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# ACCOUNTING

Principles and Applications

THIRD EDITION

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# **ACCOUNTING**    **THIRD EDITION**

## **Principles and Applications**

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**Accounting: Principles and Applications**

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## PREFACE

A recent news article reported that a new business venture was selling its product as fast as it could be made. The article also noted that the company had just filed for bankruptcy. What happened? How could a firm with a good product and droves of customers fail? The answer turned out to be that the company's management lacked accounting information and hadn't realized it. At the first sign of trouble—a severe shortage of cash—they had no plan to solve the problem and no information with which to evaluate alternative courses of action.

Such financial disasters could be averted with no more than the basic information contained in an introductory course in accounting. This textbook covers the essentials of both financial and managerial accounting, providing students with the basis for a better understanding of the business world and for making more intelligent financial decisions. Financial matters of the sort that individuals and business firms face every day are used as examples of accounting principles in action.

In preparing this Third Edition, we have tried to be responsive to the feedback received from our colleagues and students. Many users felt, for example, that the overview of accounting and financial reporting in the Prologue and chapters 1 and 2 of the previous edition was too extensive. We came to agree, and so we have deleted the Prologue, condensed the introductory material into a brief first chapter, and modified Chapter 2 so that it goes directly to a discussion of the primary financial statements and the basic accounting equation.

We also agreed with the suggestions to emphasize and strengthen the coverage of managerial concepts and applications. Historically, full-year introductory accounting texts have not provided ample coverage of managerial topics. Dave Buehlmann has studied, conducted research, and taught extensively in the managerial accounting area; his addition as a co-author has significantly strengthened that part of the book.

Students have trouble with managerial accounting because they don't have the nice  $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$  framework that provides the logical structure of financial accounting. We have attempted to provide that structure. We establish in Chapter 17 a managerial accounting model by showing that all management decisions can be broadly classified into three functions: *planning*, *implementing*, and *controlling*. Throughout the following chapters, students are shown how managerial decision making and its techniques or tools are related to these functions: budgets to planning, for example, measurements (product cost accumulation, segment reporting, etc.) to implementing, and performance reports to controlling. We wish to

link in students' minds the managerial accounting tool and the managerial decision, and we reiterate this tie-in with each new chapter. This structure should enable students to understand where each chapter fits into the management process and to see the relevance of the managerial accounting tools being discussed to the managerial decision being made.

We believe this approach leads to better understanding and application of managerial accounting information for two additional reasons:

1. it explains the need for the information (the why) and not just its preparation (the how), and
2. it presents the information in a manner similar to the way students will come upon it in their careers in business.

All important subjects are covered thoroughly, but the number of chapters has been reduced by reorganizing to eliminate redundancies. Chapter 9, on long-term operational assets, illustrates this point: Many texts have a chapter on property, plant, and equipment, another on intangible assets, and sometimes one on natural resources. Each of these chapters deals primarily with accounting for the same four basic events: acquisition of assets, allocation of asset cost, maintenance and repair of assets, and the disposal of assets. In this book, we clearly distinguish between the three classes of assets and then discuss and illustrate the accounting procedures in one chapter. Students have no trouble understanding that the same concepts and procedures apply to all three classes of assets.

We have reduced the level of difficulty of the coverage of liabilities and payables by integrating all material on short- and long-term liabilities into one chapter (10) and covering bonds payable separately in Chapter 11. This allows students more time to learn and apply these difficult procedures and concepts.

To allow instructors and students greater flexibility in choosing the amount of detail appropriate for their course, several chapters are followed by supplements. The basic concepts and essential procedures are presented in the chapters; the supplements expand upon procedural aspects, describe alternative or more complex techniques, or simply provide additional coverage.

Each chapter is carefully structured to help students focus on important ideas and remember them. First, an outline of major topics to be covered provides a sense of the chapter's objectives. Second, the definitions of key terms in the margins make it easier to learn terminology and to review for exams. Third, several concise summaries within the chapter help students remember the important terms and ideas just discussed. Fourth, the end-of-chapter review and the list of key terms (with page references) serve as additional reinforcement. Finally, to add realism to the students' understanding of accounting, we have included brief essays from pertinent articles in *The Wall Street Journal*, *Fortune*, and other journals (they are highlighted in color in the Contents).

The end-of-chapter material contains various kinds of questions, exercises, and problems. Each is designed to test student understanding in a different way.

The exercises deal with single concepts, and each can be completed fairly quickly (a maximum of 30 minutes).

The problems generally take longer to complete than the exercises, and they probe for a deeper level of understanding. There are now two sets of problems for each chapter, to aid in class assignment decisions. Those problems identified as “unifying concepts” require students to analyze the computed results. The Analysis for Business Decisions problems, new to the Third Edition, are intended to help students understand how accounting affects day-to-day business decisions. These problems require students to interpret data, as well as solve problems.

The questions, exercises, and problems are graded in difficulty so that students gain confidence as they review and test their understanding. Instructors can assign material that will challenge students up to the level appropriate to their course goals.

### **ADDITIONAL FEATURES OF THE THIRD EDITION**

The most significant of the improvements made in this edition (in addition to those already mentioned) are:

1. In Chapter 3 we get right into debits and credits and the steps of the accounting cycle. We have eliminated the descriptive material that delayed this discussion.
2. In teaching adjusting entries in Chapter 4, we have focused on the liability approach for unearned revenues and the asset approach for prepaid expenses. The revenue and expense approaches are discussed separately at the end of the chapter.
3. The explanation of the work sheet method of accounting for inventories is deferred to the supplement to Chapter 6.
4. The chapter providing an overview of the balance sheet has been dropped and the material on classified financial statements added to Chapter 2.
5. Short-term investments are now covered with cash and receivables (Chapter 8).
6. As mentioned, all the material on short- and long-term liabilities has been integrated into one chapter (10), enabling students to see their relationships more clearly.
7. We now introduce bonds payable (11) before bond investments (12), since students seem to find this sequence easier to follow.
8. We have added to Chapter 12 a supplement on international accounting, which focuses on exchange rate and restatement problems.
9. In July 1986, the FASB issued an exposure draft entitled “Statement of Cash Flows.” We explain the elements of this draft in Chapter 15, but we retain our discussion of a working-capital-basis statement, so students will have an easier time understanding the cash-basis statement.
10. Information on inflation accounting has been deleted from chapters 6 and 7, expanded, and placed in a supplement after Chapter 16. This change will allow for more detailed coverage by those who want to consider this topic or for easy elimination by those who prefer to cover inflation accounting in more advanced courses.

11. To introduce managerial accounting in Chapter 17, we provide, as previously mentioned, a framework of the key managerial functions—planning, implementing, and control—and relate them to the managerial accounting cycle of budgeting, measuring activity, and reporting performance. Each chapter on managerial accounting is tied to this cycle so that the relationship of concepts and procedures is constantly reinforced.

12. In recognition of the increasing importance of service and nonprofit organizations in our economy, we have sought opportunities to show how managerial accounting concepts apply to these entities (the use of job-order costing in a service firm, for example).

13. Realizing that most students will be users, not preparers, of accounting information, we have in the managerial chapters emphasized the needs of the decision maker and de-emphasized procedural detail that is not essential to the students' understanding of the broader concepts. For example:

- (a) Relating cost accounting information to pricing decisions and the evaluation of product profitability.
- (b) Placing process costing in a supplement and discussing only the easier of the two cost-flow alternatives in the chapter. Students need to understand what, in general, is part of a product cost, not all the options available for determining it.
- (c) Relating standard costs to planning and control decisions.
- (d) Simplifying the discussion of how to compute standard cost variances while emphasizing variance investigation.
- (e) Using CVP analysis to evaluate managerial planning decisions and alternatives.
- (f) Emphasizing the use of performance reports in managerial decision making rather than simply the preparation of the reports.

14. Chapter 27 has been revised to reflect the provisions of the Tax Reform Act of 1986. Chapters 9 and 10 have also been revised to include relevant income tax requirements of this law.

## **LEARNING AND TEACHING AIDS THAT ACCOMPANY THE TEXTBOOK**

We have personally written all but one of the supplements that accompany the text and carefully reviewed the excellent practice set written by Nancy O. Tang. We think the result is an integrated package that is unmatched in usefulness to students and instructors.

### **Study Guide**

The Study Guide includes chapter outlines; learning objectives; detailed chapter summaries; discussions of topics that cause problems for students and suggestions for overcoming those problems; and tests for student self-assessment, including matching, true-false, multiple-choice questions, and



computational exercises (all with solutions). The Study Guide provides a means for students to reexamine the concepts and procedures in each chapter from several different perspectives, each of which reinforces the others.

### **Practice Set (Manual and Computerized)**

Nancy Tang (Portland State University) has prepared a Practice Set that covers the accounting cycle. It requires approximately 6 to 12 hours to complete. The Instructor's Guide to the Practice Set includes some general notes, quizzes, and the solution. A computerized version, prepared by Educational Computer Systems, is also available for use on an IBM PC and all compatible equipment.

### **Working Papers**

There are two sets of Working Papers for students to use in solving the problems in the book, including those that pertain to the supplements.

### **Solutions Manual and Transparencies**

A complete set of pedagogical aids is available to instructors, including a Solutions Manual with answers to all discussion questions and detailed solutions to every exercise and problem. A set of Transparencies includes solutions to all problems and selected exercises set in oversize type.

### **Teaching Masters**

A set of classroom teaching notes is also available for lecture preparation or for making transparencies for classroom projection. These include key concepts, outlines of procedures, and alternative examples.

### **Instructor's Resource Guide**

The Instructor's Resource Guide contains chapter outlines, teaching suggestions, alternative examples for classroom use, and sample quizzes. The Guide should be very helpful to new instructors or graduate teaching assistants who wish to use the teaching notes and examples.

### **Test Bank**

The Test Bank (2,000 questions) and a Computerized Test Generation System provide tailor-made exams without delay. The Test Bank also provides two exams for appropriately grouped chapters.

### **Computer Tutorial Programs**

Finally, COMPACT II is a set of nine tutorial programs designed to help students in areas that are less easily understood through other media. COMPACT II also includes a calculator that enables students to compute the answers directly on the computer. The programs are: The Accounting Cycle, Interest Accrual, Account Classification, Partial Income Statement, Lower-of-Cost-or-Market Rule, Inventory Cost Flow, Depreciation, Bond Valuation, The Funds Statement, Financial Statement Analysis, and The Calculator. These programs are available for use on an IBM PC.



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January 1987

K. Fred Skousen  
 Harold Q. Langenderfer  
 W. Steve Albrecht  
 David M. Buehlmann

## TO THE STUDENT

Welcome to the study of accounting! Many of you are seeking only a general understanding of accounting and have no intention of becoming accountants; others are considering careers in accounting and need a strong foundation upon which to build a knowledge of accounting principles and procedures. Regardless of your objective, if you will follow the suggestions here, you will be more successful in this course.

First, you should realize that accounting is as essential to commerce as language is to civilization. In fact, accounting is often called the language of business. Without accounting, we couldn't judge the success of economic activities. We wouldn't be able to plan our personal finances or our country's economic policies. Thus, accounting affects each of us. It provides the information upon which almost every financial decision is based. Recognizing its importance and far-reaching effects should motivate you to study hard, which is the key to your success in this course.

Second, accounting is best learned by doing. That is why so much homework is assigned and why it is essential that you do the homework regularly. Those accounting students who learn most are the ones who do not fall behind. Accounting concepts build upon each other, so it is difficult to understand concepts and applications in later chapters if the material in earlier chapters is not fully understood. Answering the discussion questions at the end of each chapter is a good way to review the chapter and to test your understanding of the topics covered. If you are not able to answer the questions, you probably do not understand the concepts and procedures well enough; that means you should restudy the appropriate sections of the chapter. A Study Guide is available that highlights the major points of each chapter and provides questions and exercises (with solutions) to help you test your understanding.

Finally, we have found that many students attempt to do well in this course by memorizing accounting details, including the solutions to specific problems. Accounting problems tend to be unique, however, each with a slightly different twist; so a better approach is to try to understand the concepts and the reasoning underlying accounting procedures, and then to apply this understanding to specific situations. Your emphasis should be on understanding and reasoning rather than on memorization.

Good luck!

# CONTENTS IN BRIEF

## PART I Financial Accounting

1

### SECTION 1

#### The Accounting Process

3

<b>CHAPTER 1</b>	Accounting and Its Environment	5
<b>CHAPTER 2</b>	The Basic Financial Statements	27
<b>CHAPTER 3</b>	Introducing the Accounting Cycle	53
<b>CHAPTER 4</b>	Adjusting Entries	88
<b>CHAPTER 5</b>	Completing the Accounting Cycle	116
<b>SUPPLEMENT</b>	(Chapters 1–5) A Case Study	153

### SECTION 2

#### Income Determination

169

<b>CHAPTER 6</b>	Income Measurement and Reporting	170
<b>SUPPLEMENT</b>	(Chapters 1–6) Special Journals	212
<b>CHAPTER 7</b>	Inventory and Cost of Goods Sold	225

### SECTION 3

#### Reporting Assets, Liabilities, and Owners' Equity

261

<b>CHAPTER 8</b>	Cash, Short-Term Investments, and Receivables	262
<b>CHAPTER 9</b>	Property, Plant, and Equipment; Intangible Assets; and Natural Resources	306
<b>CHAPTER 10</b>	Liabilities	344
<b>SUPPLEMENT</b>	Payroll Accounting	379
<b>CHAPTER 11</b>	Bonds Payable	387
<b>CHAPTER 12</b>	Long-Term Investments	415
<b>SUPPLEMENT</b>	International Accounting	439
<b>CHAPTER 13</b>	Owners' Equity—The Corporation	449
<b>CHAPTER 14</b>	Owners' Equity—Proprietorships and Partnerships	483

### SECTION 4

#### Other Dimensions of Financial Reporting

521

<b>CHAPTER 15</b>	The Statement of Changes in Financial Position	522
<b>SUPPLEMENT</b>	(Chapters 6–15) Consolidated Financial Statements	569
<b>CHAPTER 16</b>	Financial Statement Analysis	588
<b>SUPPLEMENT</b>	(Chapters 6–16) Financial Reporting and Changing Prices	631

---

**PART 2**  
**Managerial Accounting** **643**


---

**SECTION 5**  
**Foundations of Managerial Accounting** **645**


---

<b>CHAPTER 17</b>	An Introduction to Managerial Accounting	646
<b>CHAPTER 18</b>	Analyzing Cost Behavior Patterns	665
<b>CHAPTER 19</b>	Cost Accumulation Systems	694
<b>SUPPLEMENT</b>	The Process Costing System	728
<b>CHAPTER 20</b>	Standard Costs for Planning and Control	739

**SECTION 6**  
**Operations Planning** **775**


---

<b>CHAPTER 21</b>	Analyzing Cost-Volume-Profit Relationships	776
<b>CHAPTER 22</b>	Operating Budgets	804

**SECTION 7**  
**Control and Performance Evaluation** **839**


---

<b>CHAPTER 23</b>	Responsibility Accounting and Cost Control	840
<b>CHAPTER 24</b>	Control and Performance Evaluation in Profit and Investment Centers	873

**SECTION 8**  
**Other Dimensions of Managerial Accounting** **899**


---

<b>CHAPTER 25</b>	Nonroutine Decisions	900
<b>CHAPTER 26</b>	Capital Budgeting	929
<b>CHAPTER 27</b>	The Impact of Income Taxes on Business Decisions	959
<b>SUPPLEMENT A</b>	Present and Future Value Tables	991
<b>SUPPLEMENT B</b>	The Financial Statements of International Business Machines (IBM) Corporation	993

<b>GLOSSARY</b>	1015
-----------------	------

<b>INDEX</b>	1033
--------------	------

# CONTENTS

<b>PART I</b>			
<b>Financial Accounting</b>	<b>1</b>		
<b>SECTION 1</b>			
<b>The Accounting Process</b>	<b>3</b>		
<b>CHAPTER 1</b>			
<b>Accounting and Its Environment</b>	<b>5</b>		
The Role of Accounting	5		
The Relationship of Accounting to Business	6		
Users of Accounting Information	8		
The Evolution of Accounting	10		
The Basic Concepts and Assumptions			
Underlying Financial Accounting	10		
The Entity Concept	11		
Proprietorship	11		
Partnership	12		
Corporation	12		
The Assumption of Arm's-Length Transactions	12		
The Cost Principle	13		
The Money Measurement Concept	14		
The Going-Concern Assumption	14		
Double-Entry Accounting	15		
The Structure and Role of Accounting			
Theory	15		
The Structure of Accounting Theory	15		
The Role of Accounting Theory	16		
The Significance and Development of GAAP	17		
Career Opportunities in Accounting	18		
Working for a CPA Firm	18		
Working for a Business	20		
Working in Government or Other Nonprofit Organizations	21		
		Educational Preparation	21
		Career Opportunities for Accountants	22
		Chapter Review	22
		<b>CHAPTER 2</b>	
		<b>The Basic Financial Statements</b>	<b>27</b>
		The Primary Financial Statements	28
		The Balance Sheet or Statement of Financial Position	28
		Assets	28
		Liabilities	28
		Owners' Equity	29
		The Format of a Balance Sheet	30
		A Classified and Comparative Balance Sheet	31
		Limitations of a Balance Sheet	32
		The Income Statement or Statement of Earnings	33
		Revenues	33
		Expenses	34
		Net Income (or Net Loss)	34
		The Format of an Income Statement	34
		The Statement of Changes in Financial Position (Funds Statement)	36
		How the Financial Statements Tie Together	38
		Additional Financial Statements for Corporations	38
		Notes to Financial Statements	40
		The Audit Report	41
		Chapter Review	41
		<b>CHAPTER 3</b>	
		<b>Introducing the Accounting Cycle</b>	<b>53</b>
		The Process of Transforming Transaction Data into Useful Accounting Information	53

The Basic Accounting Equation	55	Adjusting for Income Taxes	124
Using Accounts to Categorize Transactions	56	Reporting the Retained Earnings Balance	124
Expanding the Accounting Equation to Include Revenues and Expenses	58	Preparing Financial Statements	125
The First Four Steps in the Accounting Cycle	60	Closing Entries	
Step 1. Analyze Transactions and Business Documents	60	Real and Nominal Accounts	126
Step 2. Journalize Transactions	62	The Closing Process	126
Acquiring Cash, Either from Owners or by Borrowing	64	Using an Income Summary Account	127
Acquiring Other Assets	65	Closing Dividends	129
Selling Goods or Providing Services	66	The Closing Process for Proprietorships and Partnerships	129
Collecting Cash and Paying Obligations	68	Preparing a Post-Closing Trial Balance	130
Step 3. Post Journal Entries to Accounts	70	Interpretation of Accounting Data	131
Step 4. Determine Account Balances and Prepare a Trial Balance	72	Chapter Review	132
A Simple Illustration of the First Steps in the Accounting Cycle	73	SUPPLEMENT	
Chapter Review	77	Reversing Entries	150
CHAPTER 4		SUPPLEMENT (Chapters 1–5)	
Adjusting Entries	88	A Case Study	153
Additional Characteristics of the Accounting Model	88	SECTION 2	
Periodic Reporting	89	Income Determination	169
Accrual Accounting	90		
Revenue Recognition	90	CHAPTER 6	
The Matching Principle	90	Income Measurement and Reporting	170
Accrual- Versus Cash-Basis Accounting	91	A Definition of Income	170
Adjusting Entries (Step 5 of the Accounting Cycle)	92	Methods of Measuring Income	171
Unrecorded Revenues	93	Accrual-Basis Historical Cost Income—	
Unrecorded Expenses	95	An Analysis	173
Unearned Revenues	96	The Measurement of Revenues	173
Prepaid Expenses	99	Recognizing Revenue on Credit Sales	174
Alternative Approaches to Adjusting Entries	102	Sales Discounts	175
An Alternative Approach to Adjustments for Unearned Revenues	102	Sales Returns and Allowances	176
An Alternative Approach to Adjustments for Prepaid Expenses	103	Losses from Uncollectible Accounts	177
Concluding Comment	104	The Measurement of Expenses	177
Chapter Review	105	The Cost of Goods Sold Expense	178
CHAPTER 5		The Perpetual Inventory Method	179
Completing the Accounting Cycle	116	The Periodic Inventory Method	181
Preparing a Work Sheet	116	Purchase Discounts	182
Special Considerations in Using a Work Sheet	123	Purchase Returns and Allowances	184
Adjusting for Supplies	123	Freight-In	184
		Sales and Purchase Adjustments and the Cost of Goods Sold Calculation	184
		Taking a Physical Count of Inventory	186
		Closing Entries for Cost of Goods Sold	187
		Other Operating Expenses	189

The Income Statement	190	The Gross Margin Method	245
Other Revenues and Expenses	192	The Retail Inventory Method	246
Gains and Losses	192	Chapter Review	247
Extraordinary Items	192		
Earnings per Share	193		
Are Earnings Up or Down?	193		
Chapter Review	194	SECTION 3	
		<b>Reporting Assets, Liabilities, and Owners' Equity</b>	<b>261</b>
SUPPLEMENT			
<b>Using a Work Sheet in Accounting for Inventory</b>	<b>205</b>	CHAPTER 8	
		<b>Cash, Short-Term Investments, and Receivables</b>	<b>262</b>
SUPPLEMENT ( <i>Chapters 1–6</i> )		Accounting for Cash	262
<b>Special Journals</b>	<b>212</b>	Control of Cash	263
Computerized Journals	212	Accounting for Petty Cash	264
The Sales Journal	213	Reconciling the Bank Account	266
The Purchases Journal	216	Accounting for Short-Term Investments	270
The Cash Receipts Journal	218	Journalizing Short-Term Investments	271
The Cash Disbursements Journal	219	Valuing Short-Term Investments at Lower of Cost or Market	272
		Accounting for Receivables	272
CHAPTER 7		Accounts Receivable	274
<b>Inventory and Cost of Goods Sold</b>	<b>225</b>	<i>Estimating the Allowance for Doubtful         Accounts</i>	277
The Proper Measurement of Inventory	225	Credit-Card Sales	279
Inventory Cutoff and the Effects of Inventory Errors	226	Credit-Card Mania	280
An Inventory Fraud	229	Notes Receivable	281
Other Factors in Accounting for Inventory	230	Non-Interest-Bearing Notes	283
Inventory in Manufacturing Versus Nonmanufacturing Firms	230	Discounting Notes Receivable	284
Inventory Cost Flows	231	Other Receivables	285
Periodic Inventory Cost Flow Alternatives	232	Chapter Review	286
FIFO Periodic Inventory Costing	233		
LIFO Periodic Inventory Costing	234	SUPPLEMENT	
Weighted-Average Periodic Inventory Costing	234	<b>Internal Control</b>	<b>297</b>
Specific-Identification Inventory Costing	235		
A Comparison of Costing Alternatives Using the Periodic Inventory Method	236	CHAPTER 9	
Perpetual Inventory Cost Flow Alternatives	237	<b>Property, Plant, and Equipment; Intangible Assets; and Natural Resources</b>	<b>306</b>
FIFO Perpetual Inventory Costing	237	Types of Long-Term Operational Assets	306
LIFO Perpetual Inventory Costing	238	Accounting for the Initial Cost of Property, Plant, and Equipment	307
Moving-Average Inventory Costing	239		
A Comparison of All Inventory Costing Alternatives	240	Allocating the Cost of Plant and Equipment to Expense	309
Reporting Inventory at Amounts Below Cost	241	The Straight-Line Method of Depreciation	310
Inventory Valued at Net Realizable Value	241	The Sum-of-the-Years'-Digits Method of Depreciation	312
Inventory Valued at Lower of Cost or Market	241		
Methods of Estimating Inventories	244		



Declining-Balance Method of Depreciation	313	Non-Interest-Bearing Notes	355
The Units-of-Production Method of Depreciation	314	Interest-Bearing Notes with Stated Rate of Interest Less than the Market Rate of Interest	356
A Comparison of Depreciation Methods	316	Mortgages Payable	358
Partial-Year Depreciation Calculations	316	How Interest Rates Affect Mortgage Payments	360
Changes in Depreciation Estimates	317	Accounting for Leases	360
Cost Allocation Methods Used for Tax Purposes	318	Deferred Income Taxes Payable	363
A Comparison of ACRS with Other Depreciation Methods	320	Pension Liabilities	365
A Footnote on Property, Plant, and Equipment	321	Contingent Liabilities	366
Repairing and Improving Plant and Equipment	322	Analyzing Current Liabilities	367
Disposal of Property, Plant, and Equipment	323	Chapter Review	367
Discarding Property, Plant, and Equipment	323	SUPPLEMENT	
Selling Property, Plant, and Equipment	324	Payroll Accounting	379
Exchanging Property, Plant, and Equipment	325		
A Gain on the Exchange of Similar, Productive Assets	325	CHAPTER 11	
A Loss on the Exchange of Similar, Productive Assets	326	Bonds Payable	387
Exchanges of Dissimilar Assets	327	The Nature of Bonds	387
Exchanges Under the Income Tax Rules	328	Types of Bonds	388
Accounting for Intangible Assets	329	Characteristics of Bonds	389
Patents	329	Determining a Bond's Issuance Price	390
Franchises and Licenses	330	Bonds Issued at Face Value	391
Goodwill	330	Bonds Issued at a Discount	391
Accounting for Natural Resources	331	Bonds Issued at a Premium	392
Chapter Review	332	Following the Bond Market	393
CHAPTER 10		Accounting for Bonds Payable	394
Liabilities	344	Accounting for Bonds Issued at Face (Par) Value	394
Current Liabilities	344	Accounting for Bonds Issued at a Discount or at a Premium	396
Short-Term Obligations to Pay Cash	345	Accounting for Bonds Issued at a Discount	396
Accounts Payable	345	Accounting for Bonds Issued at a Premium	398
Notes Payable	346	Accounting for Bonds Sold Between Interest Dates	399
Sales Taxes Payable	347	Effective-Interest Amortization	401
The Current Portion of Long-Term Debt	347	Bond Retirements at Maturity	403
Accrued Liabilities	348	Bond Retirements Before Maturity	404
Payroll Liabilities	348	Chapter Review	405
Obligations to Perform Services	350		
Long-Term Liabilities	351	CHAPTER 12	
Measuring Long-Term Liabilities	351	Long-Term Investments	415
The Present Value Concept	352	Accounting for Long-Term Investments in Stocks	415
The Present Value of an Annuity	353	The Cost Method	417
Long-Term Notes Payable	354		
Interest-Bearing Note with Stated Interest Rate Equal to Market Rate	354		

What Constitutes Significant Influence?	418	Prior-Period Adjustments	468
The Equity Method	419	The Statement of Retained Earnings	468
The Cost and Equity Methods Illustrated	419	Retained Earnings Restrictions	468
Accounting for Long-Term Investments in Bonds	421	Chapter Review	470
Accounting for the Acquisition of Bonds	422		
Accounting for Interest Earned on Bond Investments	424	CHAPTER 14	
Accounting for the Amortization of Bond Discounts and Premiums	425	<b>Owners' Equity—Proprietorships and Partnerships</b>	<b>483</b>
Effective-Interest Amortization	427		
Accounting for the Sale of Bond Investments or the Receipt of Their Maturity Value	429	Characteristics Shared by Proprietorships and Partnerships	484
Chapter Review	429	Ease of Formation	484
		Limited Life	485
		Unlimited Liability	485
		The Dangers of Unlimited Liability	485
SUPPLEMENT		Proprietorship Accounting	486
<b>International Accounting</b>	<b>439</b>	Characteristics Unique to Partnerships	488
Exchange Rates and Accounting Standards	440	Mutual Agency	488
Accounting for Transactions in Foreign Currencies	441	Co-ownership of Partnership Property	488
Foreign Purchases	441	Sharing of Partnership Profits	488
Foreign Sales	442	Basic Partnership Accounting	489
Unrealized Exchange Gains and Losses	442	Forming a Partnership	489
Restatement of Foreign Subsidiary Financial Statements	443	Partners' Drawings Accounts	490
Translation and Remeasurement	444	The Statement of Partners' Capital	490
Example of Restatement into U.S. Dollars	445	Accounting for Partnership Profits and Losses	492
The Search for Uniformity	447	Stated Ratio	493
		Capital Investment Ratio	493
CHAPTER 13		Allowance for Salaries with the Remainder at Stated Ratio	494
<b>Owners' Equity—The Corporation</b>	<b>449</b>	Allowance for Interest on Invested Capital with the Remainder at Stated Ratio	495
Characteristics of a Corporation	450	Accounting for Changing Partnership Members	497
The Stock of a Corporation	452	Admitting a New Partner	497
Investing in the Stock Market	454	Purchasing an Interest	498
Accounting for the Issuance of Par-Value Stock and No-Par Stock with a Stated Value	454	Investing Directly in the Partnership	499
Accounting for the Issuance of No-Par Stock Without a Stated Value	456	The Withdrawal of a Partner	502
Accounting for Treasury Stock	456	Selling an Interest to an Outsider	502
Summarizing Stockholders' Equity	458	Selling an Interest to the Other Partners	502
Distributing the Earnings	460	Payment to a Departing Partner from the Partnership's Assets	503
Accounting for Dividends	460	The Death of a Partner	504
Cash Dividends and Dividend Preferences	461	The Liquidation of a Partnership	504
Current-Dividend Preference	462	The Sale of a Partnership	505
Cumulative-Dividend Preference	463	The Division of Gains and Losses on the Sale of a Partnership	506
Participating-Dividend Preference	463	The Payment of Liabilities and Distribution of Remaining Cash	506
Stock Dividends	465	Chapter Review	507
Accounting for Stock Splits	466		
Accounting for Retained Earnings	467		