



Charles T. Horngren

Introduction to
FINANCIAL ACCOUNTING

2nd Edition

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To Professor Dudley W. Curry

Charles T. Horngren is the Edmund W. Littlefield Professor of Accounting at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his Ph.D. from the University of Chicago. He is also a recipient of an honorary DBA from Marquette University.

A Certified Public Accountant, Horngren served on the Accounting Principles Board for six years, the Financial Accounting Standards Board Advisory Council for five years, and the Council of the American Institute of Certified Public Accountants for three years. He is currently serving as a trustee of the Financial Accounting Foundation.

A member of the American Accounting Association, Horngren has been its President and its Director of Research. He received the Outstanding Accounting Educator Award in 1973, when the Association initiated an annual series of such awards.

The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award in 1975 and its Distinguished Professor Award in 1983. He is the first person to have received both awards.

Professor Horngren is also a member of the National Association of Accountants, where he was on its research planning committee for three years. He is a member of the Board of Regents, Institute of Management Accounting, which administers the Certified Management Accountant examinations.

Horngren is the author of three other books published by Prentice-Hall: *Cost Accounting: A Managerial Emphasis*, Fifth Edition, 1982; *Introduction to Management Accounting*, Sixth Edition, 1984; and *CPA Problems and Approaches to Solutions*, Fifth Edition, 1979 (with J. A. Leer).

Charles T. Horngren is the Consulting Editor for the Prentice-Hall Series in Accounting.

PREFACE

Introduction to Financial Accounting is the first member of a matched pair of books that provides full coverage of the essentials of financial and managerial accounting. The second book is *Introduction to Management Accounting*. In combination, the pair can be used throughout two semesters or three quarters of introductory accounting.

Introduction to Financial Accounting is a textbook for introductory accounting courses that presuppose no prior knowledge of accounting. It deals with important topics that all students of management should study. My goals have been to choose *relevant* subject matter and to present it *clearly* and *flexibly*. The book is oriented to the user of financial statements, but it does not neglect the needs of potential accounting practitioners.

Because financial accounting is so pervasive, an understanding of its uses and limitations is valuable whether the student eventually becomes a company president, a sales manager, a professional accountant, a hospital administrator or a politician. In particular, knowledge of accounting for business is worthwhile because all of us relate to companies in one or more of the following ways: investors, managers, customers, creditors, government regulators, observers, or critics.

A philosopher once said, "You have to know what something *is* before you know what it *is used for*. When you know what it is used for, then you can decide what changes deserve serious thought." *Introduction to Financial Accounting* describes the most widely used accounting theory and practice. Emphasis is on *what accounting is* rather than *what it should be*. After all, beginning students must know what accounting today is really like before they can make judgments as to what changes in practice are desirable. Ample consideration is given to proposed changes in accounting throughout the book (especially in Chapter 14 on inflation and in Chapter 16 on the conceptual framework), but the thrust is toward understanding generally accepted theory and practice.

This text stresses underlying concepts, but it makes them concrete

with profuse illustrations, many taken from corporate annual reports. Moreover, accounting procedures such as transaction analysis, journalizing and posting are given abundant consideration. In this way, the reader obtains a thorough grasp of the fundamentals of accounting. The study of concepts develops understanding of procedures, and the study of procedures enriches understanding of concepts.

Although this book does not try to be different just for the sake of being different, a major objective is to equip students with enough fundamental concepts and terminology so that they can comprehend a typical corporate annual report. It is a shame that so many students today, after taking one or two courses in accounting, are bewildered by the contents of an annual report. For example, they have little idea of what a consolidated statement is, what inflation accounting is, and what effects income taxes have on financial statements. These students deserve more relevant subject matter, even though no basic course will be able to prepare the student to understand annual reports in their entirety.

Flexibility has been a driving force in writing this book. Are you among the many instructors who favor solidifying the fundamentals by using lots of journal entries, T-accounts, work sheets, and special journals? Then see Chapters 4 and 5, including their appendixes, and the appendixes to Chapters 6, 8, and 15. Are you among the other instructors who favor downplaying the details and emphasizing concepts? Then consider skipping the material just cited, in whole or in part.

The flexibility of the book is illustrated by the heavy use of chapter appendixes. They give the instructor latitude in picking and choosing among various topics. In short, greater depth and breadth are available, depending on the preferences of the teacher. Moreover, parts of the bodies of some chapters can be omitted if desired. Prime candidates for exclusion can be found in Chapters 6–16. Examples are the following topics: any materials in Chapter 6, other than the valuation of accounts receivable, and the presentation of consolidated statements in Chapter 12.

A major feature is the use of the fundamental accounting equation as a central thread throughout the book for explaining new concepts and analyzing transactions. For example, consider the presentations in Chapter 9 on plant assets, Chapter 10 on bonds, Chapter 12 on intercompany investments, Chapter 13 on interperiod income tax allocation, and Chapter 15 on the statement of changes in financial position. Such presentations give instructors immense latitude. They can use journal entries, or T-accounts, or the balance sheet equation format *exclusively*, if desired. Indeed, if time is short, quick introduction to financial accounting can be achieved by skipping Chapters 4 and 5 entirely and presenting the latter topics by concentrating solely on the balance sheet equation.

Additional features of this book include attempts to spark the reader's curiosity from the outset by:

1. Introducing financial statements of actual companies in Chapter 1.
2. Integrating a few financial ratios in an appendix to Chapter 2, a few more in Chapter 3, a few more in Chapter 7, and so on, rather than relegating all such matters of interpretation of financial statements to the rear of the book.
3. Introducing simple income tax aspects in Chapter 3 rather than later. Income taxes are not only important, they stimulate reader interest.

4. Providing a solid conceptual foundation in the first three chapters before covering the mechanics of journals, ledgers, and related procedural matters in Chapters 4 and 5. Instructors who prefer to use debits and credits from the outset may assign appropriate parts of Chapters 4 and 5 in conjunction with Chapters 1, 2, and 3. A few instructors in short courses may prefer to skip Chapters 4 and 5 in part or in entirety.
5. Highlighting such vital subjects as the Foreign Corrupt Practices Act (Chapter 8), accounting for changing prices (Chapter 14), and the FASB search for a conceptual framework (Chapter 16).
6. Using a minimum of technical detail to introduce relatively complicated subjects and allowing chapter appendixes to examine the subjects in more depth. Examples are LIFO-FIFO in Chapter 7, compound interest in Chapter 10, changing prices in Chapter 14, and the statement of changes in financial position in Chapter 15.
7. Using published financial information as a basis for sections of assignment material in each chapter.
8. Presenting a set of learning objectives at the beginning of each chapter.

ALTERNATIVE WAYS OF USING THIS BOOK

Texts are fundamentally teaching instruments. Teaching is highly personal and heavily influenced by the backgrounds and interests of assorted students in miscellaneous settings. To satisfy this audience, a book must be a pliable tool, not a straitjacket.

In my opinion, the first eleven chapters plus Chapter 15 (Statement of Changes in Financial Position) provide the foundation for the field of financial accounting. These twelve chapters may be amplified by assigning other chapters in a variety of sequences that do not disrupt the readers' flow of thought. The most obvious candidates for insertion are:

- Chapters 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11 and any of 12–16.

↑	↑
8*	14
15	15
16	16

*The appendix on special journals

Chapter 8 deals with internal controls, cash, and special journals. The chapter appendix (special journals) may be assigned anytime after Chapter 5.

Chapter 15 may be assigned after Chapter 9 (or even after Chapter 5); it is placed near the end of this book because the statement of changes in financial position is an excellent vehicle for reviewing all the fundamentals of financial accounting.

ASSIGNMENT MATERIAL

As always, careful choices among the wide variety of assignment material in each chapter will slant the course toward various combinations of breadth and depth, theory and procedures, simplicity and complexity.

The assignment material contains sections called Understanding Published Financial Reports, which have exercises or problems that use information presented in actual corporate annual reports or news stories. In this

way, some major points in the chapter will be underscored by “real world” illustrations. Most of the annual reports used are relatively recent. However, many older annual reports contain examples of issues or concepts that continue to be pertinent.

Special review assignment material is contained in Chapters 5 and 16. In addition, some assignments in Chapters 12–16 tend to crystallize previous work. The review assignment material for Chapter 16 is especially noteworthy. It uses corporate annual reports as a basis for review of all parts of the course. These cases or problems provide a splendid test of the student’s overall comprehension. Their successful solution enhances a student’s confidence enormously, especially because he or she is dealing with real companies’ financial statements.

The front of the solutions manual contains several alternate detailed assignment schedules and ample additional suggestions to teachers regarding how best to use this book.

CHANGES IN THIS EDITION

Users of the first edition gave the assignment material high marks regarding quality, quantity, and range. They especially liked the references in the text and the assignment materials to actual companies. The second edition enhances the latter feature because it spurs student interest and enthusiasm. The assignment material for each chapter has been reorganized and enlarged. Noteworthy changes in the assignment material are:

- a. More, particularly basic exercises using actual companies and actual data.
- b. Simpler, as illustrated by the Fundamental Assignment Material.
- c. Additional alternate exercises and problems.
- d. New organization for easier use.

If they desire, instructors may use materials from the Understanding Published Financial Reports subgroups exclusively throughout a course and cover all the essentials of financial accounting. For example, instructors may assign relatively simple, straightforward homework in the Fundamental Assignment Material section by using only the subgroup called Understanding Published Financial Reports. These exercises demonstrate how a course in introductory accounting can stick to essentials even while using real-life numbers and organizations.

Although the Assignment Material received the heaviest reworking, all the chapters were thoroughly rewritten and updated. Consider the following examples of changes.

- a. New sections called Highlights to Remember and Accounting Vocabulary are in each chapter.
- b. Examples of actual companies are included in at least one Summary Problem for Your Review in each chapter.
- c. The sequence of topics was changed in Chapters 6 and 7 regarding receivables and inventories.
- d. Bank reconciliations are explained in the body of Chapter 8 instead of in the chapter appendix.
- e. Investments in bonds are considered in Chapter 12 (Investments) rather than Chapter 10 (Liabilities).

- f. The explanation of present value tables is in an appendix to Chapter 10 instead of at the end of the book.
- g. The extensive discussion of financial ratios in Chapter 5 has been condensed and shifted to Chapter 16.
- h. There is a relatively easy comparison in Chapter 15 of the focus on the changes in cash with the focus on the changes in working capital.

ACKNOWLEDGMENTS

Introduction to Financial Accounting is dedicated to Dudley W. Curry, who in 1980 became an emeritus professor at Southern Methodist University, where he won several awards for outstanding teaching. His work on this book has earned my highest praise and deepest gratitude. He read every word, improved many, added some, harmed none. He encouraged me to write this book, provided invaluable ideas and bountiful constructive criticism, and prepared the following supplementary aids: student guide, working papers, practice set, and test bank. In addition, he prepared and revised many problems.

I am also especially grateful to Jonathan Schiff for his review of the manuscript and his preparation of Instructor's Resource Outlines.

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My appreciation extends to my former colleagues, David O. Green, George H. Sorter, and William J. Vatter, who had an early marked influence on my approach to teaching elementary accounting.

For many years, Stanford professors have made heavy use of annual reports in the construction of assignment materials. My appreciation goes to the following companies for permission to use their corporate logos in this volume: Anheuser-Busch, Champion Spark Plug, Clark Equipment, Cluett Peabody, Crane Co., Delta Air Lines, E. I. DuPont de Nemours, Ferro Corp., Ford Motor Co., General Motors, Goodyear Tire and Rubber, Harrah's, Holiday Inns, Inland Steel, Johnson & Johnson, McDonald's, Milton Roy Co., Portland General Electric, PPG Industries, Ralston Purina, Savin Corp., Stauffer Chemical, and Xerox Corp. My colleagues, particularly James M. Patell, have been generous in allowing me to use some of their case materials. Many cases have been condensed or heavily adapted as homework problems for use in this book. The names of my colleagues are indicated in parentheses at the beginning of each item used.

Elsie Young has my special thanks for her skillful and gracious typing and related help. The following students ably performed assorted editorial chores: Dana Derebery, Coral Hand, Lynnette Haxton, Stephen Howard, Judith Osborne, Sarah Velz.

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Comments from users are welcome.

CHARLES T. HORNGREN

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