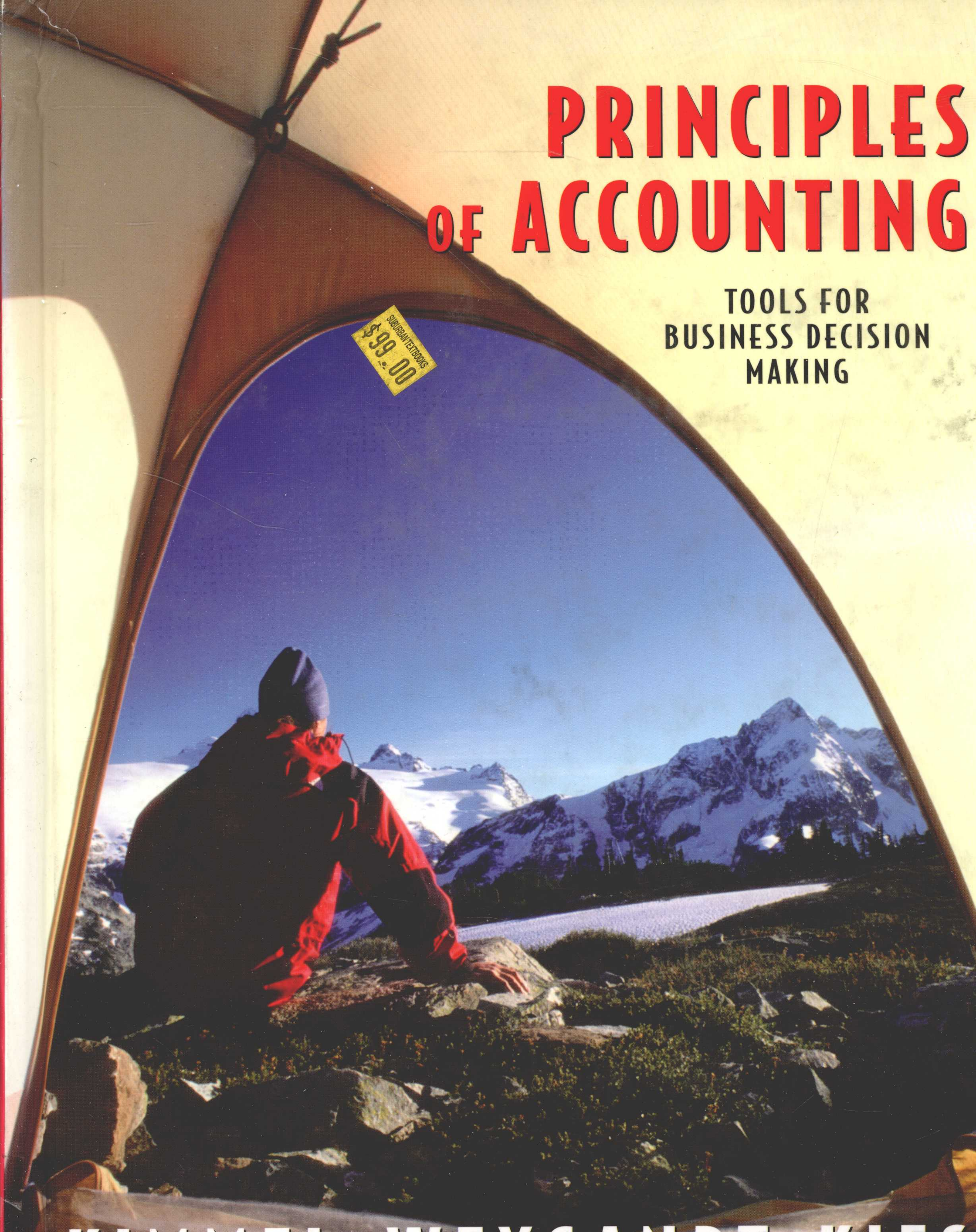
PRINCIPLES OF ACCOUNTING

TOOLS FOR BUSINESS DECISION MAKING



KIMMEL WEYGANDT KIES

Principles of Accounting

Tools for Business Decision Making

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our parents and our in-laws,
and to our families,
most especially our spouses,
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Cover Photo: ©Dave Schiefelbein/The Image Bank/Getty Images

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The cover was printed by Von Hoffmann.

This book is printed on acid-free paper. ∞

Library of Congress Cataloging-in-Publication Data

Kimmel, Paul D.
Principles of accounting: tools for business decision making/Paul D. Kimmel, Jerry J. Weygandt, Donald E. Kieso.
p. cm.
Various multi-media instructional aids are available to supplement the text.
Includes index.
ISBN 0-471-40133-1 (cloth)
1. Accounting. I. Kieso, Donald E. II. Kimmel, Paul D. III. Title.
HF5635.W5243 2003
657—dc22

2003057076

ISBN 0-471-40133-1
WIE ISBN 0-471-45185-1
Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

TOOLS FOR ANALYSIS

Liquidity

Working capital	Current assets − Current liabilities	p. 69
Current ratio	$\dfrac{\text{Current assets}}{\text{Current liabilities}}$	p. 69
Current cash debt coverage ratio	$\dfrac{\text{Cash provided by operations}}{\text{Average current liabilities}}$	p. 73
Inventory turnover ratio	$\dfrac{\text{Cost of goods sold}}{\text{Average inventory}}$	p. 281
Days in inventory	$\dfrac{\text{365 days}}{\text{Inventory turnover ratio}}$	p. 281
Receivables turnover ratio	$\dfrac{\text{Net credit sales}}{\text{Average net receivables}}$	p. 384
Average collection period	$\dfrac{\text{365 days}}{\text{Receivables turnover ratio}}$	p. 384

Solvency

Debt to total assets ratio	$\dfrac{\text{Total liabilities}}{\text{Total assets}}$	p. 70
Cash debt coverage ratio	$\dfrac{\text{Cash provided by operations}}{\text{Average total liabilities}}$	p. 73
Times interest earned ratio	$\dfrac{\text{Net income + Interest expense + Tax expense}}{\text{Interest expense}}$	p. 485
Free cash flow	Cash provided by operations − Capital expenditures − Cash dividends	p. 645

Profitability

Earnings per share	$\dfrac{\text{Net income − Preferred stock dividends}}{\text{Average common shares outstanding}}$	p. 65
Price-earnings ratio	$\dfrac{\text{Stock price per share}}{\text{Earnings per share}}$	p. 65
Gross profit rate	$\dfrac{\text{Gross profit}}{\text{Net sales}}$	p. 236
Profit margin ratio	$\dfrac{\text{Net income}}{\text{Net sales}}$	p. 237
Return on assets ratio	$\dfrac{\text{Net income}}{\text{Average total assets}}$	p. 432
Asset turnover ratio	$\dfrac{\text{Net sales}}{\text{Average total assets}}$	p. 433
Payout ratio	$\dfrac{\text{Cash dividends declared on common stock}}{\text{Net income}}$	p. 550
Return on common stockholders' equity ratio	$\dfrac{\text{Net income − Preferred stock dividends}}{\text{Average common stockholders' equity}}$	p. 551

RAPID REVIEW

Kimmel, Weygandt, Kieso

Principles of Accounting

FINANCIAL STATEMENTS

Order of Preparation	Date
1. Income statement	For the period ended
2. Retained earnings statement	For the period ended
3. Balance sheet	As of the end of the period
4. Statement of cash flows	For the period ended

Income Statement (perpetual inventory system)

Name of Company
Income Statement
For the Period Ended

Sales revenues		
Sales	$X	
Less: Sales returns and allowances	X	
Sales discounts	X	
Net sales		$X
Cost of goods sold		X
Gross profit		X
Operating expenses		
(Examples: store salaries, advertising, delivery, rent, depreciation, utilities, insurance)		X
Income from operations		X
Other revenues and gains		
(Examples: interest, gains)	X	
Other expenses and losses		
(Examples: interest, losses)	X	X
Income before income taxes		X
Income tax expense		X
Net income		$X

Income Statement (periodic inventory system)

Name of Company
Income Statement
For the Period Ended

Sales revenues			
Sales		$X	
Less: Sales returns and allowances		X	
Sales discounts		X	
Net sales			$X
Cost of goods sold			
Beginning inventory		X	
Purchases	$X		
Less: Purchase returns and allowances	X		
Net purchases	X		
Add: Freight in	X		
Cost of goods purchased		X	
Cost of goods available for sale		X	
Less: Ending inventory		X	
Cost of goods sold			X
Gross profit			X
Operating expenses			
(Examples: store salaries, advertising, delivery, rent, depreciation, utilities, insurance)			X
Income from operations			X
Other revenues and gains			
(Examples: interest, gains)		X	
Other expenses and losses			
(Examples: interest, losses)		X	X
Income before income taxes			X
Income tax expense			X
Net income			$X

Retained Earnings Statement

Name of Company
Retained Earnings Statement
For the Period Ended

Retained earnings, beginning of period	$X
Add: Net income (or deduct net loss)	X
	X
Deduct: Dividends	X
Retained earnings, end of period	$X

STOP AND CHECK: Net income (loss) presented on the retained earnings statement must equal the net income (loss) presented on the income statement.

Balance Sheet

Name of Company
Balance Sheet
As of the End of the Period

Assets

Current assets			
(Examples: cash, short-term investments, accounts receivable, merchandise inventory, prepaids)			$X
Long-term investments			
(Examples: investments in bonds, investments in stocks)			X
Property, plant, and equipment			
Land		$X	
Buildings and equipment	$X		
Less: Accumulated depreciation	X	X	X
Intangible assets			X
Total assets			$X

Liabilities and Stockholders' Equity

Liabilities	
Current liabilities	
(Examples: notes payable, accounts payable, accruals, unearned revenues, current portion of notes payable)	$X
Long-term liabilities	
(Examples: notes payable, bonds payable)	X
Total liabilities	X
Stockholders' equity	
Common stock	X
Retained earnings	X
Total liabilities and stockholders' equity	$X

STOP AND CHECK: Total assets on the balance sheet must equal total liabilities and stockholders' equity; and, ending retained earnings on the balance sheet must equal ending retained earnings on the retained earnings statement.

Statement of Cash Flows

Name of Company
Statement of Cash Flows
For the Period Ended

Cash flows from operating activities	
Note: May be prepared using the direct or indirect method	
Cash provided (used) by operating activities	$X
Cash flows from investing activities	
(Examples: purchase / sale of long-term assets)	
Cash provided (used) by investing activities	X
Cash flows from financing activities	
(Examples: issue / repayment of long-term liabilities, issue of stock, payment of dividends)	
Cash provided (used) by financing activities	X
Net increase (decrease) in cash	X
Cash, beginning of the period	X
Cash, end of the period	$X

STOP AND CHECK: Cash, end of the period, on the statement of cash flows must equal cash presented on the balance sheet.

(continued on next page)

RAPID REVIEW

ACCOUNTING CONCEPTS (Chapters 1–4)

Characteristics	Assumptions	Principles	Constraints
Relevance	Monetary unit	Revenue recognition	Materiality
Reliability	Economic entity	Matching	Conservatism
Comparability	Time period	Full disclosure	
Consistency	Going concern	Cost	

BASIC ACCOUNTING EQUATION (Chapter 3)

Basic Equation	**Assets**	=	**Liabilities**	+	**Stockholders' Equity**									
Expanded Basic Equation	Assets	=	Liabilities	+	Common Stock	+	Retained Earnings	–	Dividends	+	Revenues	–	Expenses	
Debit / Credit Rules	Dr. + / Cr. –		Dr. – / Cr. +		Dr. – / Cr. +		Dr. – / Cr. +		Dr. + / Cr. –		Dr. – / Cr. +		Dr. + / Cr. –	

ADJUSTING ENTRIES (Chapter 4)

Type		Adjusting Entry	
Prepayments	1. Prepaid expenses	Dr. Expenses	Cr. Assets
	2. Unearned revenues	Dr. Liabilities	Cr. Revenues
Accruals	1. Accrued revenues	Dr. Assets	Cr. Revenues
	2. Accrued expenses	Dr. Expenses	Cr. Liabilities

Note: Each adjusting entry will affect one or more income statement accounts and one or more balance sheet accounts.

Interest Computation

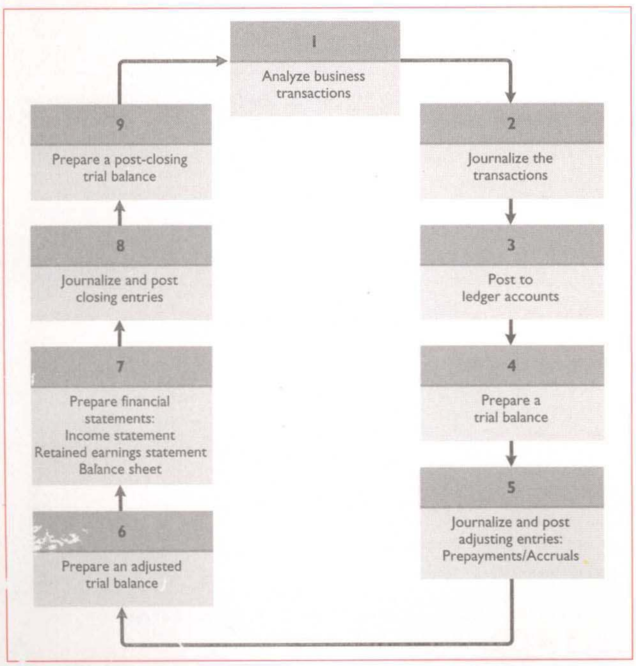
Interest = Face value of note × Annual interest rate × Time in terms of one year

CLOSING ENTRIES (Chapter 4)

Purpose

1. Update the Retained Earnings account in the ledger by transferring net income (loss) and dividends to retained earnings.
2. Prepare the temporary accounts (revenue, expense, dividends) for the next period's postings by reducing their balances to zero.

ACCOUNTING CYCLE (Chapter 4)



INVENTORY (Chapters 5 and 6)

Ownership

Freight Terms	Ownership of goods on public carrier resides with:
FOB Shipping point	Buyer
FOB Destination	Seller

Perpetual vs. Periodic Journal Entries

Event	Perpetual	Periodic
Purchase of goods	Inventory Cash (A/P)	Purchases Cash (A/P)
Freight (shipping point)	Inventory Cash	Freight In Cash
Return of goods	Cash (or A/P) Inventory	Cash (or A/P) Purchase Returns and Allowances
Sale of goods	Cash (or A/R) Sales Cost of Goods Sold Inventory	Cash (or A/R) Sales No entry
End of period	No entry	Closing or adjusting entry required

CASH (Chapter 7)

Principles of Internal Control

Establishment of responsibility
Segregation of duties
Documentation procedures
Physical, mechanical, and electronic controls
Independent internal verification
Other controls

Bank Reconciliation

Bank	Books
Balance per bank statement Add: Deposits in transit Deduct: Outstanding checks Adjusted cash balance	Balance per books Add: Unrecorded credit memoranda from bank statement Deduct: Unrecorded debit memoranda from bank statement Adjusted cash balance

Note: 1. Errors should be offset (added or deducted) on the side that made the error.
2. Adjusting journal entries should only be made on the books.

STOP AND CHECK: Does the adjusted cash balance in the Cash account equal the reconciled balance?

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PLANT ASSETS (Chapter 9)

Computation of Annual Depreciation Expense

Straight-line	$\dfrac{\text{Cost} - \text{Salvage value}}{\text{Useful life (in years)}}$
***Units-of-activity**	$\dfrac{\text{Depreciable cost}}{\text{Useful life (in units)}} \times$ Units of activity during year
***Declining-balance**	Book value at beginning of year × Declining balance rate* *Declining-balance rate = 1 ÷ Useful life (in years)

Note: If depreciation is calculated for partial periods, the straight-line and declining-balance methods must be adjusted for the relevant proportion of the year. Multiply the annual depreciation expense by the number of months expired in the year divided by 12 months.

BONDS (Chapter 10)

Premium	Market interest rate < Contractual interest rate
Face Value	Market interest rate = Contractual interest rate
Discount	Market interest rate > Contractual interest rate

Computation of Annual Bond Interest Expense

Interest expense = Interest paid (payable) + Amortization of discount
(OR − Amortization of premium)

***Straight-line amortization**	$\dfrac{\text{Bond discount (premium)}}{\text{Number of interest periods}}$
***Effective-interest amortization (preferred method)**	Bond interest expense − Bond interest paid (Carrying value of bonds at beginning of period × Effective interest rate) − (Face amount of bonds × Contractual interest rate)

STOCKHOLDERS' EQUITY (Chapter 11)

No-Par Value vs. Par Value Stock Journal Entries

No-Par Value	Par Value
Cash Common Stock	Cash Common Stock (par value) Paid-in Capital in Excess of Par Value

Comparison of Dividend Effects

	Cash	Common Stock	Retained Earnings
Cash dividend	↓	No effect	↓
Stock dividend	No effect	↑	↓
Stock split	No effect	No effect	No effect

INVESTMENTS (Chapter 12)

Comparison of Long-Term Bond Investment and Liability Journal Entries

Event	Investor	Investee
Purchase / issue of bonds	Debt Investments Cash	Cash Bonds Payable
Interest receipt / payment	Cash Interest Revenue	Interest Expense Cash

Comparison of Cost and Equity Methods of Accounting for Long-Term Stock Investments

Event	Cost	Equity
Acquisition	Stock Investments Cash	Stock Investments Cash
Investee reports earnings	No entry	Stock Investments Investment Revenue
Investee pays dividends	Cash Dividend Revenue	Cash Stock Investments

STATEMENT OF CASH FLOWS (Chapter 13)

Cash flows from operating activities (**indirect method**)

Net income			$X
Add:	Decreases in current assets	$ X	
	Increases in current liabilities	X	
	Amortization and depreciation	X	
	Losses on disposals of assets	X	
Deduct:	Increases in current assets	(X)	
	Decreases in current liabilities	(X)	
	Gains on disposals of assets	(X)	X
Cash provided (used) by operating activities			$X

Cash flows from operating activities (**direct method**)

Cash receipts		
(Examples: from sales of goods and services to customers, from receipts of interest and dividends on loans and investments)	$ X	
Cash payments		
(Examples: to suppliers, for operating expenses, for interest, for taxes)	(X)	
Cash provided (used) by operating activities		$X

FINANCIAL STATEMENT ANALYSIS (Chapter 14)

Presentation of Irregular Items

Discontinued operations	Income statement (presented separately after "Income before irregular items")
Extraordinary items	Income statement (presented separately after "Discontinued operations")
Changes in accounting principle	Income statement (cumulative effect adjustment presented just above "Net income")

Income Statement and Comprehensive Income

Sales	$XX
Cost of goods sold	XX
Gross profit	XX
Operating expenses	XX
Income from operations	XX
Other revenues (expenses) and gains (losses)	XX
Income before income taxes	XX
Income tax expense	XX
Income before irregular items	XX
Irregular items	**XX**
Net income	**XX**
Other comprehensive income items	**XX**
Comprehensive income	**$XX**

*Items with asterisk are covered in appendix.

MANAGERIAL ACCOUNTING (Chapter 15)

Characteristics of Managerial Accounting

Primary Users	Internal users
Reports	Internal reports issued as needed
Purpose	Special purpose for a particular user
Content	Pertains to subunits, may be detailed, use of relevant data
Verification	No independent audits

Types of Manufacturing Costs

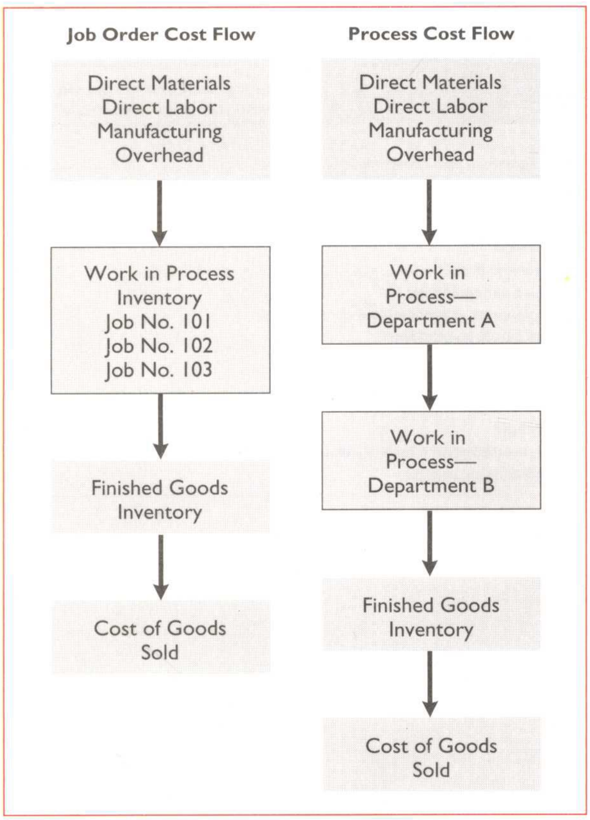
Direct materials	Raw materials directly associated with finished product
Direct labor	Work of employees directly associated with turning raw materials into finished product
Manufacturing overhead	Costs indirectly associated with manufacture of finished product

JOB ORDER AND PROCESS COSTING (Chapters 16 and 17)

Types of Accounting Systems

Job order	Costs are assigned to each unit or each batch of goods
Process cost	Costs are applied to similar products that are mass-produced in a continuous fashion

Job Order and Process Cost Flow



COST-VOLUME-PROFIT (Chapter 18)

Types of Costs

Variable costs	Vary in total directly and proportionately with changes in activity level
Fixed costs	Remain the same in total regardless of change in activity level
Mixed costs	Contain both a fixed and a variable element

CVP Income Statement Format

	Total	**Per Unit**
Sales	$XX	$XX
Variable costs	XX	XX
Contribution margin	XX	XX
Fixed costs	XX	
Net income	$XX	

Breakeven Point

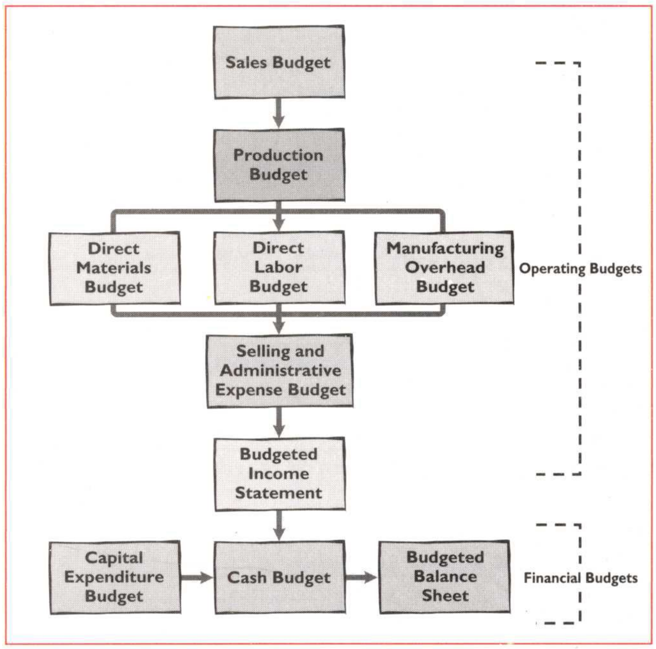
$$\text{Break-even point in units} = \text{Fixed costs} \div \text{Contribution margin per unit}$$

Target Net Income

$$\text{Required sales in units} = \left(\text{Fixed costs} + \text{Target net income}\right) \div \text{Contribution margin per unit}$$

BUDGETS (Chapter 19)

Components of the Master Budget



RESPONSIBILITY ACCOUNTING (Chapter 20)

Types of Responsibility Centers

Cost	Profit	Investment
Expenses only	Expenses and Revenues	Expenses and Revenues and ROI

Return on Investment

$$\text{Return on investment (ROI)} = \text{Investment center controllable margin} \div \text{Average investment center operating assets}$$

STANDARD COSTS (Chapter 21)

Standard Cost Variances

$$\text{Total materials variance} = \text{Materials price variance} + \text{Materials quantity variance}$$

$$\text{Total labor variance} = \text{Labor price variance} + \text{Labor quantity variance}$$

$$\text{Total overhead variance} = \text{Overhead controllable variance} + \text{Overhead volume variance}$$

$$\text{Materials price variance} = \boxed{AQ \times AP} - \boxed{AQ \times SP}$$

$$\text{Materials quantity variance} = \boxed{AQ \times SP} - \boxed{SQ \times SP}$$

$$\text{Labor price variance} = \boxed{AH \times AR} - \boxed{AH \times SR}$$

$$\text{Labor quantity variance} = \boxed{AH \times SR} - \boxed{SH \times SR}$$

$$\text{Overhead controllable variance} = \boxed{\text{Actual overhead}} - \boxed{\text{Overhead budgeted}}$$

$$\text{Overhead volume variance} = \boxed{\text{Fixed overhead rate}} \times \boxed{\text{Normal capacity} - \text{Standard hours allowed}}$$

CAPITAL BUDGETING (Chapter 22)

Annual Rate of Return

$$\text{Annual rate of return} = \text{Expected annual net income} \div \text{Average investment}$$

Cash Payback

$$\text{Cash payback period} = \text{Cost of capital investment} \div \text{Annual cash inflow}$$

Discounted Cash Flow Approaches

Net Present Value

Compute net present value (a dollar amount).

If net present value is zero or positive, accept the proposal. If net present value is negative, reject the proposal.

Internal Rate of Return

Compute internal rate of return (a percentage).

If internal rate of return is equal to or greater than the minimum required rate of return, accept the proposal. If internal rate of return is less than the minimum rate reject the proposal.

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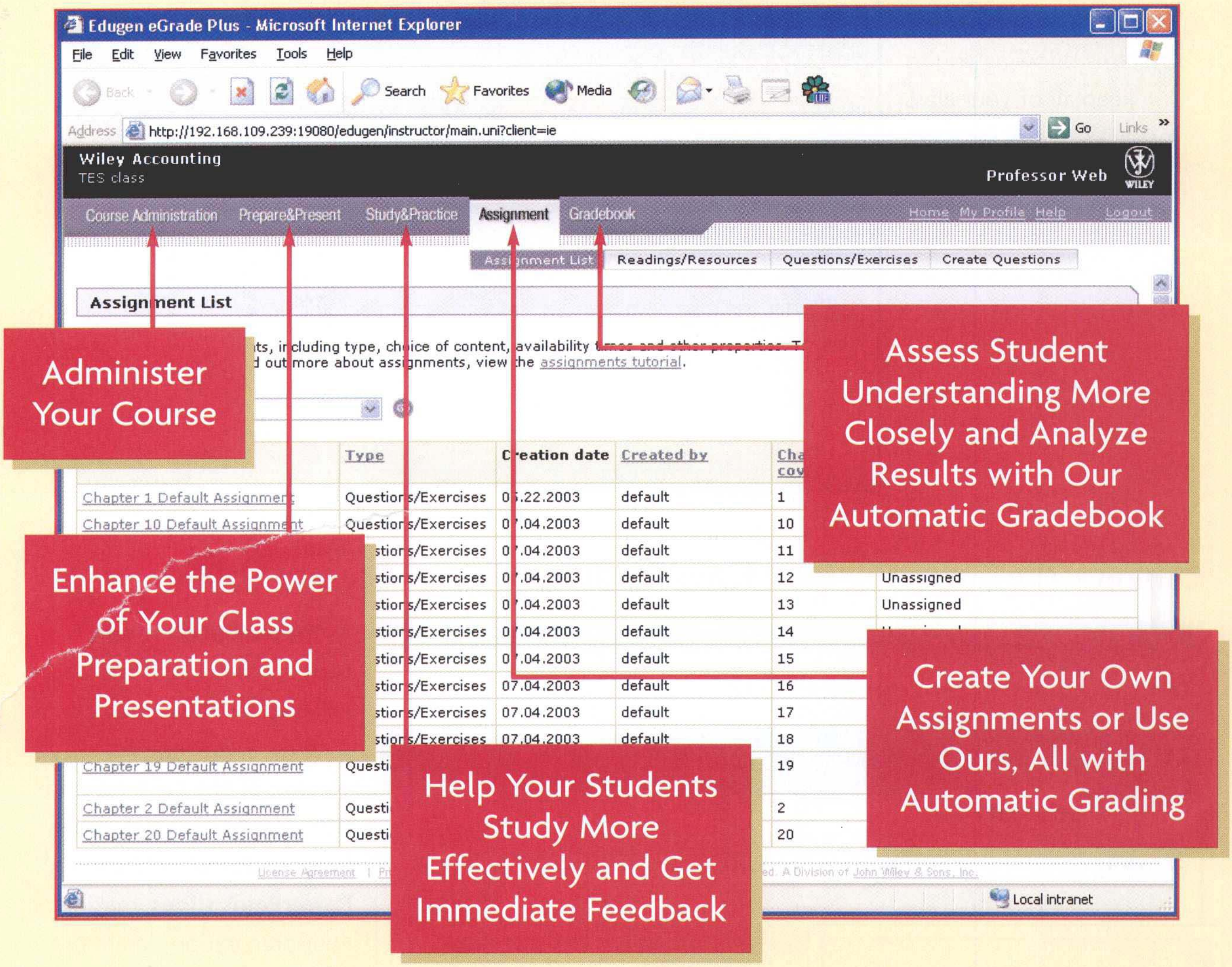

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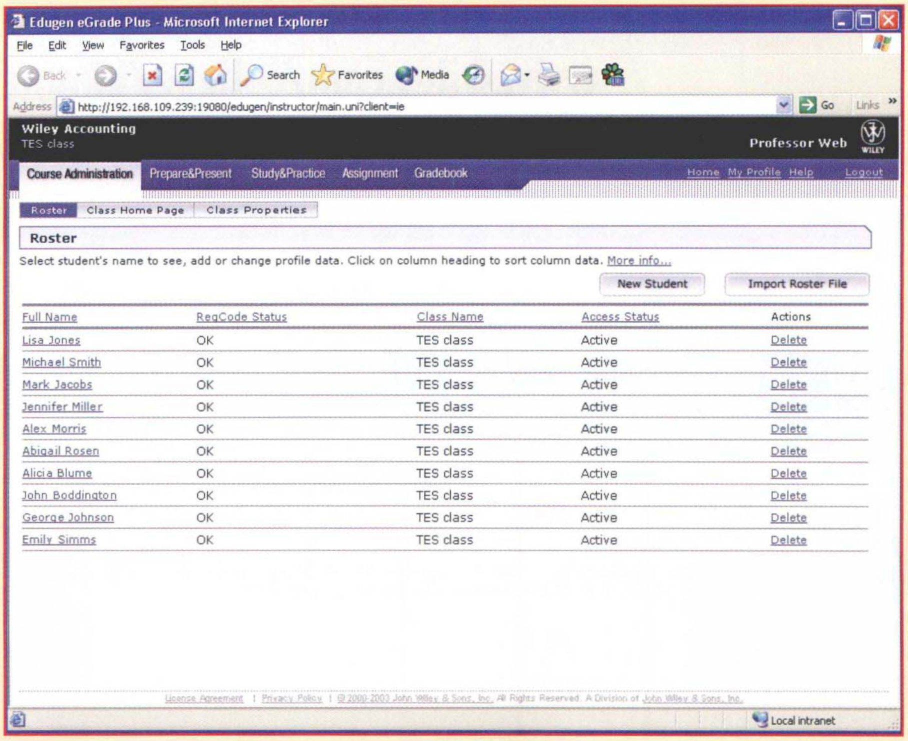

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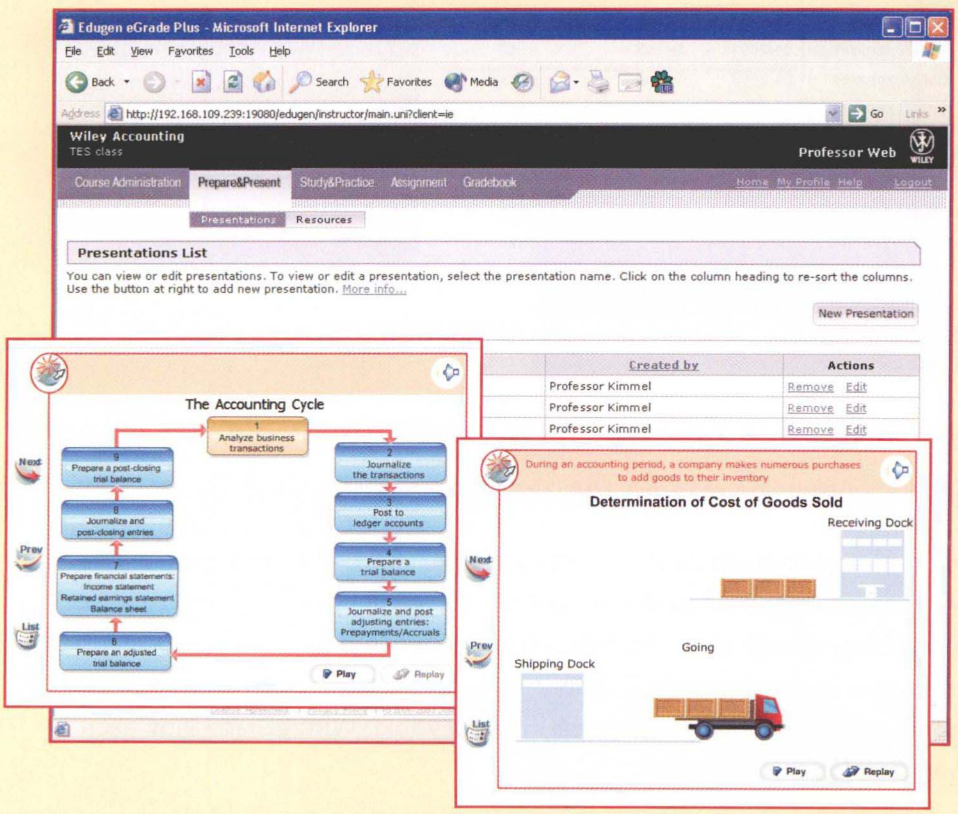

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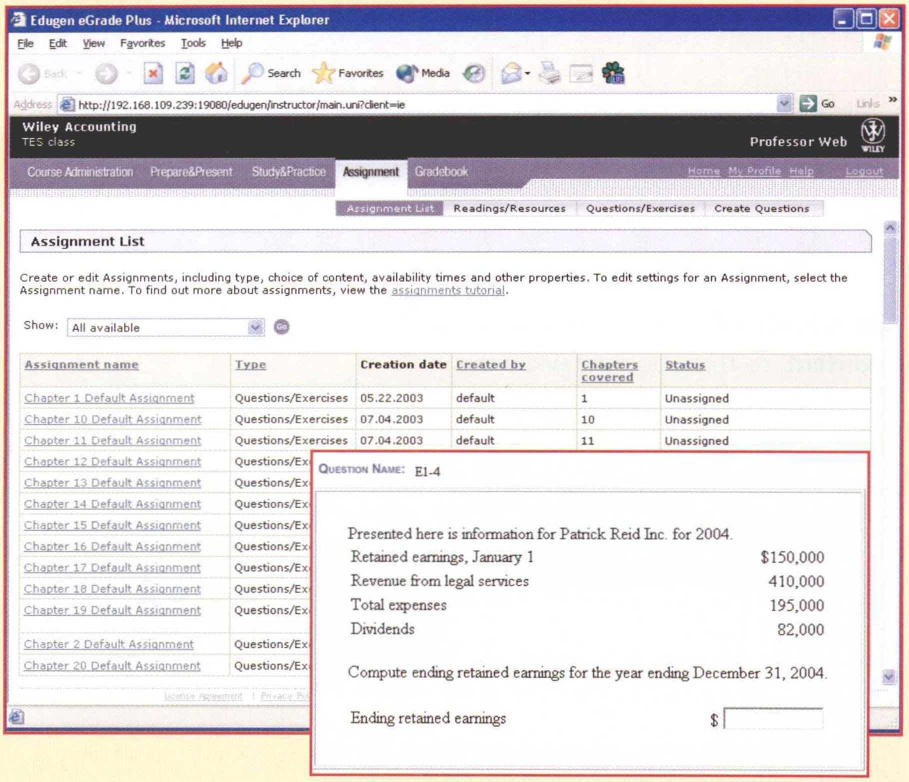

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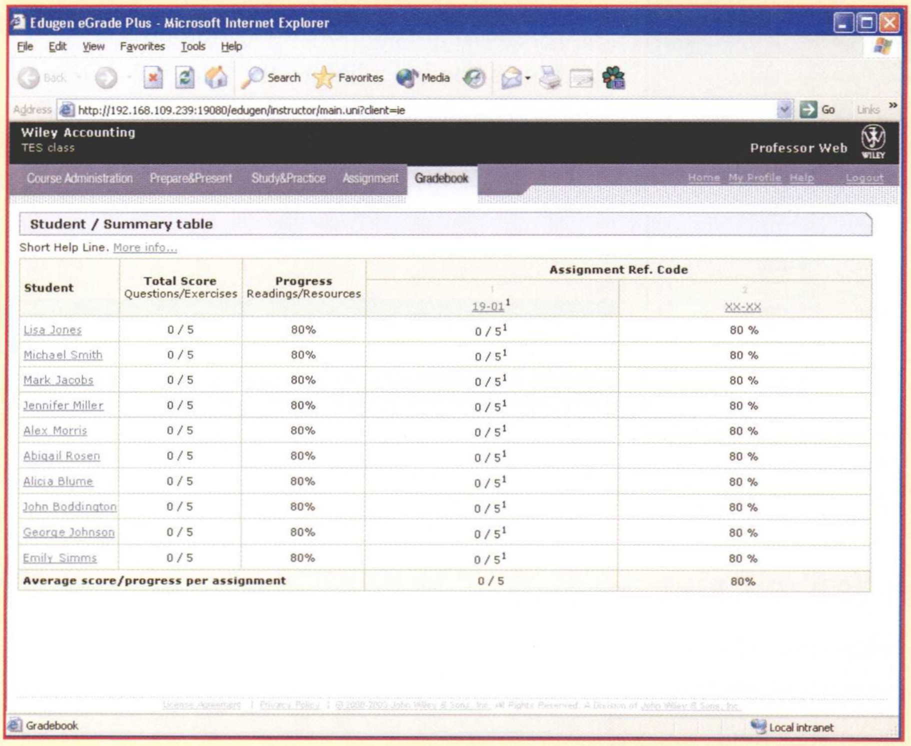

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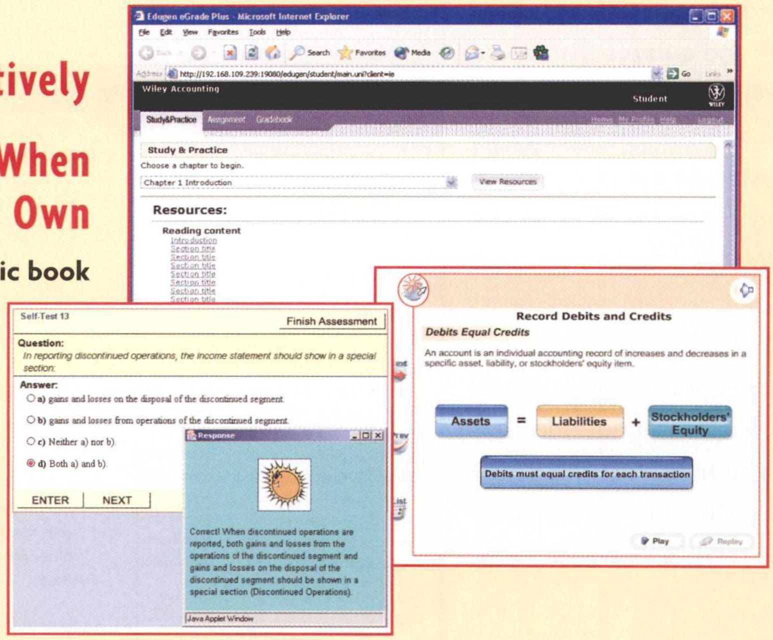

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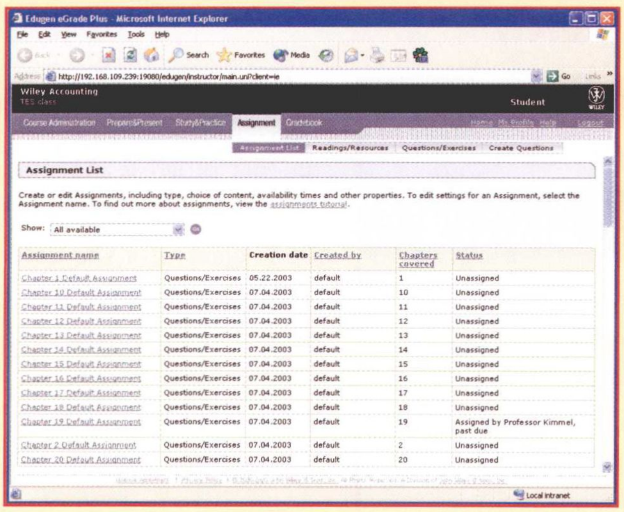

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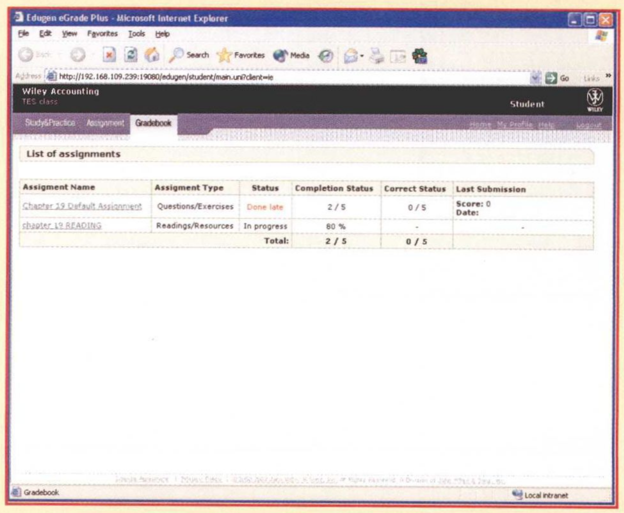

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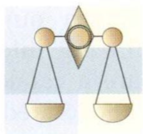
Donald E. Kieso, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of numerous other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, the AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, as Secretary-Treasurer of the American Accounting Association and on several corporate boards. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, and as a member of the Boards of Directors of Kishwaukee Community Hospital and Valley West Community Hospital. He served as a charter member of the national Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvoso Award of Merit, and the NIU Foundation's Humanitarian Award for Service to Higher Education.

The goal of this text is to introduce students to accounting in a way that demonstrates the importance of accounting to society and the relevance of accounting to their future careers. We strive to teach students those things that they really need to know and to do it in a way that maximizes their opportunities for successful completion of the course. To accomplish these goals, the foundation of this text relies on a few key beliefs.



"It really matters." The failures of Enron, WorldCom, Arthur Andersen, and others has had devastating consequences. Our Business Insight—Ethics Perspective boxes, Ethics cases, video clips on the CD, and a number of our Feature Stories and Research Cases are designed to reveal accounting's critical role to society. In short, it has never been more clear that accounting really matters.

"Less is More." Our instructional objective is to provide students with an understanding of those core concepts that are fundamental to the use of accounting. Most students will forget procedural details within a short period of time. On the other hand, concepts, if well taught, should be remembered for a lifetime. Concepts are especially important in a world where the details are constantly changing.

Decision Checkpoints

"Don't just sit there—do something." The overriding pedagogical objective of this book is to provide students with continual opportunities for active learning. One of the best tools for active learning is strategically placed questions. Our discussions are framed by questions, often beginning with rhetorical questions and ending with review questions. Even our selection of analytical devices, called Decision Toolkits, uses key questions to demonstrate the purpose of each.

"I'll believe it when I see it." This text employs a "macro" approach in its first two chapters. That is, rather than start by showing how to record transactions, we instead use the first two chapters to teach students how to understand and use the real financial statements of **Tootsie Roll**, **Hershey**, and **Best Buy**. Many students determine their opinion of a course during the initial weeks. Students will be most willing to commit time and energy to a topic when they believe that it is relevant to their future career. By employing this macro approach, we clearly demonstrate the relevance of accounting during the period that students are forming their impression of the course.

"You need to make a decision." All business people must make decisions. Decision making involves critical evaluation and analysis of the information at hand, and this takes practice. We have integrated important analytical tools throughout the book. After each new decision tool is presented, we summarize the key features of that tool in a Decision Toolkit. At the end of each chapter, we provide a comprehensive demonstration of an analysis of a real company using the decision tools presented in the chapter.

"It's a small world." The Internet has made it possible for even small businesses to sell their products virtually anywhere in the world. Few business decisions can be made without consideration of international factors. To heighten student awareness of international issues, we have many references to international companies and issues and provide A Global Focus exercise in each of the financial accounting chapters.

TOOLS FOR STUDENT SUCCESS

Principles of Accounting provides many proven pedagogical tools to help students learn accounting concepts and apply them to decision making in the business world. This pedagogical framework emphasizes the *processes* students undergo as they learn. Turn to the **Student Owner's Manual** on page xx to see all the learning tools of the book in detail. Here are a few key features.

Learning How to Use the Text

- The **Student Owner's Manual**, p. xx, and notes in red in Chapter 1, explain to students how to take advantage of the text's learning tools to help achieve success in the course.
- A **Learning Styles Quiz**, p. xxix, includes tips on in-class and at-home learning strategies.
- **The Navigator** guides students through each chapter by pulling all the learning tools together into a learning system. Throughout the chapter, **The Navigator** prompts students to use the learning aids and to set priorities as they study.

THE NAVIGATOR

Understanding the Context

- **Study Objectives**, listed at the beginning of each chapter, reappear in the margins and again in the **Summary of Study Objectives**.
- A **Feature Story** helps students picture how the chapter topic relates to the real world of accounting and business and serves as a recurrent example.
- A **Chapter Preview** links the Feature Story to the major topics of the chapter and provides a road map to the chapter.

PREVIEW OF CHAPTER 5

Merchandising is one of the largest and most influential industries in the United States. Therefore, understanding the financial statements of merchandising companies is important. In this chapter you will learn the basics about reporting merchandising transactions. In addition, you will learn how to prepare and analyze a commonly used form of the income statement—the multiple-step income statement. The content and organization of the chapter are as follows.

MERCHANDISING OPERATIONS

Merchandising Operations	Recording Purchases of Merchandise	Recording Sales of Merchandise	Income Statement Presentation	Evaluating Profitability
• Operating cycles • Inventory systems—perpetual and periodic	• Purchase returns and allowances • Freight costs • Purchase discounts • Summary of purchasing transactions	• Sales returns and allowances • Sales discounts	• Sales revenues • Gross profit • Operating expenses • Nonoperating activities • Determining cost of goods sold—periodic system	• Gross profit rate • Profit margin ratio

TOOLS FOR STUDENT SUCCESS

Learning the Material

- Emphasis on accounting experiences of **real companies and business situations throughout**.

YAHOO!	YAHOO! INC. Balance Sheet (partial) (in thousands)	
	Long-term investments	
	Long-term investments in marketable securities	$580,418

- Four types of **Business Insight** boxes give students glimpses into how real companies make decisions using accounting information.
- **Color illustrations**, including **Infographics**, help students visualize and apply accounting concepts to the real world.
- **Before You Go On** sections provide learning checks (**Review It**) and mini demonstration problems (**Do It**). Questions marked with the **Tootsie Roll** send students to find information in Tootsie Roll's 2002 annual report that is both printed in and packaged with the book.

BEFORE YOU GO ON . . .

Review It

1. What are the major sections in a classified balance sheet?
2. What is the primary determining factor to distinguish current assets from long-term assets?
3. What was **Tootsie Roll**'s largest current asset at December 31, 2002? The answer to this question is provided on page 100.
4. Where is accumulated depreciation reported on the balance sheet?

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Cash Flows

- **Accounting Equation analyses** in the margin next to key journal entries reinforce understanding of the impact of an accounting transaction on the financial statements. They report the **cash effect** of each transaction to reinforce understanding of the difference between cash effects and accrual accounting.
- **Helpful Hints**, **Alternative Terminology**, and highlighted **Key terms and concepts** help focus students on key concepts as they study the material.
- **International Notes** provide a convenient way to expose students to international issues.
- **Decision tools** useful for analyzing and solving business problems are presented and then summarized in **Decision Toolkits**. A **Using the Decision Toolkit** exercise asks students to use the decision tools presented in the chapter and takes them through the problem-solving steps.

DECISION TOOLKIT

Decision Checkpoints	Info Needed for Decision	Tool to Use for Decision	How to Evaluate Results
Is the company maintaining an adequate margin between sales and expenses?	Net income and net sales	Profit margin ratio $= \frac{\text{Net income}}{\text{Net sales}}$	Higher value suggests favorable return on each dollar of sales.