

# Fundamental Accounting Principles

F.A.P. Sixteenth Edition

Larson • Wild • Chiappetta

Volume 2 Chapters 13-26

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16

edition

Volume 2 Chapters 13–26,

# Fundamental Accounting Principles

Kermit D. Larson

University of Texas at Austin

John J. Wild

University of Wisconsin at Madison

Barbara Chiappetta

Nassau Community College



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To my wife **Nancy**.

To my wife **Gail** and children, **Kimberly, Jonathan, Stephanie**, and **Trevor**.

To my husband **Bob**, my sons **Michael** and **David**, and my **mother**.

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Volume 2 Chapters 13–26,

# Fundamental Accounting Principles



## ABOUT THE AUTHORS

**KERMIT D. LARSON** is the Arthur Andersen & Co. Alumni Professor of Accounting Emeritus at the University of Texas at Austin. He served as chairman of the University of Texas, Department of Accounting and was visiting associate professor at Tulane University. His scholarly articles have been published in a variety of journals, including *The Accounting Review*, *Journal of Accountancy*, and *Abacus*. He is the author of several books, including *Financial Accounting* and *Fundamentals of Financial and Managerial Accounting*, both published by McGraw-Hill/Irwin.

Professor Larson is a member of the American Accounting Association, the Texas Society of CPAs, and the American Institute of CPAs. His positions with the AAA have included vice president, southwest regional vice president, and chairperson of several committees, including the Committee of Concepts and Standards. He was a member of the committee that planned the first AAA doctoral consortium and served as its director.

Professor Larson served as president of the Richard D. Irwin Foundation. He also served on the Accounting Accreditation Committee and on the Accounting Standards Committee of the AACSB. He was a member of the Constitutional Drafting Committee of the Federation of Schools of Accountancy and a member of the Commission on Professional Accounting Education. He has been an expert witness on cases involving mergers, antitrust litigation, consolidation criteria, franchise taxes, and expropriation of assets by foreign governments. Professor Larson served on the Board of Directors and Executive Committee of Tekcon, Inc., and on the National Accountants Advisory Board of Safe-Guard Business Systems. In his leisure time, he enjoys skiing and is an avid sailor and golfer.

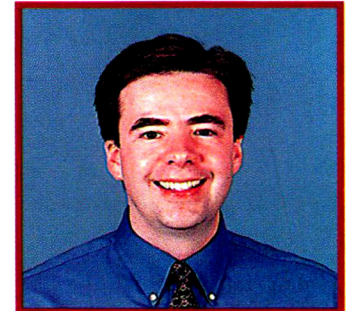


**JOHN J. WILD** is a professor of business and the Vilas Research Scholar at the University of Wisconsin at Madison. He has previously held appointments at Michigan State University and the University of Manchester in England. He received his BBA, MS, and PhD from the University of Wisconsin.

Professor Wild teaches courses at both the undergraduate and graduate levels. He has received the Mabel W. Chipman Excellence-in-Teaching Award and the departmental Excellence-in-Teaching Award at the University of Wisconsin. He also received the Beta Alpha Psi and Roland F. Salmonson Excellence-in-Teaching Award from Michigan State University. Professor Wild is a past KPMG Peat Marwick National Fellow and is a recipient of fellowships from the American Accounting Association and the Ernst and Young Foundation.

Professor Wild is an active member of the American Accounting Association and its sections. He has served on several notable committees of these organizations, including the Outstanding Accounting Educator Award, National Program Advisory, Publications, and Research Committees. Professor Wild is author of *Financial Statement Analysis* and *Financial Accounting: Information for Decisions*, both published by McGraw-Hill/Irwin. His research publications appear in *The Accounting Review*, *Journal of Accounting Research*, *Journal of Accounting and Economics*, *Contemporary Accounting Research*, *Journal of Accounting, Auditing and Finance*, *Journal of Accounting and Public Policy*, and other business periodicals. He is associate editor of *Contemporary Accounting Research* and has served on several editorial boards including *The Accounting Review*.

Professor Wild, his wife, and four children enjoy travel, music, sports, and community activities.



**BARBARA CHIAPPETTA** received her BBA in Accountancy and MS in Education from Hofstra University and is a tenured full professor at Nassau Community College. For the past 20 years, she has been an active executive board member of the Teachers of Accounting at Two-Year Colleges (TACTYC), serving 10 years as vice president and 5 years as president. As an active member of the American Accounting Association, she has served on the Northeast Regional Steering Committee, chaired the Curriculum Revision Committee of the Two-Year Section, and participated in numerous national committees. In April 1998, Professor Chiappetta was inducted into the American Accounting Association Hall of Fame for the Northeast Region. She received the Nassau Community College dean of instruction's Faculty Distinguished Achievement Award in the spring of 1995. Professor Chiappetta was honored with the State University of New York Chancellor's Award for Teaching Excellence in 1997. As a confirmed believer in the benefits of the active learning pedagogy, Professor Chiappetta has authored *Student Learning Tools*, an active learning workbook for a first-year accounting course, published by McGraw-Hill/Irwin.

In her leisure time, Professor Chiappetta enjoys tennis and participates on a U.S.T.A. team. She also enjoys the challenge of bridge. Her husband, Robert, is an entrepreneur in the leisure sport industry. She has two sons—Michael, a lawyer, currently practicing in New York City, and David, formerly lead guitarist in the rock band Blindman's Sun and currently pursuing a career in film scoring.





PUTTING THE STUDENT  
ON A PEDESTAL





## A WORD TO THE STUDENT

**WHEN** we set about revising FAP, we spoke to hundreds of educators throughout the country, listening to their thoughts about what worked in previous editions and what they felt could be improved. The experience they brought to us was born of countless hours of teaching, of helping students just like you to master what can be a challenging subject. They had a great deal to tell us and we listened.

**NOW**, after nearly two years of work, we present to you the **SIXTEENTH EDITION** of **FAP**. It is the result of a simple, guiding principle: **THE STUDENT COMES FIRST**. Every change to this edition, from the **ENTREPRENEURIAL FLAVOR** to the extensive use of helpful **STUDY AIDS**, is designed to make the principles of accounting easier for you to learn—and more fun too! You will encounter chapter-opening vignettes and “Did You Know” boxes containing names like eBay, FUBU, Birdhouse, NetLedger, Freeplay and Red Hat, **YOUNG COMPANIES** helping to shape the **NEW ECONOMY** in which you will soon **COMPETE FOR WORK**. You’ll also notice a boxed feature entitled “You Make the Call” that challenges you to apply your understanding to a real-world situation.

And we haven’t stopped with the text. A new, 2-volume CD-ROM called **FAP Partner** offers additional help for the most challenging topics in the principles course while **NetTutor** gives you free, real-time access to an accounting expert ready to help you with any questions you have.

There’s a great deal more to this edition of **FAP** as you’ll discover when you read the following pages. We hope you’ll agree that **Fundamental Accounting Principles** by **Larson, Wild, and Chiappetta** provides you with everything you need to master the principles of accounting.

Sincerely,

**The McGraw-Hill/Irwin FAP Team**



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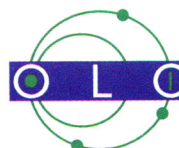
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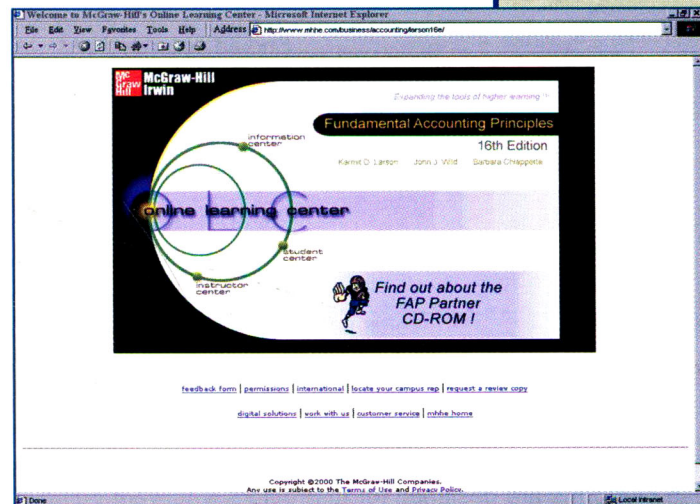
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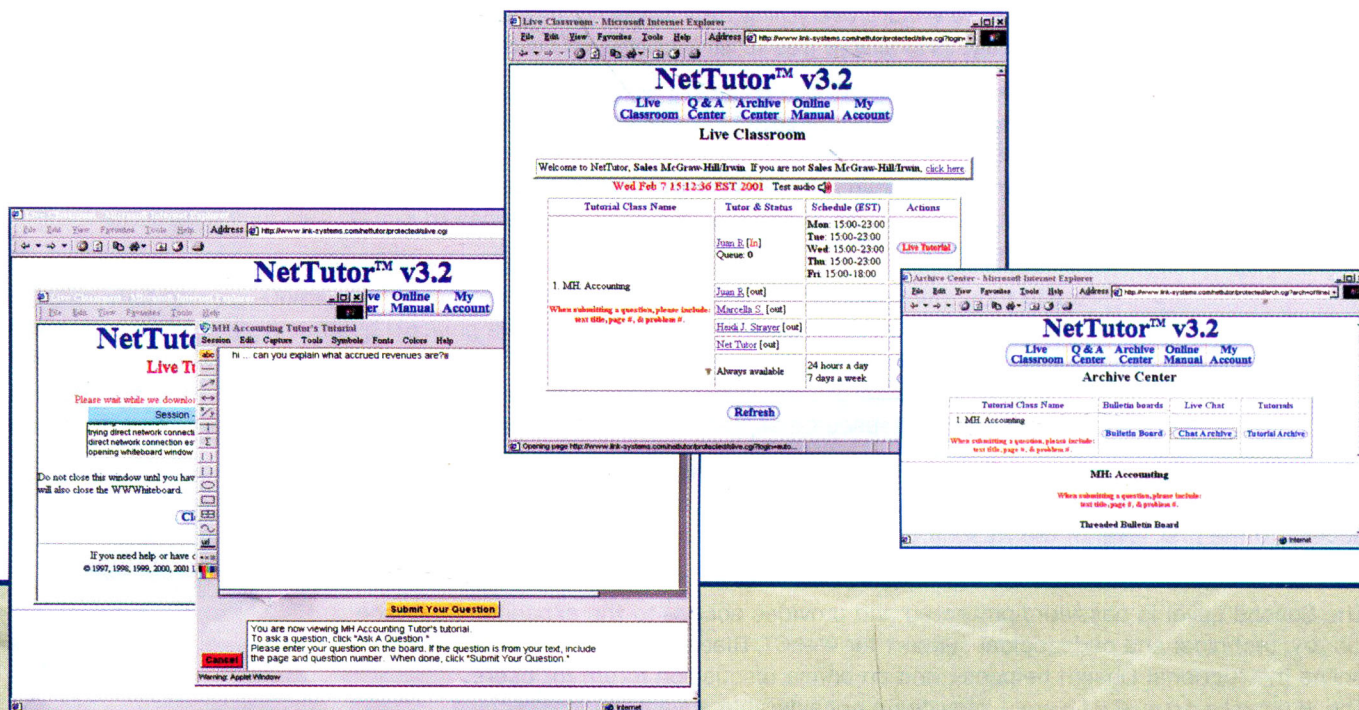


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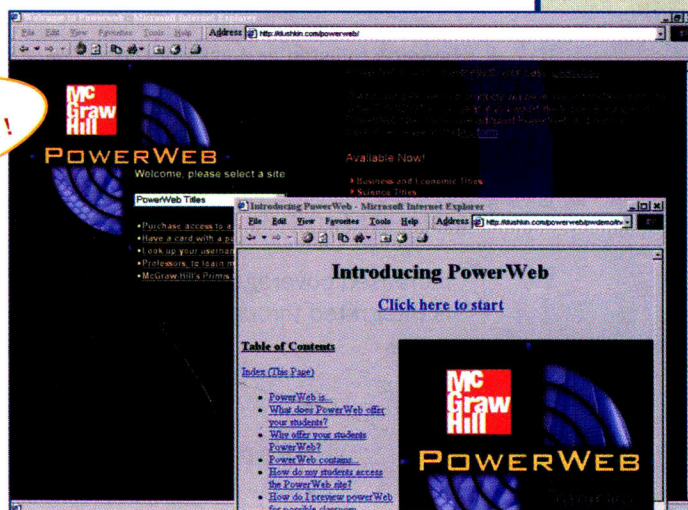
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# SOLID ACCOUNTING COVERAGE...

**WE LISTENED!** **IN ADDITION** to a number of reviewers, we held focus groups in cities around the country to learn what **INSTRUCTORS LIKE YOU** are thinking about in the principles of accounting course and the materials you use to teach it. John Wild attended every session to listen and ask questions. We got **FANTASTIC FEEDBACK** and our authors have integrated that feedback into this new edition of the text. We think you'll like what you see.

## THROUGHOUT THE TEXT:

Increased coverage of e-business, the Web, and entrepreneurship as related to accounting is integrated throughout the text as appropriate. Following are *some* content revisions:

### Chapter 1

#### JobDirect **NEW opener**

New, early introduction to financial statements

Revised motivation on the relevance of accounting

Revised section on accounting and related careers

New table on compensation in accounting careers

### Chapter 2

Simplified transaction analysis with accounting equation

Early introduction to statement of cash flows

Revised Nintendo financials

Top 10 list of key entrepreneurial qualities

### Chapter 3

#### Creative Assets **NEW opener**

Streamlined section on using T-Accounts

Shortened section on posting of transactions

New discussion of using entries to analyze transactions

### Chapter 4

#### CrossWorlds **NEW opener**

Revised presentation on accounting adjustments

Streamlined discussion of the adjusting process

### Chapter 5

#### Red Hat **NEW opener**

Shortened section on closing entries

New Excel screen captures with acetates for work sheet

Streamlined section on account numbering system

### Chapter 6

#### Wooden Ships of Hoboken **NEW opener**

Simplified presentation of income statement formats

Streamlined section on merchandising cash flows

### Chapter 7

#### FUBU **NEW opener**

Streamlined presentation of gross profit method

Toys "R" Us **Updated**

### Chapter 8

#### NetLedger **NEW opener**

More discussion on Web-based accounting

New simplified visuals for special journals (using PeachTree screen captures)

Revised special journals using perpetual inventory system

Streamlined coverage of special journals

New analysis of Harley-Davidson segments

### Chapter 9

#### eBay **NEW opener**

New feature on cyber fraud

Shortened discussion of voucher system of control

### Chapter 10

#### Tarina Tarantino **NEW opener**

Streamlined discussion on full disclosure principle

Dell and Apple **Updated**



**Chapter 11**

Papa John's **NEW opener**

Streamlined discussion of partial-year depreciation

Shortened and simplified section on "Revenue and Capital Expenditures"

Deleted section on exchange of dissimilar assets

Coors and Anheuser-Busch **Updated**

**Chapter 12**

Sector 9 **NEW opener**

New section on employee bonus plans

Shortened section on "Income Tax Liabilities"

Best Buy **Updated**

Revised appendix on payroll records

**Chapter 13**

AltiTUNES **NEW opener**

Expanded discussion of limited liability companies

New section on partnership return on equity

Boston Celtics revised feature

**Chapter 14**

World Wrestling Federation **NEW opener**

Deleted section on "Issuing Stock through Subscriptions"

Streamlined section on participating and nonparticipating preferred stock dividends

Deleted the Dividends Declared account to streamline journal entries for cash (and stock) dividends

Deleted the section on "Liquidating Cash Dividends"

Shortened section on "Discontinued Segments"

Simplified section on "Changes in Accounting Principles"

Streamlined section on diluted earnings per share

Shortened sections on book value per share and dividend yield

**Chapter 15**

David Bowie Bonds **NEW opener**

Streamlined Appendix on "Present Values of Bonds and Notes"

New Appendix 15B on "Leases and Pensions"

**Chapter 16**

Freeplay **NEW opener**

New illustrations on adjustments for unrealized gains and losses on securities

**Chapter 17**

Interactive Sports **NEW opener**

Simplified preparation of the statement of cash flows

Shortened section on "Analyzing Cash Sources and Uses"

**Chapter 18**

Nike vs. Reebok **Updated**

Revised discussion on comparative analysis (benchmarking)

Streamlined section on "Working Capital and Current Ratio"

**Chapter 19**

American Paper Optics **NEW opener**

New section on "Lean Business Model"

Shortened discussion on manufacturing management principles

Expanded discussion of service businesses

New presentation of manufacturing statement

**Chapter 20**

iFRONTIER **NEW opener**

Moved manufacturing statement to Chapter 19

Simplified section on "Overapplied and Underapplied Overhead"

Deleted section on "Multiple Overhead Allocation Rates"

New section on costing and pricing for service businesses

Moved Appendix 20A on General Accounting System to the Web

**Chapter 21**

INCA **NEW opener**

New footnote illustration of process costing using weighted-average method

Deleted section on "Spoiled Units of Production"

New section on "Hybrid Costing"

**Chapter 22**

Kate Spade **NEW opener**

Simplified discussion of "Activity-Based Costing"

Streamlined sections on "Departmental Accounting"

**Chapter 23**

Latham Entertainment **NEW opener**

Streamlined section on "Assumptions of CVP Analysis"

**Chapter 24**

Birdhouse **NEW opener**

Deleted section on "Zero-Based Budgeting"

Streamlined section on the budgeted balance sheet

New section on "Activity-Based Budgeting"

**Chapter 25**

Toes on the Noes **NEW opener**

New discussion of service applications

**Chapter 26**

Leading Edge Aviation Services **NEW opener**

New applications to service businesses



## ... SET IN A MODERN FRAMEWORK



An Entrepreneurial Icon calls out all relevant material within the chapters, whether an opening vignette, box, or end-of-chapter assignment.

## ENTREPRENEURIAL CHAPTER-OPENERS

These opening vignettes focus on young entrepreneurs and the relevance of accounting in their business decisions. We highlight companies like eBay, FUBU, Red Hat, NetLedger, JobDirect, Sector 9, Kate Spade, INCA, Birdhouse, Freeplay, and WWF—names that students will recognize from magazines, newspapers, television, and the Internet. The openers discuss how accounting information and an understanding of it aided these start-ups in successfully launching and running their operations. They serve as excellent motivators—showing the importance of accounting in business.

## ENTREPRENEURIAL FLAVOR — NEW

Today's students live in a world where start-up companies have redefined traditional notions of success in business. To reflect this shift, **FAP** integrates ideas and practices followed by today's entrepreneurs, speaking more directly to students and better preparing them for the workforce they will enter. **This approach is distinctive in the accounting principles market.**

**FAP** weaves the entrepreneurial flavor throughout the text in a variety of ways.



## Cash and Internal Control



*"I hope to make it easier to conduct business with strangers over the Net." —Pierre Omidyar*

### A Look Back

Chapter 8 focused on accounting information systems. We explained the fundamental principles and components of information systems, the use of special journals and subsidiary ledgers, and technology-based systems. We also discussed the analysis of segment data.

### A Look at This Chapter

This chapter extends our study of accounting to the area of internal control and accounting for cash. We describe procedures that are good for internal control. We also explain the control of and accounting for cash.

### A Look Ahead

Chapter 10 focuses on receivables and short-term investments. These items are the most liquid assets other than cash. We explain how to account and report for these assets.



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Chapter 8 Accounting Information Systems

**Entrepreneurial Decision**

**BTN 8-8** Dakota Rice has operated a local gift shop for two years. Initially, she handled all aspects of the store's accounting manually. Over the past year, she has focused on upgrading the store to a computerized system and has successfully installed software to handle billing, purchasing, and payroll. Dakota hopes this year to move from a periodic inventory system to a perpetual one. She is thinking of investing in a bar code labeler and scanner system to help manage inventory.

**Required**

1. What are the cost-benefit considerations of a bar code system?
2. How would a bar code system work with the accounting information system to accomplish perpetual inventory accounting?

**Part Three****Learning Objectives****Conceptual**

- C1** Define internal control and its purpose.
- C2** Identify principles of internal control.
- C3** Define cash and cash equivalents and explain how to report them.
- C4** Identify control features of banking activities.

**Analytical**

- A1** Compute the days' sales uncollected ratio and use it to analyze liquidity.

**Procedural**

- P1** Apply internal control to cash receipts.
- P2** Apply the voucher system to control cash disbursements.
- P3** Explain and record petty cash fund transactions.
- P4** Apply the net method to control purchase discounts.
- P5** Prepare a bank reconciliation.

**Did You Know?**

**Entrepreneurial Giving** Many entrepreneurs donate 10% or more of their pretax income to charities. Consultants cite evidence that socially conscious behavior brings tangible financial rewards. A recent survey found 76% of respondents saying they'd switch from their current store to one with a good cause if price and quality are equal.

**You Make the Call**

**Entrepreneur** As a small retailer, you are considering allowing customers to purchase merchandise using credit cards. Until now, your store accepted only cash and checks. What form of analysis do you use to make this decision?

Answer—p. 421

**ENTREPRENEURIAL DECISION PROBLEM**

A new Entrepreneurial Decision problem is included at the end of each chapter (in the "Beyond the Numbers" assignment section). These problems focus on small businesses and the relevance of accounting in helping solve business problems or guide business strategy. No other text offers such assignments specifically directed at small businesses.

**ENTREPRENEURIAL BOXES**

A selected number of new *Did You Know?* and *You Make The Call* boxes focus on entrepreneurial issues and decisions. The *Did You Know?* boxes provide current and informative observations relevant to business start-ups. The *You Make the Call* boxes engage students to apply accounting to decisions confronting entrepreneurs. These boxes are especially effective at engaging students interested in small business and start-up possibilities.

**Flea Market in Cyberspace**

**e** SAN JOSE, CA—Who ever thought a flea market could be worth \$12 billion? Paris-born entrepreneur Pierre Omidyar started his Net auction service, eBay (a combination of the words *electronic* and *Bay Area*), five years ago to help his girlfriend collect Pez candy dispensers (**eBay.com**). Omidyar, then 27, saw a need for a Web site where people could buy and sell all kinds of items such as computers, antiques, toys, and music. eBay is now the largest person-to-person auction site on the Web. It creates the marketplace, but buyers and sellers do their own work. eBay never touches the goods or the money. Its earnings derive from commissions, between 1 and 5%, depending on the item's value.

Omidyar calls eBay an experiment in e-commerce. But how does he persuade strangers to trust one another enough to hand over merchandise or cash? "Most people are honest, trustworthy people," says Omidyar. Still, he set up basic controls to establish responsibilities of each party to a trade and to monitor and record transactions. When complications still arose between buyers and sellers, Omidyar had to install a better control system.

Omidyar's response was fourfold. First, he devised a control system whereby buyers and sellers rate their experiences with the other party. This *Feedback Forum* is a public record of past eBay dealings of buyers and sellers. Omidyar says, "It's become a kind of virtuous cycle that's encouraged good behavior." Second, he brought in escrow services to assist traders in making deals. Buyers can have their goods delivered to an escrow service before their money is sent to the seller. Likewise, sellers can require that a buyer send money to the escrow service before sending the goods. Third, he gave traders free insurance. Fourth, he set up SafeHarbor, a dispute resolution service. Omidyar is creating an online marketplace where buyers and sellers can trade with confidence. He hopes to make eBay a place where anyone can buy and sell anything. Omidyar's company has raised \$3 billion from investors. (Sources: *Business Week*, Dec. 1, 2000; *Web Site*, Dec. 1, 2000.)