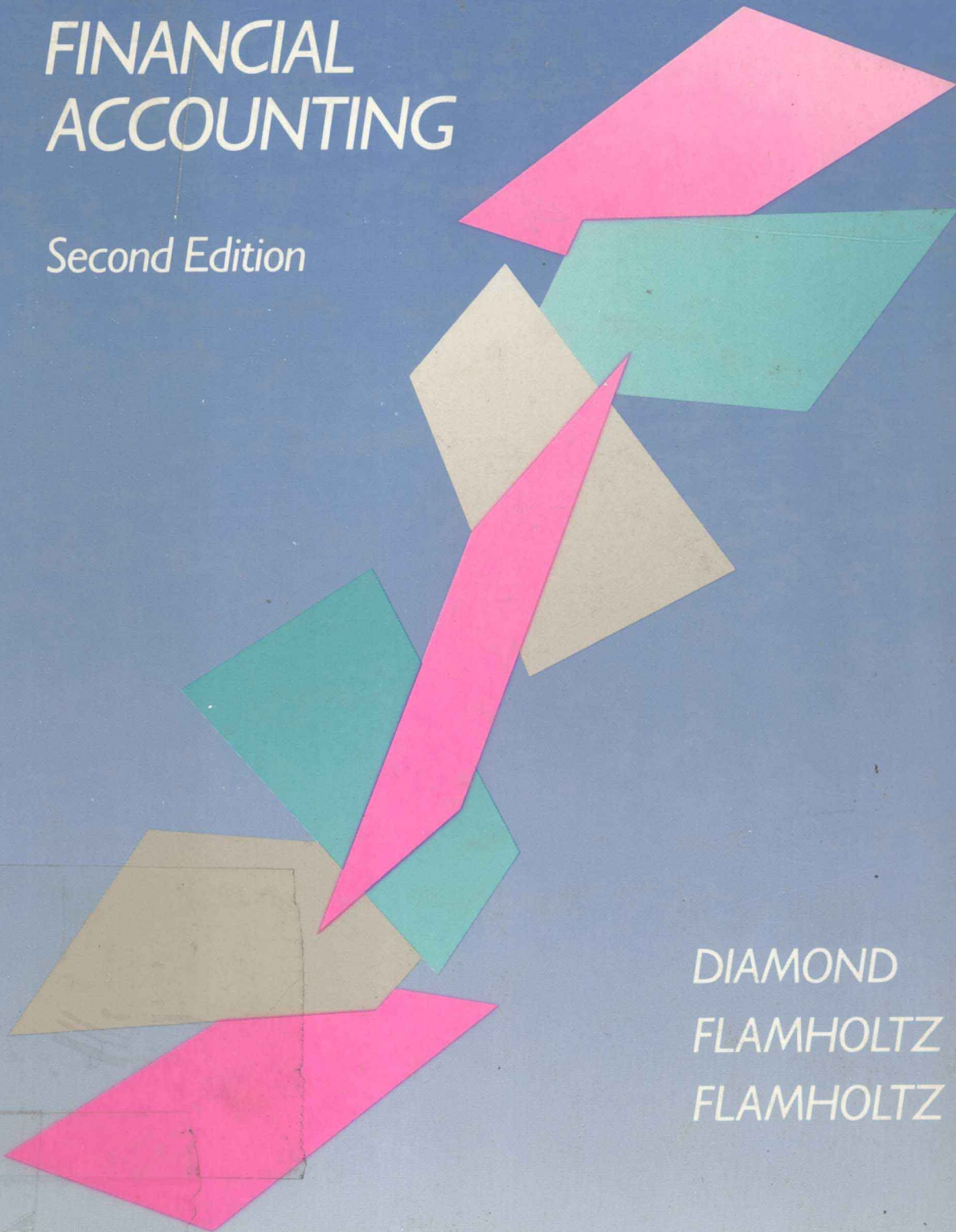


# FINANCIAL ACCOUNTING

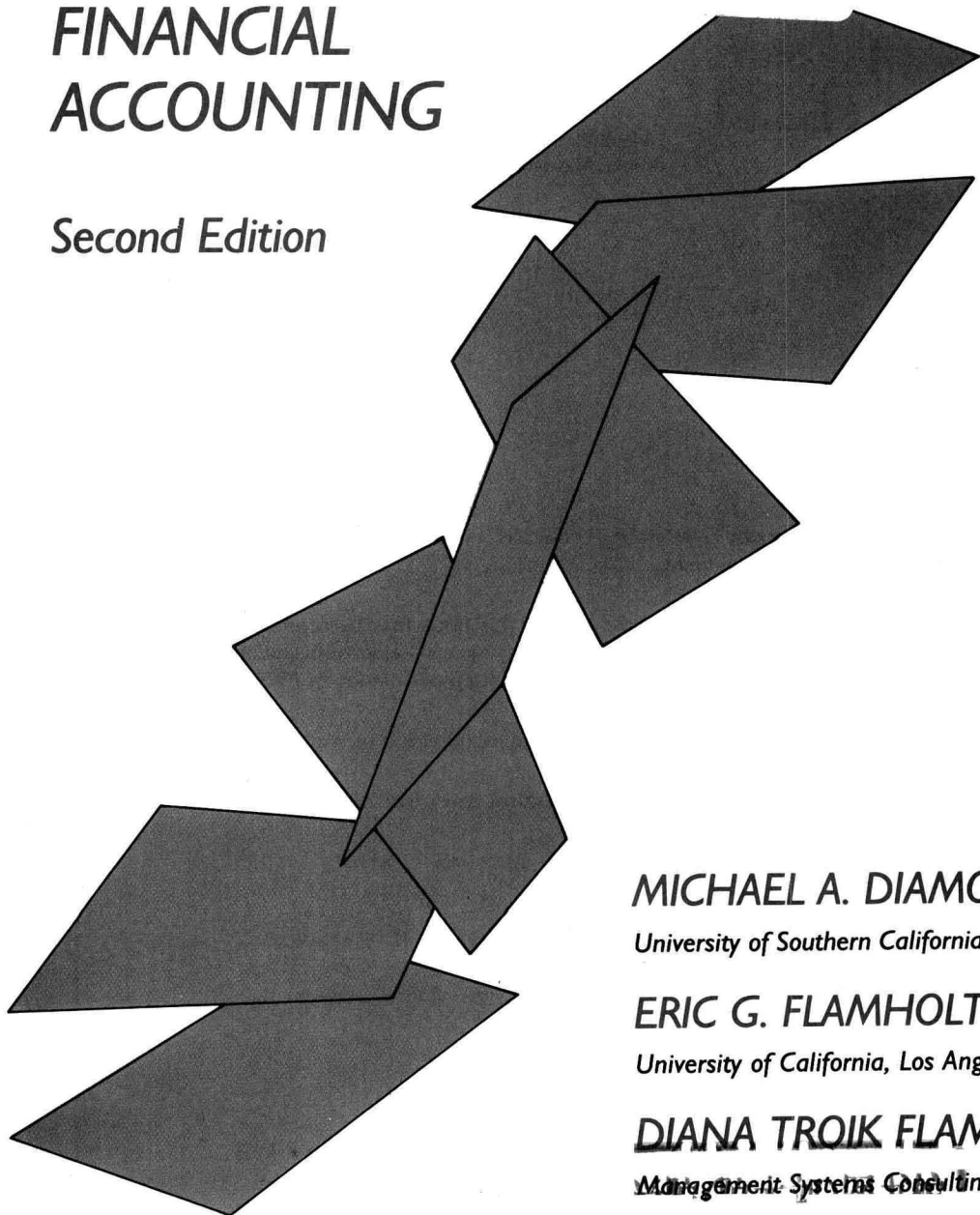
*Second Edition*



DIAMOND  
FLAMHOLTZ  
FLAMHOLTZ

# FINANCIAL ACCOUNTING

*Second Edition*



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# PREFACE

*Financial Accounting* is designed to be used in first-year accounting courses that cover one or two quarters or one semester. It presumes that the student has had no previous exposure to accounting. Because of the book's flexible organization, it can be used in introductory accounting courses at either the undergraduate or the graduate level.

As with the first edition of *Financial Accounting*, the second edition is based upon two premises. First, knowledge of accounting is important for all members of today's complex international economy, whether they are in industry, government, or professional accountancy. Therefore this book is written to meet the needs of the general student as well as of those who are prospective accounting majors. Second, accounting is an interesting subject, and we believe that the time spent in learning its concepts and practices should be enjoyable. For this reason, *Financial Accounting* is written in a highly readable, conversational style that will appeal to those students who often enter introductory accounting with a measure of trepidation.

In designing and writing this textbook, we were well aware that it must meet the needs of a wide range of students with varying interests and goals. Potential accounting majors must have a solid foundation in accounting concepts and practices if they are to complete their major requirements successfully. Other business majors, as well as nonbusiness majors, must be introduced to accounting concepts and practices in such a way that they can apply this knowledge to their various careers. To meet the needs of this diverse group, we have chosen the goal that all students should be able to read, understand, and reasonably interpret the financial statements contained in annual reports of major companies after completing their study of this text.

In addition to being an essential topic, we believe that accounting is fascinating. To complete successfully their first accounting courses, students spend many hours reading the text and preparing class materials. We have gone to considerable lengths to make this process interesting and enjoyable. The text includes extensive quotes from business journals such as *Forbes* and the *Wall Street Journal*, as well as many excerpts from actual financial statements and annual reports, to add realism and spark student interest. The financial statements of Toys "R" Us are used as an integrating force throughout the text. Whenever possible, we demonstrate the usefulness of specific accounting techniques so as to encourage further study.

## ■ CHANGES IN THE SECOND EDITION

The second edition of *Financial Accounting* has been revised to reflect current accounting changes and suggestions by various reviewers. However, like its predecessor, it has several features that aid student understanding: (1) balance between theory and practice; (2) emphasis on the use of accounting information in decision making; (3) contemporary theory and practice; (4) organizational flexibility; and (5) a complete and integrated learning package.

The second edition of *Financial Accounting* builds on the foundation of the first edition. Where appropriate, the text and end-of-chapter material have been updated to reflect current accounting standards. Thus, for example, the latest standards relating to deferred income taxes, consolidations, accounting for changing prices, and the statement of cash flows are explained at a level appropriate for an introductory book.

Several changes have been made to specific chapters. Chapter 7, “Management Control and Accounting for Cash,” has been completely revised. The chapter now contains an overview of management control and fraudulent financial reporting, built around the report of the Treadway Commission. Accounting for cash is then discussed, as an example of how internal controls are built into an accounting system. The material relating to special journals, which was in Chapter 7 in the first edition, has now been placed in Appendix A.

Chapter 8, “Accounting for Short-term Monetary Assets,” has been rewritten so that it includes only a short discussion of accounting for short-term investments but a more detailed discussion of accounting for receivables. This revised chapter is considerably shorter than the version in the first edition, which covered both cash and receivables in detail.

Chapter 13, “Corporate Organization and Capital Stock Transactions,” has been reorganized. It now contains a discussion of treasury stock transactions that was previously in Chapter 14, “Stockholders’ Equity—Retained Earnings and Dividends.” The order of material in Chapter 14 has been rearranged. The discussion of corporate income statements has been moved from the first part of the chapter to the second part. Also, the material on earnings per share has been simplified.

Chapter 15, “Investment in Corporate Securities,” has been revised to reflect the new FASB statement on consolidations. In addition, the coverage of the preparation of consolidated financial statements has been reduced to a level more appropriate to an introductory book.

The last three chapters have been reordered. Chapter 16, “The Statement of Cash Flows,” has been completely rewritten to reflect the FASB’s new statement on cash flows. Both the direct and the indirect methods are illustrated. Because of the FASB’s preference for the direct method, however, this method is explained in more detail. We have moved the material on “Interpreting Financial Statement Data” from Chapter 18 to Chapter 17, and Chapter 18 now covers material related to special financial accounting problems. The title of the new Chapter 18 is “Accounting for Changing Prices and Problems Related to Multinational Corporations.”

## ■ FEATURES

The second edition of *Financial Accounting*, like its predecessor, has several features that aid student learning and understanding: (1) balance between theory and practice; (2) emphasis on the use of accounting information in decision making; (3) contemporary theory and practice; (4) organizational flexibility; and (5) a complete and integrated learning package.

## ■ BALANCE BETWEEN THEORY AND PRACTICE

In writing this textbook, we carefully planned a blend of theory and practice that meets the needs of all its users. Financial statements and major accounting concepts are introduced in Chapter 1, before students are exposed to the mechanics of the accounting cycle. Details of the accounting cycle are explained patiently in Chapters 2 through 4. In Chapter 5, attention is turned back to the financial statements, and the actual financial statements of Toys “R” Us are first introduced to explain and illustrate key points. Throughout these chapters on the accounting cycle, the ongoing example of the Hartman Flower Company is used to illustrate relevant accounting concepts and procedures.

The remaining chapters are designed to reflect the proper balance between concepts and practice. For example, in Chapter 10, “Property, Plant, and Equipment; Natural Resources; and Intangible Assets,” the concepts behind these topics are ex-

plained fully before the various depreciation methods are illustrated. In Chapter 16, “The Statement of Cash Flows,” the uses and purposes of this statement are explained completely before the student is led carefully through an example illustrating its preparation. Other chapters are designed in a similar fashion.

## ■ EMPHASIS ON USING ACCOUNTING INFORMATION IN DECISION MAKING

In this text, we consistently approach accounting as an information system that provides useful financial data. This concept of accounting emphasizes its purpose in providing information for decisions rather than solely for its measurement procedures in recording, classifying, and summarizing financial information.

The emphasis on decision making is reflected in many of the features incorporated in the text. Ratios and other analytic tools are introduced at appropriate points in the specific chapter dealing with the related accounting concept. Chapter 17, “Interpreting Financial Statement Data,” then draws all these ratios and tools together. However, this chapter does more than summarize ratio analysis; it shows students how they can use data from a variety of sources to analyze and interpret the financial statements of companies.

At the end of each chapter, in addition to a wide variety of other assignment material, we have added an “Understanding Financial Statements Problem” and a “Financial Decision Case.” In these problems and cases, students are placed in the role of decision makers and are asked to analyze and interpret financial statements and quantitative data.

Management’s role in the selection of accounting principles and in the preparation of the firm’s financial statements is emphasized throughout the text. For example, the chapters that cover inventory methods, depreciation methods, leases, and purchase versus pooling all discuss the various effects that different methods can have on a firm’s financial statements, which management must consider when choosing among these different approaches.

## ■ CONTEMPORARY THEORY AND PRACTICE

The second edition of *Financial Accounting* is contemporary in all respects. Where appropriate, current official pronouncements of authoritative accounting bodies are referenced. Because of its predominance in our economic system, the corporate form of business is the focus throughout. Problem material reflects our current economic environment, with emphasis on service and technology companies. Where appropriate, reference is made to current economic events such as mergers of major companies, the RJR Nabisco buyout, the purchase of Pillsbury by Grand Metropolitan, and the General Motors–Toyota joint venture.

The treatment of four particular topics—accounting for changing prices, international accounting, taxation, and computers—shows how up-to-date the text is. Chapter 18 contains clear, concise, and up-to-date coverage of two of the most perplexing problems facing the accounting profession—accounting for changing prices and international accounting. The coverage of inflation accounting in Chapter 18 reflects the changes made by FASB Statement No. 89. However, the effects of changing prices are not treated as an isolated subject; they are also discussed in other parts of the book, such as the chapter on inventories (Chapter 9) and the chapter on property, plant, and equipment (Chapter 10).

The second part of Chapter 18 discusses international accounting. The particular topics covered include accounting for foreign currency transactions, the translation of foreign currency statements, and international accounting standards. The coverage of these topics helps schools meet the current standards of the American Assembly of Collegiate Schools of Business regarding the coverage of international topics.

These topics are covered with the full understanding of both their complex nature and the fact that this is an introductory textbook. Thus students will gain an understanding of these international topics, as well as accounting for changing prices, without becoming overburdened by detail more appropriate to intermediate and advanced courses.

The effects of taxes on the firm's financial statements are discussed in the various chapters in which the relevant accounting principle is discussed. Thus the effects of income taxes are discussed in the chapter on inventories (Chapter 9) and in the chapter on property, plant, and equipment (Chapter 10). Chapter 11, on current liabilities, contains a discussion of interperiod income tax allocation at a level that is appropriate to an introductory textbook. Chapter 14 contains a discussion of intraperiod income tax allocation. This treatment reflects our view that income tax consideration plays an important role in management decisions and should be discussed when those decisions are covered, not in a separate chapter.

## ■ ORGANIZATIONAL FLEXIBILITY

*Financial Accounting* is written with the full understanding that accounting instructors have various teaching styles and different approaches to the subject. Also, even over a short period of time, the makeup of individual classes changes, and a text must have the flexibility to meet such changes.

The eighteen chapters in this book can be divided easily into three primary parts; two of them, covering the first fifteen chapters, contain the essential elements of an introductory course. The first part (Chapters 1 through 7) contains a complete explanation of the accounting cycle, as well as a chapter on accounting for merchandising firms (Chapter 6) and a chapter on management control (Chapter 7). These last two chapters can be omitted or covered in part without interrupting the flow of the text. However, as noted, Chapter 7 is quite contemporary in nature and contains a discussion of fraudulent financial reporting and ethnics.

The next eight chapters make up the second part, a comprehensive discussion of the various financial accounting concepts and practices that both accounting and non-accounting majors should know. However, a considerable amount of flexibility is built into these chapters. For example, the end of Chapter 11, on current liabilities, contains a complete discussion of compound interest and present-value topics. If the instructor desires, this part of the chapter can be omitted.

The third part of this book contains chapters on (1) the statement of cash flows, (2) interpreting financial statements, and (3) accounting for changing prices and international accounting. Depending on the preference of the instructor and the amount of time available, some or all of the topics in the last three chapters can be covered. As previously noted, relevant discussions of ratio analysis and accounting for changing prices are contained in other chapters. The statement of cash flows is introduced in Chapter 1 and discussed again in Chapter 5. Therefore, if there is not enough time available to cover these last three chapters, the student will still have been introduced to some of the topics contained in them.

Finally, two appendixes cover more procedural matters. One contains a discussion of special journals; the second contains an overview of accounting for sole proprietorship and partnerships.

## ■ A COMPLETE AND INTEGRATED LEARNING PACKAGE

This text and the complete student's and instructor's support packages have been designed as an integrated unit.

## ■ PEDAGOGICAL FEATURES

We have gone to great lengths to design a pedagogically sound textbook. Each of the chapters contains a set of learning objectives at the beginning and a summary of these objectives at the end of the chapter. Each chapter concludes with the following end-of-chapter material: a list of Key Terms, Problem or Problems for Review, Questions, Exercises, Problems, Understanding Financial Statement Problems, and Financial Decision Cases. Beginning with Chapter 8, there are problems entitled Using the Computer.

## ■ LEARNING OBJECTIVES

Each chapter is preceded by a concise set of learning objectives. These objectives clearly indicate to the students what they should be able to accomplish after studying the chapter. Then each of these objectives is summarized in paragraph form at the end of the chapter.

## ■ KEY TERMS AND GLOSSARY

At the end of each chapter is a list of key terms discussed in that chapter. These terms are highlighted in **boldface** where they are introduced in the chapter. At the end of the book, in Appendix E, is a complete glossary of these key terms, arranged alphabetically for easy use.

## ■ PROBLEMS FOR YOUR REVIEW

At the end of each chapter is at least one review problem (in many cases two or three), emphasizing key points in the chapter. These problems are followed by detailed solutions, so that the students can compare their solutions with the correct one. Many review problems contain notes that anticipate student questions or problem areas.

## ■ END-OF-CHAPTER ASSIGNMENT MATERIALS

This text contains a varied set of end-of-chapter assignment materials. *Questions* relate to the major concepts and key terms introduced in the chapter. *Exercises* involve single concepts and provide the student with practice in applying those concepts. These Exercises, as well as the Questions, are arranged in the same order in which the material is introduced in the chapter.

Exercises are followed by *Problems*. These end-of-chapter Problems are more complex and usually cover several related topics. They are generally arranged in the order in which the topics are presented in the chapter. In the second edition, the end-of-chapter material has been expanded. Many of the exercises and problems have been revised, and new ones have been added. Each chapter now contains an exercise related to the Toys “R” Us financial statements.

As noted, each chapter also contains a problem called *Understanding Financial Statements*; a *Financial Decision Case*, and (beginning with Chapter 8) a problem entitled *Using the Computer*. Understanding Financial Statements problems are based on actual financial statements of major corporations. Students are asked to interpret these statements, relating subjects learned in the chapter to realistic situations. In the Financial Decision Cases, students are asked to analyze and interpret financial data and address business decisions based on this data. Using the Computer problems are straightforward exercises that are specially designed to be worked on any available spreadsheet. These problems introduce students to accounting calculations and problems that are readily adaptable to the power of spreadsheet programs.

## ■ THE STUDENT SUPPORT PACKAGE

The student support package contains a *Study Guide*, *Working Papers*, *Practice Set*, and a *Computerized Accounting Simulation*.

### ■ THE STUDY GUIDE

Prepared by Lawrence A. Klein of Bentley College, the Study Guide helps students develop the ability to apply concepts and techniques discussed in the main text. Each chapter corresponds to a text chapter, and contains an extensive chapter summary as well as fill-in the blank, multiple choice questions, and short answer problems that students can use to test their knowledge of text topics. The answers to all these questions and exercises, with complete explanations, are provided for the student.

### ■ WORKING PAPERS

Prepared by Raj Iyengar of University of Southern California, partially completed working papers are provided for each problem. They are designed to reduce the amount of nonproductive pencil work required of the student.

### ■ PRACTICE SET

Virginia Equipment Company. Prepared by Harry Dickinson of Virginia Commonwealth University, this puts students in the role of decision maker by allowing a choice of accounting methods for completing various transactions. It is to be used after coverage of inventory and cost of goods sold.

### ■ ON GUARD, INC.: A COMPUTERIZED ACCOUNTING INFORMATION SYSTEM

Prepared by Earl Weiss and Don Raun of California State University, Northridge, this unique microcomputer supplement provides a flexible set of eleven modules that are tied to the text. Students are required to analyze transactions, enter items into the microcomputer general ledger accounting system, and output financial statements. The modules are designed to enable instructors either to use the program throughout the entire course as an ongoing supplement or to assign a traditional accounting cycle practice set. In addition, students may use "WHAT-IF" questions to see the effect of various changes on the outputs of the accounting system.

## ■ THE INSTRUCTOR'S SUPPORT PACKAGE

The instructor's support package includes a *Solutions Manual*, an *Instructor's Manual*, a *Test Bank* (in book and microcomputer forms), *Transparencies*, and a *Check Figures*, and an *Annual Report*.

### ■ SOLUTIONS MANUAL

Prepared by Raj Iyengar, the Solutions Manual contains detailed solutions to all questions, exercises, problems, and other end-of-chapter materials. Complete solutions, including all intermediate calculations, are provided.

### ■ INSTRUCTOR'S MANUAL

Prepared by Raj Iyengar, the Instructor's Manual has been designed as a useful teaching aid and resource guide for the instructor. A flow chart diagram approach is taken to illustrate concepts, with examples for class use provided. A matrix of end-of-chapter material, organized by learning objective, is included for each text chapter. Included in the matrix are all questions, exercises, and problems, with their estimated level of difficulty and time required for completion.

An overview of the end-of-chapter material is followed by a chapter outline, also organized by learning goals. Additional examples of key computations and illustrations have been developed for selected chapters.

## ■ TEST BANK

Prepared by Mark S. Bettner of Bucknell University, the Test Bank contains over 1,200 test items. Included for each chapter and Appendices A and B are approximately 15 fill-in-the-blanks, 30 multiple-choice questions, and 16 exercises. Detailed solutions to all questions are included at the end, including explanations and computations where applicable.

## ■ COMPUTERIZED TEST BANK

The same test material appearing in the printed Test Bank is available on disk for use with the IBM PC or compatible.

## ■ TRANSPARENCIES

Acetate transparencies for problems are in oversized type for easy readability and are available from the publisher to adopters of the text.

## ■ CHECK FIGURES

For the instructor, a checklist of key figures for appropriate exercises and problems is available in quantity from the publisher.

## ■ ANNUAL REPORT

Copies of the current Toys 'R' Us Annual Report are available free to adopters from the publisher. The actual annual report reinforces illustrations used in the text.

## ■ ACKNOWLEDGMENTS

The second edition of this text would not have been completed successfully without the help of many of our colleagues and friends. Although it is impossible to list all who have made a contribution, we would like to acknowledge those who have provided so much help and insight.

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M.A.D.  
E.G.F.  
D.T.F.

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