

Third Edition

ACCOUNTING

What the
Numbers
Mean

DAVID H. MARSHALL
WAYNE W. MCMANUS

U.S. Companies
and Companies of U.S. Firms
(in millions)

Cash, beginning of year
Operating activity
Plus: Increase
Minus:
Depreciation
Increase in accounts payable
Less:
Increase in accounts receivable
Increase in inventory
Net cash from operating activity
Investment activity
Fixed asset acquisitions
Net cash from investment activity
Financing activity
Decrease in notes payable
Decrease in long-term debt
Dividends paid
Increase in common stock
Net cash from financing activity
Net increase in cash
Cash, end of year

MISS MARGIN

Accounting

What the Numbers Mean

Third Edition

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Preface

The word *accounting* most often conjures up images of tedious figures, thick glasses, and headaches. However, the savvy businessperson realizes that accounting has come to be known as the *language of business* with good reason. Accounting conveys important financial information that is used in the management planning, control, and decision-making processes integral to achieving organizational objectives. Some command of this language is a necessity for those who wish to participate in these processes.

In 1989 the Accounting Education Change Commission was formed “to foster changes in the academic preparation of accountants consistent with the goal of improving their capabilities for successful professional careers.” In Position Statement No. Two, “The First Course in Accounting,” (June, 1992) the commission stated:

The primary objective of the first course in accounting is for students to learn about accounting as an information development and communication function that supports economic decision-making. The knowledge and skills provided by the first course in accounting should facilitate subsequent learning even if the student takes no additional academic work in accounting or directly related disciplines. For example, the course should help students perform financial analysis; derive information for personal or organizational decisions; and understand business, governmental, and other organizational entities.¹

We believe that this text permits students to achieve this objective. Typical undergraduate business students are required to complete two entry-level accounting courses covering topics in financial and managerial accounting. The authors of this text believe that over the years, many of the textbooks used in those courses have become increasingly encyclopedic. The result has been the teaching of a

¹ Accounting Education Change Commission, Position Statement No. Two, “The First Course in Accounting” (Torrence, CA, 1992), p. 2.

great deal of accounting detail without having students obtain a “big picture” of financial statement and accounting information use. One of the objectives of this text is to provide that “big picture” while meeting the objective for a first course in accounting identified by the Accounting Education Change Commission. When supplemented with appropriate cases and other materials, this text can be used in both the financial and managerial entry-level courses taken by undergraduate business majors. Students who intend to pursue an accounting major will also have to learn the procedures of accounting, which can be taught in courses or with laboratory cases (e.g., practice sets) designed for those students. The majority of students in the entry-level courses will not become accounting majors. This book is aimed at helping them learn how to become effective users of accounting information while providing a solid foundation for those students who will pursue advanced study in accounting.

Many students whose academic interests are not in the business field can also benefit from exposure to accounting. These students, however, often have a restricted curriculum and may simply not be interested in investing two elective courses in acquiring some basic accounting tools. The structure of this book lends itself to a one-semester course that provides a basic understanding of accounting information. Students who could benefit from this approach include undergraduate majors in the following areas:

- Engineering
- Behavioral sciences
- Public administration
- Prelaw programs

Professionals in any of these broad disciplines are likely to be confronted with financial management issues early in their careers. In fact, accounting issues are likely to touch the majority of career paths open to a student today. MBA students who do not have a background in undergraduate business study or feel the need for a refresher course can use this book to gain or revive certain key business skills.

The text takes the reader through the basics: what accounting information is, what it means, and how it is used. Students examine financial statements and discover what they do and do not communicate. This knowledge will help them gain the decision-making and problem-solving abilities so crucial outside the academic environment.

This book is for the benefit of the many who simply want to know “what the numbers mean.”

ORGANIZATION

Chapter 1 presents a basic description of accounting and its evolution. Emphasis is placed on developments that have occurred to meet the needs of the users of accounting information and on dispelling the misconception that accounting standards are just a code of rules. The remainder of the text is divided into two major topic areas: financial accounting topics (Chapters 2 through 11) and managerial accounting topics (Chapters 12 through 16).

In presenting these two aspects of accounting, the spiral approach is used. In this teaching method, a general sketch is presented, and each chapter fills in a few of the finishing details until the reader possesses the full picture. The spiral approach is based on the belief that students can better navigate a subject matter if they are given a glimpse of the big picture first. Thus the objectives of the course are clear from the beginning, and the student can keep them in sight throughout the learning process.

Following this model, the first chapter of each section outlines the pertinent fundamental relationships and presents appropriate terminology so that the student is given an overview before exposure to the details. In the following chapters, the fundamentals are elaborated and developed until the picture is sufficiently fleshed out. The focus throughout the presentation is on understanding the meaning of the numbers in financial statements, their relationship to each other, and how they are used in evaluation, planning, and control. In taking the spiral approach, an instructor focuses on the function, not the formation, of the financial statements.

Highlights

The financial accounting portion (Chapters 2 through 11):

- Chapter 2—Getting the big picture

A model of the accounting process and the role of financial statements.

The introduction of a schematic diagram that illustrates the interrelationship of various financial statements and facilitates understanding the effects of various transactions.

- Chapter 3—Introducing basic concepts

Return on investment.

Return on equity.

Liquidity.

- Chapter 4—Understanding the method

The bookkeeping system in general terms.

A powerful transaction analysis scheme featuring the “horizontal model,” which builds on the schematic diagram presented in Chapter 2.

Introduction of journal entries and T-accounts with emphasis on the horizontal model as the way to understand the effect of transactions on the balance sheet and income statement.

- Chapters 5 through 10—Examining the specifics

The elements of the balance sheet, income statement, and statement of cash flows in relation to the schematic diagram.

The *unique* and valuable explication of Explanatory Notes in Chapter 10, crucial to understanding financial statements as a whole.

Knowledge of business practices as a foundation for an understanding of accounting for transactions.

- Chapter 11—Using the knowledge

Financial statement analysis: from financial data to decision making.

The managerial accounting portion (Chapters 12–16):

- Chapter 12—Getting the big picture

An introduction to cost accounting systems and cost classifications. Diagrams of cost flow, cost systems, and cost behavior.

- Chapters 13 through 16—Examining the specifics and putting them to use

An in-depth look at the specific uses of cost data in the planning, control, and decision-making processes.

The relationship between cost data and other factors involved in these processes.

NOTABLE FEATURES

Text

- **Business Procedure Capsules** are used throughout the chapters to highlight and discuss various business practices and their financial statement impact. Understanding these business practices facilitates a more complete understanding of financial statements in general.
- **Learning Objectives** guide students conceptually by providing a framework for each chapter.
- **Chapter Summaries and Key Terms and Concepts** promote greater retention of important points and definitions.



- **Financial Statements and Other Financial Information from the 1994 Annual Report of Armstrong World Industries, Inc.**, are presented in the Appendix. Frequent reference to this material is made in the financial accounting portion of the text. This real-world example piques student interest and gives students a hands-on experience. In addition, students are asked to obtain their own example of an actual annual report.
- **End-of-chapter Problems** illustrate important concepts and applications. Problems that require the use of Armstrong World Industries, Inc., financial statements and other financial information from the Appendix are identified with the logo shown here in the margin. The pencil logo, also shown in the margin, identifies questions requiring written answers.

Supplements

- **Study Guide and Workpapers** for student use, includes several hundred matching, true/false, and multiple choice review questions with annotated answers, and working papers laid out for all problems.
- **Ready Notes and Solutions to Odd-Numbered Problems** are provided for student use. Ready Notes are copies of the teaching transparencies with space for students to take class notes. Solutions are provided for the odd-numbered problems. Even-numbered problems are usually similar to the preceding odd-numbered problem. Having the full solution (not just a check figure) of the preceding problem available as a “model” provides additional examples beyond those in the text, reinforces learning, minimizes frustration, and facilitates the use of the book as a self-study or Continuing Professional Educational resource.
- **Instructor’s Manual and Test Bank** featuring teaching/learning objectives, chapter outlines, teaching observations, exercise and problem solutions, quiz/exam questions, and take-home quizzes. An extended version of the test bank is available in WordPerfect (v.6.1) format on a 3½" diskette for adopters.
- **Transparency Acetates** provide instructors with a framework for chapter-by-chapter discussions. Some are figures lifted from the text, others simply organize the material under discussion.
- **Irwin’s Computerized Testing Software**, an advanced-feature test generator, allows you to add and edit questions; save and reload tests; create up to 99 different versions of each test; attach graphics to questions; import and export ASCII files; and select questions based on type, level of difficulty, or keyword. This software provides password protec-

tion of saved tests and question databases, and can run on a network. Irwin's free customized exam preparation service, Teletest, is also available.

ADDITIONAL NOTES FROM THE AUTHORS

In this text, we have followed a pragmatic approach in explaining the information content and use of financial statements and financial data. Students should be encouraged to read *The Wall Street Journal* and other business publications regularly, and instructors should attempt to call students' attention to current developments relating to the course material.

Users of the text are cautioned that accounting is not a spectator sport, and that comprehension of the material does require actually working through the problems. Reviewing solutions to odd-numbered problems that are in the *Ready Notes and Solutions to Odd-Numbered Problems* without first attempting the problems will significantly dilute the learning process.

We hope the approach and scope of coverage in this text have achieved the previously identified objectives and, in addition, have filled the user's need. Any ideas for increasing the effectiveness of this text are welcome.

ACKNOWLEDGMENTS

It is with a great deal of pleasure that Wayne McManus is welcomed as a co-author of this third edition. Mr. McManus, a onetime colleague of Mr. Marshall at Millikin University, has been involved with the project since its inception, and is the author of the first two editions of the *Study Guide and Workpapers*.

Several Millikin University colleagues encouraged the creation of this text, including Dr. C. R. Decker and Dean R. A. Mannweiler. In addition to encouragement, Professor Daniel F. Viele and Mr. Stuart Koop provided valuable assistance. The original work on this text was done by Mr. Marshall during an academic leave from Millikin University, and without that time and support this book would still be just an idea.

Armstrong World Industries, Inc., has provided copies of its annual report for classroom use for many years. This link to reality has been a valuable teaching aid. We are grateful for permission from Armstrong World Industries, Inc., to include the financial statements and other financial information from its 1994 annual report as an Appendix.

Although the approach to the material and the scope of the coverage in this text are the results of our own conclusions, truly new ideas are rare. The authors whose textbooks we have used in the past have influenced many of our ideas for particular accounting and financial management explanations. Likewise, students and colleagues through the years have helped us clarify illustrations and teaching techniques. Many of the users of the first two editions—both teachers and students—have offered comments and constructive criticisms that have been encouraging and helpful. All of this input is greatly appreciated.

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Brief Contents

1	ACCOUNTING—PRESENT AND PAST	1
PART I	FINANCIAL ACCOUNTING	25
2	FINANCIAL STATEMENTS AND ACCOUNTING CONCEPTS/PRINCIPLES	27
3	FUNDAMENTAL INTERPRETATIONS MADE FROM FINANCIAL STATEMENT DATA	75
4	THE BOOKKEEPING PROCESS AND TRANSACTION ANALYSIS	102
5	ACCOUNTING FOR AND PRESENTATION OF CURRENT ASSETS	142
6	ACCOUNTING FOR AND PRESENTATION OF PROPERTY, PLANT AND EQUIPMENT, AND OTHER NONCURRENT ASSETS	190
7	ACCOUNTING FOR AND PRESENTATION OF LIABILITIES	239
8	ACCOUNTING FOR AND PRESENTATION OF OWNERS' EQUITY	280
9	THE INCOME STATEMENT AND THE STATEMENT OF CASH FLOWS	317
10	EXPLANATORY NOTES AND OTHER FINANCIAL INFORMATION	366
11	FINANCIAL STATEMENT ANALYSIS	389

PART II	MANAGERIAL ACCOUNTING	431
12	MANAGERIAL/COST ACCOUNTING AND COST CLASSIFICATIONS	433
13	COST-VOLUME-PROFIT ANALYSIS	472
14	BUDGETING AND PERFORMANCE REPORTING	501
15	STANDARD COSTS AND VARIANCE ANALYSIS	537
16	CAPITAL BUDGETING	563
APPENDIX	Financial Statements and Other Financial Information from the Armstrong World Industries, Inc., 1994 Annual Report	583
INDEX		623

Contents

INDEX OF BUSINESS PROCEDURE CAPSULES

xxiii

1	ACCOUNTING—PRESENT AND PAST	1
	WHAT IS ACCOUNTING? 2	
	Financial Accounting. Managerial Accounting/Cost Accounting.	
	Auditing—Public Accounting. Internal Auditing. Governmental and	
	Not-for-Profit Accounting. Income Tax Accounting.	
	HOW HAS ACCOUNTING DEVELOPED? 7	
	Early History. The Accounting Profession in the United States. Financial	
	Accounting Standard Setting at the Present Time. Standards for Other	
	Types of Accounting. International Accounting Standards. Ethics and	
	the Accounting Profession.	
	THE CONCEPTUAL FRAMEWORK 13	
	“Highlights” of Concepts Statement, No. 1—Objectives of Financial	
	Reporting by Business Enterprises. Objectives of Financial Reporting for	
	Nonbusiness Organizations.	
	PLAN OF THE BOOK 18	

PART I FINANCIAL ACCOUNTING

25

2	FINANCIAL STATEMENTS AND ACCOUNTING	
	CONCEPTS/PRINCIPLES	27
	FINANCIAL STATEMENTS 28	
	From Transactions to Financial Statements. Financial Statements	
	Illustrated. Explanations and Definitions. <i>Balance Sheet. Income</i>	
	<i>Statement. Statement of Changes in Owners' Equity. Statement of Cash</i>	
	<i>Flows.</i> Comparative Statements in Subsequent Years. Illustration of	
	Financial Statement Relationships.	
	ACCOUNTING CONCEPTS AND PRINCIPLES 45	
	Concepts/Principles Related to the Entire Model. Concepts/Principles	
	Related to Transactions. Concepts/Principles Related to Bookkeeping	

xvii

	Procedures and the Accounting Process. Concepts/Principles Related to Financial Statements. Limitations of Financial Statements.	
	THE CORPORATION'S ANNUAL REPORT	51
3	FUNDAMENTAL INTERPRETATIONS MADE FROM FINANCIAL STATEMENT DATA	75
	FINANCIAL RATIOS AND TREND ANALYSIS	76
	Return on Investment. The DuPont Model, an Expansion of the ROI Calculation. Return on Equity. Working Capital and Measures of Liquidity. Illustration of Trend Analysis.	
4	THE BOOKKEEPING PROCESS AND TRANSACTION ANALYSIS	102
	THE BOOKKEEPING/ACCOUNTING PROCESS	103
	The Balance Sheet Equation—A Mechanical Key. Transactions. Bookkeeping Jargon and Procedures. Understanding the Effects of Transactions on the Financial Statements. Adjustments/Adjusting Entries. Transaction Analysis Methodology.	
5	ACCOUNTING FOR AND PRESENTATION OF CURRENT ASSETS	142
	CASH	143
	The Bank Reconciliation.	
	SHORT-TERM MARKETABLE SECURITIES	148
	Balance Sheet Valuation. Interest Accrual.	
	ACCOUNTS RECEIVABLE	149
	Bad Debts/Uncollectible Accounts. Cash Discounts.	
	NOTES RECEIVABLE	154
	Interest Accrual.	
	INVENTORIES	156
	Inventory Cost-Flow Assumptions. The Impact of Changing Costs (Inflation/Deflation). The Impact of Inventory Quantity Changes. Selecting an Inventory Cost-Flow Assumption. Inventory Accounting System Alternatives. Inventory Errors. Balance Sheet Valuation at the Lower of Cost or Market.	
	PREPAID EXPENSES AND OTHER CURRENT ASSETS	170
6	ACCOUNTING FOR AND PRESENTATION OF PROPERTY, PLANT AND EQUIPMENT, AND OTHER NONCURRENT ASSETS	190
	LAND	191

BUILDINGS AND EQUIPMENT	194
Cost of Assets Acquired. Depreciation for Financial Accounting Purposes. Maintenance and Repair Expenditures. Disposal of Depreciable Assets. Trade-In Transactions.	
ASSETS ACQUIRED BY CAPITAL LEASE	206
INTANGIBLE ASSETS	217
Leasehold Improvements. Patents, Trademarks, and Copyrights. Goodwill.	
NATURAL RESOURCES	221
OTHER NONCURRENT ASSETS	221
7 ACCOUNTING FOR AND PRESENTATION OF LIABILITIES	239
CURRENT LIABILITIES	241
Short-Term Debt. Current Maturities of Long-Term Debt. Accounts Payable. Unearned Revenue or Deferred Credits. Other Accrued Liabilities.	
LONG-TERM LIABILITIES	251
Long-Term Debt. Deferred Income Taxes. Other Long-Term Liabilities.	
8 ACCOUNTING FOR AND PRESENTATION OF OWNERS' EQUITY	280
PAID-IN CAPITAL	282
Common Stock. Preferred Stock. Additional Paid-In Capital.	
RETAINED EARNINGS	291
Cash Dividends. Stock Dividends and Stock Splits.	
TREASURY STOCK	296
CUMULATIVE FOREIGN CURRENCY TRANSLATION ADJUSTMENT	298
REPORTING CHANGES IN OWNERS' EQUITY ACCOUNTS	298
9 THE INCOME STATEMENT AND THE STATEMENT OF CASH FLOWS	317
INCOME STATEMENT	320
Revenues. Expenses. Cost of Goods Sold. Gross Profit or Gross Margin. Other Operating Expenses. Income from Operations. Other Income and Expenses. Income before Income Taxes and Income Tax Expense. Net Income and Earnings per Share. Income Statement Presentation Alternatives. Unusual Items Sometimes Seen on an Income Statement. <i>Discontinued Operations. Extraordinary Items. Minority Interest in Earnings of Subsidiaries. Cumulative Effect of a Change in Accounting Principle.</i>	

	STATEMENT OF CASH FLOWS	341
	Content and Format of the Statement. Interpreting the Statement of Cash Flows.	
10	EXPLANATORY NOTES AND OTHER FINANCIAL INFORMATION	366
	GENERAL ORGANIZATION	367
	EXPLANATORY NOTES (OR FINANCIAL REVIEW)	368
	Significant Accounting Policies. Details of Other Financial Statement Amounts. Other Disclosures. <i>Accounting Change. Business Combinations. Contingencies and Commitments. Events Subsequent to the Balance Sheet Date. Impact of Inflation. Segment Information.</i> Management's Statement of Responsibility.	
	MANAGEMENT'S DISCUSSION AND ANALYSIS	377
	FIVE-YEAR (OR LONGER) SUMMARY OF FINANCIAL DATA	378
	INDEPENDENT AUDITORS' REPORT	379
	FINANCIAL STATEMENT COMPILATIONS	381
11	FINANCIAL STATEMENT ANALYSIS	389
	FINANCIAL STATEMENT ANALYSIS RATIOS	390
	Liquidity Measures. Activity Measures. Profitability Measures. Financial Leverage Measures.	
	OTHER ANALYTICAL TECHNIQUES	407
	Book Value per Share of Common Stock. Common Size Financial Statements. Other Operating Statistics.	
	PART II MANAGERIAL ACCOUNTING	431
12	MANAGERIAL/COST ACCOUNTING AND COST CLASSIFICATIONS	433
	MANAGERIAL ACCOUNTING CONTRASTED TO FINANCIAL ACCOUNTING	434
	COST CLASSIFICATIONS	437
	Costs for Cost Accounting Purposes. Cost Accounting Systems—General. Cost Accounting Systems—Job Order Costing, Process Costing, and Hybrid Costing. Activity-Based Costing. Cost Accounting Systems—Absorption Costing and Direct Costing. Relationship of Cost to Product or Activity. Relationship of Total Cost to Volume of Activity. Cost Classification According to a Time-Frame Perspective. Cost Classifications for Other Analytical Purposes.	