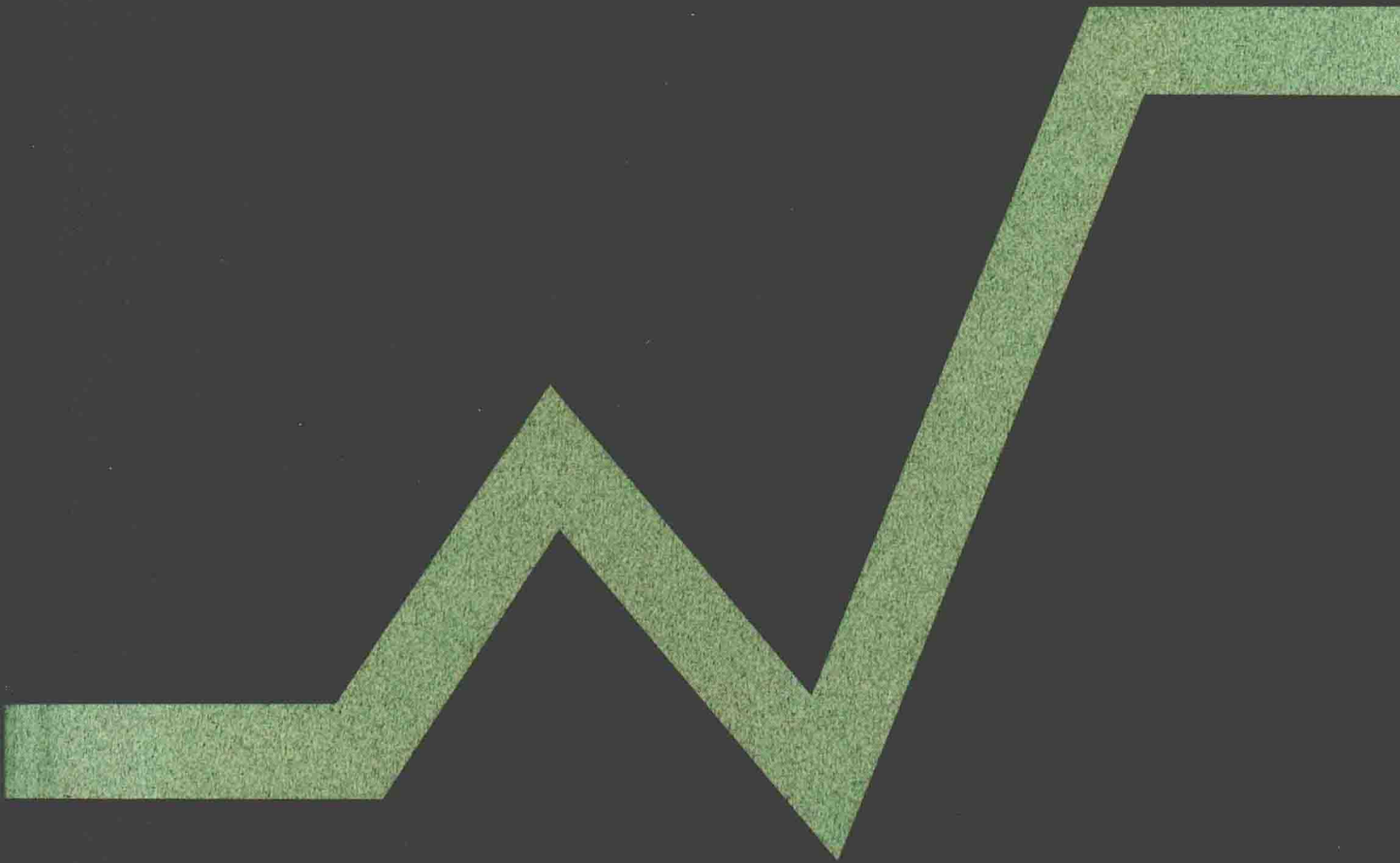


FOURTH EDITION

FINANCIAL ACCOUNTING

KERMIT D. LARSON



Financial Accounting

Kermit D. Larson

The University of Texas at Austin

1989 Fourth Edition

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

Preface

Financial Accounting and its supplements provide a complete textual package for the first accounting course at the college and university level. Students who enroll in this course have a variety of backgrounds and educational goals. For many students, the course is their first educational exposure to such business topics as alternative forms of business organization, typical business practices, financial statements, and legal instruments such as notes, bonds, and stocks. The objectives of the 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 coursework that leads to a career in accounting. *Financial Accounting* serves all of these objectives.

The central focus of *Financial Accounting* is to explain how financial information is accumulated and reported in periodic financial statements and to help students interpret and use accounting information intelligently and effectively. The concepts and principles that guide financial accounting 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 *Financial Accounting* 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 *Financial Accounting* is that learning occurs most effectively when students are actively involved. The goal is for students to 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 goal, the fourth edition of *Financial Accounting* 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, the fourth edition has been thoroughly rewritten to encourage students to hold a more active, participative mindset.

Specific features and changes in the fourth 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 items under discussion.

New Summaries. Each chapter now contains a summary that is written in parallel to the learning objectives. These summaries help students review their understanding of the chapter's topical coverage.

Expanded Assignment Material. There are approximately 500 exercise and problem assignments in the fourth edition—approximately 100 more than were in the third edition and 225 more than in the second edition. Some of the new assignments stimulate student interest with facts drawn from real world companies. Others are designed to challenge their conceptual understanding of the topics. A large number have relatively short solution times which 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 problem and structuring their solutions. To facilitate this, annotations are not provided and working papers are not specifically designed for these problems. Nevertheless, the working papers booklet includes 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.

Reorganized Coverage to Increase Flexibility

Several changes in the fourth 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 15). Also, the book now contains eight 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 Guide*, and a bank of examination questions.

- 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 14) explains the indirect method of calculating the cash provided (or used) by operating activities.
- e* The discussion of special journals has been extracted from the body of Chapters 6 and 7 and is now located in Appendix E at the end of the book. In addition to a large number of exercises to support this appendix, those who use the working papers may assign a minipractice set that appears at the end of this appendix.
- f* Appendix F (at the end of the book) supplements the present value discussion in Chapter 10 with an expanded analysis of present and future values.
- g* 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 G.
- h* Appendix H contains all of the financial disclosures that appear in the 1987 annual report of Tyler Corporation.

Other Important Changes That Affect Several Chapters

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

Additional Questions. Approximately 90 additional questions for class discussion address the conceptual issues explained in the text, which now contains approximately 425 questions.

Expanded Glossaries. There is a 12% increase in the number of glossary items. As a result, the glossaries now contain 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. The glossaries are located at the end of each chapter so that students can use them when reviewing the chapter. However, the terms also appear in the index to the book.

Integrated Learning Objectives. The learning objectives for each chapter are now integrated with the assignment and examination material to support instructional approaches that focus on learning objectives.

New Accounting Cycle Illustration. A new illustration, carried through Chapters 1–4, is designed to insure that problem requirements never precede a thorough explanation of the issues.

Descriptive Titles of Illustrations. Throughout the text, illustrations are given descriptive titles whenever this adds clarity.

New Treatment of Dividends. Dividends are now recorded in a Dividends Declared account to make corporate procedures parallel with 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 fourth 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.

Notation of Assignments Solvable with Computer Package. Selected problems from each chapter can be solved using ESP, the electronic spreadsheet software package that supports the text. Problems solvable in this manner are marked in the margin with the symbol □.

Improvements in Specific Chapters

Most of the chapters in the fourth 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.
- New illustrations in Chapter 6 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 discussed.
- A new discussion of short-term investments and lower of cost or market is provided in Chapter 7.
- The discussion of Chapter 9 has been reorganized to clarify the concept of cost recovery through depreciation and to place less emphasis on accelerated depreciation methods. The tax method of accounting for asset exchanges is more precisely explained, and the discussion of the Modified Accelerated Cost Recovery System has been updated.
- The classification of capital and operating leases in Chapter 10 and the distinction between accounting for short-term and long-term bond investments in Chapter 11 are more clearly presented.
- In Chapter 12, the discussion of partnership characteristics has been revised and includes an explanation of limited partnerships. There is 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 13, as is the explanation of earnings per share. This re-

organization provides a more logically connected set of topics in Chapter 13 and makes room for the separate chapter on stock investments, consolidations, and international operations (Chapter 15). Chapter 13 also introduces the now widely used statement of changes in stockholders' equity.

- The statement of cash flows is explained in Chapter 14. 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 16 has been reorganized, and includes new coverage of profit margin, total asset turnover and their relationship to return on total assets. The calculations for all ratios are reviewed at the end of the chapter.

Supplements to the Text

For the Instructor

The support package for *Financial Accounting* includes many items to assist the instructor. They include:

- A *Solutions Manual* with more extensive supporting calculations in this edition.
- Solution transparencies for all exercises (new for this edition) and all problems.
- An expanded set of Teaching Transparencies, many of which are now in color.
- A dramatically expanded computerized bank of examination materials, including a large variety of exercise-type problems as well as multiple-choice and true/false questions.
- A book of *Examination Materials*, which is now a complete printing of the computer test bank.
- 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 Richard D. Irwin, Inc., and specifying the questions to be drawn from the test bank.
- A new *Instructor's Lecture Guide* that includes sample course syllabi, suggested homework assignments, a series of lecture outlines, demonstration problems, and suggested points for emphasis.

For the Student

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

- *Working Papers* for the Problems and Alternate Problems, with additional forms that may be adapted for the Exercises and Provocative Problems.

- *Study Guide*, a book for independent study and review that has been expanded to include multiple-choice and true/false questions as well as several additional problems with solutions for each chapter and appendix.
- *Check Figures* for the Problems and Alternate Problems.
- *General Store, Inc.*, a manual practice set that may be assigned after Chapter 7 and Appendix E.
- *Hanalei Bay Wind and Surf II*, a computerized practice set by Sprenger, Weidkamp and Burns that may be assigned after Chapter 7.
- *dBug Computers, Inc. II*, an expanded computerized practice set by Sprenger, Weidkamp and Burns, that may be assigned after Chapter 9.
- *Freewheel Corporation*, a manual practice set by Christie Johnson that may be assigned after Chapter 14.
- *ESP—Electronic Spreadsheet Program*, a computerized spreadsheet package by John Wanlass and Kermit Larson, that provides introductions to this important accounting tool and that can be used to solve many of the problems in the text.
- *Examination Review and Study Guide*, by Sprenger, Weidkamp, and Burns, a computer program that includes glossary reviews, journalizing problems, multiple-choice exercises, and analysis of financial statements.

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Kermit D. Larson
Austin, Texas



Prologue

To the Student Reader

Ethics: The Most Fundamental Principle of Accounting

To the Student Reader

Financial Accounting is designed to help you be actively involved in the learning process. As you study accounting, you will find that you learn more quickly and more thoroughly when you are actively involved. This means that the more time you spend expressing what you are learning, primarily through answering questions and solving problems, the more effectively you will learn. We encourage you to express your ideas as you read the text. For example, the margins of this text have been left relatively open and uncluttered so you can write notes to yourself. Next to specific paragraphs, you may want to make a note of the specific learning objective that is being discussed. Also, you may write a summarizing phrase or a question that remains unanswered in your mind. While these notes may assist your later review of the material, the process of writing them will help you learn whether or not you use them in review.

Ethics: The Most Fundamental Principle of Accounting

“Each person capable of making moral decisions is responsible for making his own decisions. The ultimate locus of moral responsibility is in the individual.”¹

As college students, you no doubt realize that ethics and ethical behavior are important features of civilized society. Ethical considerations abound in daily life, both privately and professionally. The media often remind us of the importance of ethics to society. These reminders come in the form of news stories about such things as civil rights violations, fraudulent attempts to “rip off” the elderly, credit card scams, parents who failed to make child support payments, children who ignored or abused their elderly parents, politicians who failed to disclose past instances of misconduct, the alleged bribery of government officials, and Wall Street moguls who used “inside” information for personal gain.

The Meaning of Ethics

As a discipline of study, ethics deals “with what is good and bad or right and wrong or with moral duty and obligation.” In practice, ethics is “principles of conduct that govern an individual or a profession.”² Some unethical actions are unlawful. Other actions may be within the law, but, nevertheless, are widely recognized as being ethically wrong. In addition, some actions are not clearly right or wrong but are ethically questionable.

Many of the issues we face in school, in the work place, and beyond, have ethical dimensions; they are unavoidable aspects of life. How well we deal with ethical matters influences how we feel about ourselves, how we are perceived by others, and in the aggregate, the quality of our society. But why begin an accounting text with a prologue on ethics? How does ethics relate to business, and more specifically, to the discipline of accounting?

Ethics in Business

To answer the question of why we begin this text with a prologue on ethics, we must recognize that ethical standards in business and accounting are a matter of

¹Harold H. Titus and Morris Keeton, *Ethics for Today*. 4th ed. (New York: American Book-Stratford Press, 1966), p. 131

²*Webster's Third New International Dictionary of the English Language, Unabridged* (Springfield, Mass: G & C Merriam Co., 1971), p. 780.

public concern. In recent years, many people have expressed concern about deteriorating ethical standards in business. Touche Ross, an international public accounting firm, recently conducted an opinion survey on business ethics. The survey included over 1,100 business executives, deans of business schools, and members of Congress. Of those in the survey, 94 percent agree “the business community is troubled by ethical problems today.”³ Ironically, those surveyed also believe that companies that are successful over the long run seem to have high ethical standards. You may infer from this that “ethics is good business.” Ethical business practices can help create loyal customers and suppliers, trustworthy and productive employees, and a solid reputation.

Because of the widespread public interest in business ethics, many banks, insurance companies, and other businesses have recently revised or written new codes of ethics. Others are currently in the process of developing new codes of ethics. Companies generally use these codes as public statements of their commitment to ethical business practices and also as guides for employees to follow.

Ethics in Accounting

In accounting, many professional organizations such as the American Institute of Certified Public Accountants have had codes of ethics for many years. Most of these have been re-evaluated and revised in recent years. Ethics is important in accounting because accountants often are required to make decisions that have ethical implications. The activities performed by accountants have a profound impact on many individuals, businesses, and other institutions. An accountant’s decisions can affect such things as the amount of money a corporation distributes to its stockholders, the price a buyer pays for a business enterprise, the compensation levels of managers and executives, the success or failure of specific products and divisions, and the amount of local, state, and federal taxes paid by an individual or a business.

To see how an accountant’s decisions can have an ethical dimension, consider the following example. Assume that Smith and Jones agreed to be partners in a business venture that would last two years. Because the original idea for the business venture was Smith’s, they agreed that Smith would receive 75 percent of the first year’s profits and Jones would receive 25 percent. In the second year, however, their agreement was that Smith and Jones would split the profits evenly. At the end of the first year, their accountant discovers that there are two alternative methods for recording a recent transaction. If method A is used, a profit of \$100,000 will be recognized in Year 1. If method B is used, the profit of \$100,000 will not be recognized until Year 2. Clearly, the accountant’s decision about which method should be used will affect each partner’s compensation in Year 1, in Year 2, and in total. If method A is used, Smith will receive \$75,000 of the profit and Jones will receive \$25,000. But if method B is used, each partner will receive \$50,000.

In the above example, more information is needed to help the accountant choose between methods A and B. As an ethical matter, however, the accountant’s decision should not be influenced by the fact that method A is more favorable to Smith and method B is more favorable to Jones.

³Touche Ross & Co., *Ethics in American Business* (New York, 1988), pp. 1–2.

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