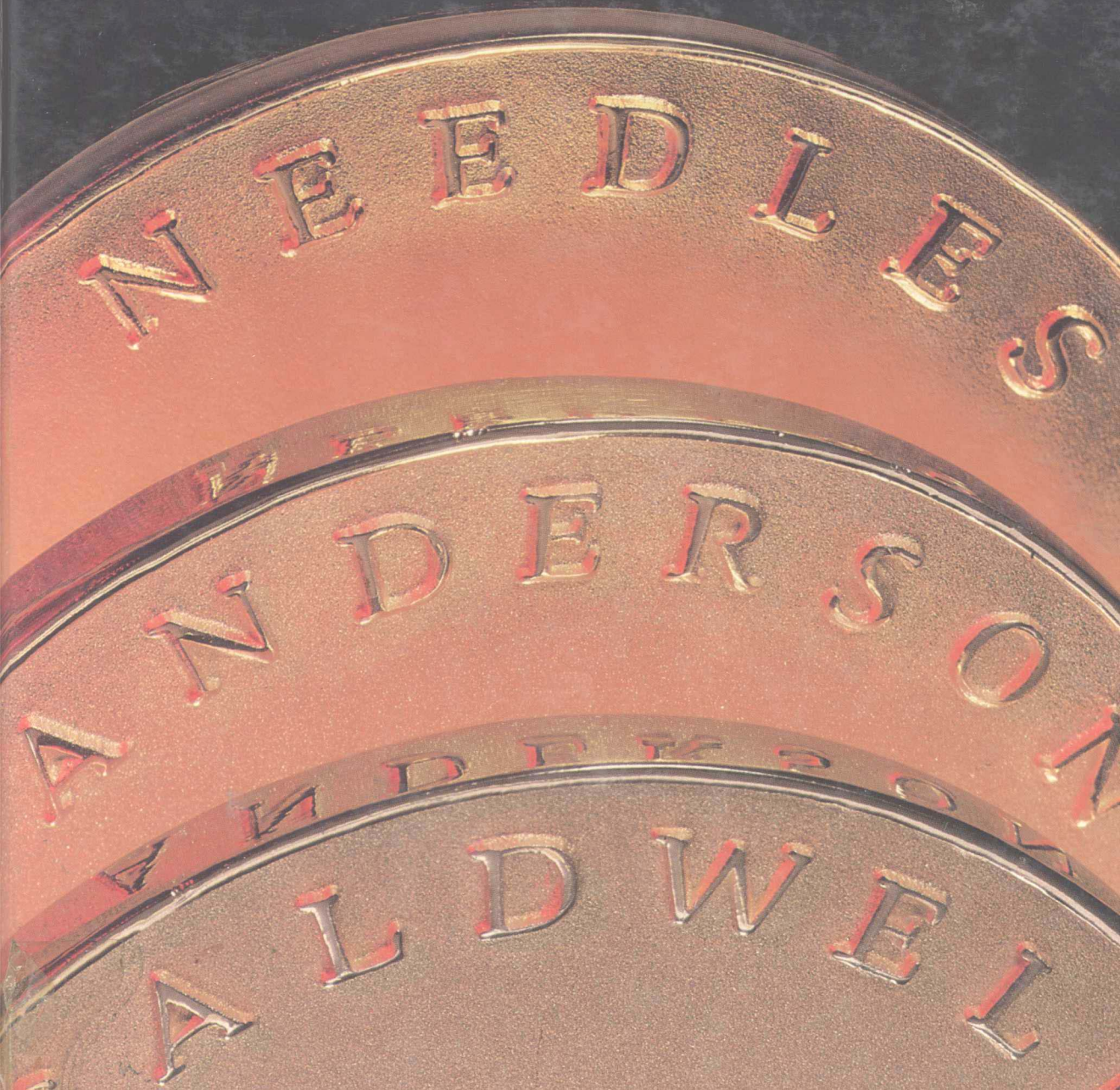

THIRD EDITION

PRINCIPLES OF ACCOUNTING



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To Marian Needles, and to Jennifer and Jeff

To Sue Anderson, and to Howard, Harold, and Hugh Anderson, and to
Deborah and Greg Shewman

To Bonnie Caldwell, and to Stephanie, Susan, and Sharon

This book is written to provide accurate and authoritative information
concerning the covered topics. It is not meant to take the place of
professional advice.

Cover photograph by James Scherer

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Street, Boston, MA 02108.

Printed in the U.S.A.

Library of Congress Catalog Card Number: 86-80401

ISBN: 0-395-35702-0

BCDEFGHIJ-RM-8987

PREFACE

PRINCIPLES OF ACCOUNTING, Third Edition, is a comprehensive first course in accounting for students with no previous training in accounting or business. It is intended for use in the traditional two-semester or two- and three-quarter sequence. Designed for both majors and nonmajors, the textbook is part of a well-integrated package for students and instructors that includes many manual and computer ancillaries not found in previous editions.

Goals of the Third Edition

We wrote this book believing that integrated learning objectives can significantly improve the teaching and learning of accounting. This system of learning by objectives enhances the role of the overall package and particularly the textbook in achieving good communication between the instructor and the student.

The success of the first two editions of this book has justified our confidence in the principle of learning by integrated objectives. At the same time, several goals guided us in developing and writing PRINCIPLES OF ACCOUNTING, Third Edition. Those goals were: (1) to write for the student's first exposure to accounting; (2) to extend learning by objectives to the entire package; (3) to make the content authoritative, practical, and contemporary; (4) to emphasize the role of accounting in decision making; (5) to adhere to a strict system of quality control; and (6) to develop the most complete and flexible package available.

The Student's First Exposure to Accounting

When organizing the text, we specifically focused on the needs of the intended audience, the freshman and sophomore student. First, we carefully paced new concepts and techniques to ensure that students would grasp and retain the material. Second, we limited the number of difficult concepts or practices in each chapter, particularly in the early part of the book. Third, we rigorously provided a clear presentation, a consistent reading level, and a uniform use of terminology throughout the text. Fourth, we focused on understanding, not memorization, believing that concepts acquire meaning when applied and practices become most easily understood when related to those concepts. Fifth, we emphasized concepts and practices useful to students throughout their careers, whether in accounting or not.

Learning by Objectives

We took a definite pedagogical approach to writing *PRINCIPLES OF ACCOUNTING*, Third Edition. We extensively used learning objectives and learning theory. Learning objectives were integrated throughout the text and package from the chapter previews and presentations to the assignment material, chapter reviews, study aids, and testing and evaluation material.

Authoritative, Practical, and Contemporary

This book presents accounting as it is practiced and carefully explains the concepts underlying those practices. Accounting terms and concepts are defined according to pronouncements of the AICPA, APB, and FASB. The Statements of Financial Accounting Concepts of the FASB's Conceptual Framework Study form the theoretical underpinning of the book and are used to assess various accounting situations and controversies. In addition, steps were taken to ensure that, to the extent possible within the framework of introductory accounting, the material realistically reflects the way accounting is done today.

The topics covered are up to date and responsive to current trends in business and accounting. Taxation, covered wherever it is relevant, and international accounting, in Chapter 21, are just two of the contemporary topics emphasized. In addition, complete coverage of the new proposed FASB statement of cash flows is contained in Appendix D.

Decision-Making Emphasis

Another of our goals was to present the contemporary business world and the real-life complexities of accounting in a clear, concise, easy-to-understand manner. Accounting is treated as an information system that helps managers, investors, and creditors make economic decisions. In addition to questions, exercises, and problems, the chapter assignments include two decision-oriented features: an "Interpreting Accounting Information" exercise and either a "Financial Decision Case" or a "Management Decision Case." In each situation, the student must extract quantitative information from the exercise or case and make an interpretation or a decision.

Quality Control

Together with our publisher, we developed a system of quality control for all parts of the package to ensure the most technically and conceptually accurate textbook and package possible. This system involved many steps, including thorough reviews by users, visits to and discussions with users by the authors, extensive in-house editorial review and accuracy checking, class testing, and finally an audit for technical and conceptual accuracy by the international CPA firm, Arthur Young & Company.

Complete and Flexible Learning System

We believe that *PRINCIPLES OF ACCOUNTING*, Third Edition, represents the most complete and flexible package available for a first course in

accounting. All parts of the package fit within the pedagogical system of learning by objectives established by the authors. This comprehensive learning is described in the following sections.

Organization of the Third Edition

The book is organized into seven parts so it may be used by schools on either a semester or quarter sequence. Those using the two-semester or two-quarter sequence may cover three parts during the first term and four parts during the second. Those using the three-quarter sequence may cover two parts in each of the first two quarters and three parts in the last quarter. If a shorter course is required, all or parts of chapters 4, 6, 13, 19, 20, 21, and 24 may be omitted or covered briefly without hindering comprehension of later chapters. For instructors wanting to introduce students to the present and future value of money or individual income taxes, appendixes on these subjects along with accounting examples and exercises are provided at the end of the text.

Textbook Features

Pedagogical Use of Color The text incorporates the use of a four-color design to enhance students' understanding of the accounting process. First, pedagogical features such as learning objectives, key terms, and emphasized material in the text are printed in red. Second, green is used to represent accounting forms and working papers that are all part of the ongoing process. Third, blue is used to emphasize the major headings in the chapter and to highlight the actual financial statements, the final product of the accounting process.

Learning Objectives Action-oriented objectives at the beginning of each chapter indicate in precise terms what students should be able to do when they complete the chapter. The objectives are stated again in the margins beside pertinent text. Each end-of-chapter review clearly relates each objective to the chapter's content, and end-of-chapter assignments are keyed to specific learning objectives.

Real-World Applications Many chapters include graphs or tables illustrating how the practices of actual businesses relate to chapter topics. Most Interpreting Accounting Information exercises are based on the published financial reports of real companies.

Key Terms and Glossary Throughout the book, key accounting terms are emphasized in bold, color type and are clearly defined in context. These terms are also assembled into a comprehensive glossary at the end of the book for easy reference.

Chapter Review A unique feature of each chapter is a special review section comprising: (1) a Review of Learning Objectives, which summarizes the chapter's main points in relation to the objectives; and (2) a Review Problem with a complete solution to demonstrate the chapter's major procedures before students tackle the exercises and problems. A Self-Test, which reviews the basic concepts covered in these early and crucial chapters is provided for Chapters 1–8. The Answers to the Self-Test provide immediate feedback to students.

Questions Discussion questions at the end of each chapter focus on major concepts and terms.

Classroom Exercises Classroom exercises provide practice in applying concepts taught in the chapter and are effective in illustrating lecture points. Each exercise is keyed to the learning objectives. In addition, transparencies are available for all exercise solutions.

Interpreting Accounting Information This feature asks the student to interpret published financial information in Chapters 1–21 and internal management reports in Chapters 22–28. Such reports and information are based on excerpts from actual annual reports or on published articles about well-known corporations or organizations. Among the companies included are K mart, Sears, U.S. Steel, Marathon Oil, Chrysler, Lockheed, and Federal Express. Each exercise requires students to demonstrate their ability to interpret published information by extracting data from what they read and by making a computation and interpretation.

A and B Problems We have included two sets of problems to provide maximum flexibility in homework assignments. Generally, the problems are arranged in order of difficulty, with problems A-1 and B-1 for each chapter being the simplest. A and B problems have been matched by topic, thus, A-1 and B-1, for example, are equivalent in content and level of difficulty. In addition, all problems are keyed to the learning objectives. For each problem, ratings of difficulty, time estimates, and solutions are available to the instructor as are transparencies of all solutions. Additional assignment material is provided in the Demonstration Problems Book.

Financial and Management Decision Cases Each chapter contains a case emphasizing the usefulness of accounting information in decision making. The business background and financial information for each case are presented in the context of a decision. The decision maker may be a manager, an investor, an analyst, or a creditor. In the role of decision maker, the student is asked to extract relevant data from the case, make computations as necessary, and make a decision.

Appendixes At the end of the book, we included appendixes on using present and future value as well as tables on compound interest and present value. Appendix C is an overview of income taxes for individuals.

Supplementary Learning Aids

The supplementary learning aids provide a variety of useful aids to students. They consist of the following:

Study Guide, also available in a Spanish edition
Working Papers, four sets, plus a set of Blank Working Papers
Demonstration Problems Book
Traditional Practice Sets, including
 Micro-Tec, Second Edition
 College Words and Sounds Store, Second Edition
 The Windham Company
 Sailsports—Cumulative Practice Set
 The Book Loft—A Shoebox Practice Set
 The Oak Shoppe—Audit Problem
Financial Analysis Cases, including
 General Mills, Inc.
 Richland Home Centers, Inc.
 Heartland Airways, Inc.
Computer-Assisted Practice Sets
 Parks Computer Company
 Matthew Sports Company
 Cook's Solar Energy Systems, Second Edition
 Sounds Abound
 Berger Automotive Company
 Stormer Painting Company
Microcomputer Business Simulations: Lawson's Supply Center
 General Ledger
 Cash
 Payroll
 Accounts Receivable
 Accounts Payable
Computerized Study Aids, including
 Lotus® Problems for Principles of Accounting
 TRICALC:™ Integrated Software for Principles of Accounting
 Computerized Study Guides, two different types
 Computerized Diagnostic Tests
Check List of Key Figures

Instructor's Aids

Instructor's Handbook
Instructor's Solutions Manual
Test Bank and Achievement Tests
Transparencies
Boxed Solutions Transparencies
Teaching Transparencies
Grade Performance Analyzer

Changes in the Third Edition

This new edition benefitted substantially from suggestions by the many users and reviewers who corresponded with us. Since satisfaction with the

approach and organization of the second edition was broad, changes in this third edition were primarily refinements and extensions of successful aspects of the previous edition. By careful editing and pruning, we streamlined the text, making it considerably shorter. The text was updated to reflect more recent data and changes in authoritative pronouncements. All retained exercises, problems, and cases were revised, and more than half are new. Quality control procedures were applied to the text, assignment material, and solutions.

Changes in the content of specific chapters are described below.

Chapter 1 Accounting as an Information System. Chapters 1 and 2 were combined, condensed, and integrated into a coherent introduction to accounting. The introduction to transactions was rewritten to show students more clearly how transactions affect the balance sheet equation and to present transactions in a format resembling that on a microcomputer. The illustrations were modified so they clearly identify the types of transactions that affect owner's equity.

Chapter 2 The Double Entry System. The section on T accounts was moved to a later point in the chapter for more logical presentation.

Chapter 3 Business Income and Adjusting Entries. The explanation on types of adjusting entries was clarified, and examples of companies with different fiscal years were added.

Chapter 5 Accounting for Merchandising Transactions. The discussion on the relationship between the periodic and perpetual inventory systems was rewritten.

Chapter 6 Accounting Systems and Special-Purpose Journals. The section on computer data processing was rewritten to give increased attention to microcomputers and how they are used in small business. Columns of the cash receipts and cash payment journals were rearranged into a more convenient format.

Chapter 7 Internal Control and Merchandising Transactions. The internal control system for purchases was revised to include a purchasing department and to introduce more realistic illustrations of bank statements.

Chapter 9 Short-Term Liquid Assets. The presentation of short-term investments was expanded and clarified.

Chapter 10 Inventories. The section on periodic versus perpetual inventory methods was rewritten and expanded for clarity and to show the parallel entries of the two methods.

Chapter 11 Current Liabilities and Payroll Accounting. Payroll tax rates were updated.

Chapter 12 Long-Term Assets: Acquisition and Depreciation. This chapter was shortened, primarily by moving the sections on disposal of depreciable assets and accounting for natural resources to Chapter 13.

Chapter 13 Long-Term Assets: Other Issues and Types. This new chapter covers capital and revenue expenditures, disposal of depreciable assets, natural resources, and intangibles.

Chapter 15 Contributed Capital. Accounting for cash dividends was moved from Chapter 16 to this chapter. Participating preferred stock, donations by nonstockholders, and donation of stock were deleted because the authors' study of 4,000 public corporations revealed few examples of these cases in practice. The topic of employee stock options was added because most public companies have such arrangements. Retirement of treasury stock and calculation of book value were moved to Chapter 16.

Chapter 16 Retained Earnings and Corporate Income Statements. Accounting for cash dividends was moved to Chapter 15, and retirement of treasury stock and calculation of book value were moved to this chapter. Chapter 16 was simplified by deleting computations of primary and fully diluted earnings per share and by reducing coverage of corporate income taxes. The section on deferred income taxes was rewritten for simplicity and clarity. The statement of changes in stockholders' equity was substituted for the statement of retained earnings.

Chapter 17 Long-Term Liabilities. The contemporary topics of zero-coupon bonds and early extinguishment of debt were added to this chapter.

Chapter 18 Statement of Changes in Financial Position: Working Capital and Cash Bases. A substantial portion of this chapter was rewritten to give increased emphasis to the cash basis approach. In addition, the T account method is presented as an alternative to the work sheet approach.

Chapter 19 Financial Statement Analysis. A new discussion of accounting issues relative to evaluating the quality of a company's earnings was added.

Chapter 20 Intercompany Investments. This chapter was simplified by moving international accounting to Chapter 21.

Chapter 21 Inflation Accounting and International Accounting. This new chapter combines two important topics related to accounting and the changing value of the dollar, both domestically and internationally.

Chapter 22 Introduction to Management Accounting. Two new introductory sections were written for this chapter to ease the transition from financial accounting to managerial accounting. All managerial accounting chapters were streamlined. In certain cases, extensions of the subject matter were removed to make these chapters easier to cover. For example, in this chapter the work sheet using periodic inventories was removed and placed in an ancillary case, *The Windham Company*.

Chapter 23 Product Costing: The Job Order System. The work sheet using perpetual inventories was removed and placed in an ancillary case, *The Windham Company*.

Chapter 24 Product Costing: The Process Cost Accounting System. The FIFO method was shortened in favor of the more popular Average method. The Unit Cost Analysis Schedule was simplified.

Chapter 25 Cost Planning and Control Tools. The High-Low method of separating variable and fixed costs was introduced.

Chapter 26 Budgetary Control: The Planning Function. To simplify the chapter, the section on nonprofit and public sector information was deleted. The topic of detailed period budgets was expanded.

Chapter 27 Cost Control Using Standard Costing. The section on cost control for nonprofit and public sector organizations was deleted. A new figure was added to illustrate materials variance analysis, and all major formulas are highlighted in the text.

Chapter 28 Capital Budgeting and Other Management Decisions. The section covering desired rate of return on investment was deleted, and the section on income taxes and business decisions was rearranged.

Appendix D The Statement of Cash Flows. Provides complete coverage of the new FASB proposal.

ACKNOWLEDGMENTS

An introductory accounting text is a long and demanding project that cannot really succeed without the help of one's colleagues. We are grateful to a large number of professors and other professional colleagues as well as students for constructive comments that have led to improvements in the text. Unfortunately, space does not permit us to mention all those who have contributed to this volume.

Some of those who have been supportive and who have had an impact on the third edition are:

Professor Jean Redfern
Golden West College

Professor Anne C. Baucom
*University of North Carolina—
Charlotte*

Professor George Holdren
University of Nebraska

Professor Roger Hehman
University of Cincinnati

Professor Linda Benz
Jefferson Community College

Professor Wilfred Beaupre
San Juan College

Mr. William Evans
Cerritos College

Professor Gregory Bischoff
Houston Community College

Professor Ken Winter
University of Wisconsin

Professor William Costello
Harcum Junior College

Professor Juan Rivera
University of Notre Dame

Professor Harold L. Royer
Miami-Dade Community College

Professor Ken Coffey
Johnson County Community College

Professor Arthur Hirschfield
Bronx Community College

Professor Rhonda Kodjayan*Mundelein College***Professor Raymond Green***Texas Tech University***Professor David A. Skougstad***Metropolitan State College***Professor Ronald N. Savey***Western Washington University***Professor Nancy Magrone***Delaware Technical and Community
College***Professor Joseph Doser***Truckee Meadows Community College***Professor Jarvis Dean***Chattanooga State Technical
Community College***Professor Greg Merrill***University of San Diego***Professor John R. Stewart***University of Northern Colorado***Professor Kenneth Hart***Ricks College***Professor Thomas Forsythe***Brown University***Professor Esther Grant***Hillsborough Community College***Professor Joe Schliep***Normandale Community College***Professor Gilroy Zuckerman***North Carolina State University***Professor Mark Kiel***North Carolina Agricultural and
Technical State University***Professor Joseph Aubert***Bemidji State University***Professor Frank Falcetta***Middlesex Community College***Professor Richard Cross***Bentley College***Mrs. Judy Hansen***Waukesha County Technical Institute***Professor Alice James***Meridian Junior College***Dr. DuWayne Wacker***University of North Dakota***Professor William McClung***Tarrant County Junior College***Dr. Richard B. Watson***University of California—
Santa Barbara***Professor Martin J. Canavan***Skidmore College***Professor Robert Wennagel***College of the Mainland***Professor Albert Arsenault***Hillsborough Community College***Professor Margaret Griffith***Cape Cod Community College***Professor D. Dale Bandy***University of Central Florida***Ms. Donna Randall Lacey****Ms. Kim Lazar**

We would also like to acknowledge the assistance of Arthur Young & Company, Boston, who reviewed the entire text and solutions manual to ascertain that the presentation is up-to-date and accurate. We are especially indebted to Bruce Bezanson, Peter Kronenberg, Margaret Kelly, Paul Corrigan, Annette Bongiorno, Mark Goodwin, Patricia Hord, Ann Marie Meyler, Jeff Rosenberg, Raymond Sullivan, and Teresa Yu.

Without the help of these and others, this book would not be possible.

B.E.N. H.R.A. J.C.C.



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We have examined the text of Principles of Accounting, Third Edition, by Needles, Anderson, and Caldwell, together with its accompanying Instructor's Solutions Manual. Our examination, which was directed at this work's technical and mathematical accuracy, internal consistency, and the appropriateness and accuracy of references to professional and other pronouncements, was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Our examination was carried out during the composition process and before final page proof. In our opinion, the material in this book is technically and mathematically accurate and internally consistent, and references to professional and other pronouncements are accurate and appropriate.

ARTHUR YOUNG & COMPANY

October 3, 1986

CONTENTS

Note: The topic of income tax is integrated throughout the book at those points where it is relevant to the discussion. Appendix C covers personal income taxes.

Preface xi

PART ONE **THE BASIC ACCOUNTING** **MODEL 1**

1 **ACCOUNTING AS AN** **INFORMATION SYSTEM 2**

Accounting Defined 2
Accounting Information and Decision Making 5
Decision Makers: The Users of Accounting Information 6
Financial and Management Accounting 10
Accounting Measurement 12
Forms of Business Organization 14
Financial Position and the Accounting Equation 16
Accounting Communication Through Financial Statements 22
The Accounting Profession 27
Interpreting Accounting Information: Merrill Lynch & Co. 38
Financial Decision Case: Murphy Lawn Services Company 44

2 **THE DOUBLE-ENTRY** **SYSTEM 45**

Measurement Problems 45
Accounts 47
The Double-Entry System: The Basic Method of Accounting 53
Recording Transactions 62
The Trial Balance 67
Some Notes on Bookkeeping Techniques 69

Interpreting Account Information: Zenith Radio Corporation 79

Financial Decision Case: Ruiz Repair Service Company 88

The following practice set may be used after Chapter 2:

Sailsports—Cumulative Practice Set

The following computer-assisted practice sets may be started after Chapter 2:

Parks Computer Company

Matthew Sports Company

Cook's Solar Energy Systems,
Second Edition

Sounds Abound

Berger Automotive Company

Stormer Painting Company

3 **BUSINESS INCOME AND** **ADJUSTING ENTRIES 89**

The Measurement of Business Income 89
The Adjustment Process 95
The Importance of Adjustments in Accounting 103
Correcting Errors 107
A Note About Journal Entries 108
Interpreting Accounting Information: City of Chicago 116
Financial Decision Case: Lockyer Systems Company 127

4 **COMPLETING THE ACCOUNTING** **CYCLE 129**

Overview of the Accounting System 129
The Work Sheet: A Tool of Accountants 130
Steps in Preparing the Work Sheet 131
Uses of the Work Sheet 137
Required Closing Entries 141
The Post-Closing Trial Balance 147

- Reversing Entries: Optional First Step of the
Next Accounting Period 147
- Interpreting Financial Information: Sperry &
Hutchinson 156
- Financial Decision Case: Donna's Quik-
Type 167

*The following computer-assisted business
simulation may be used after Chapter 4:*
Lawson's Supply Center: General Ledger

PART TWO

EXTENSIONS OF THE BASIC ACCOUNTING MODEL 169

5 ACCOUNTING FOR MERCHANDISING OPERATIONS 170

- Income Statement for a Merchandising
Concern 170
- Revenue from Sales 171
- Cost of Goods Sold 174
- Operating Expenses 182
- Handling Merchandise Inventory at the End of
the Accounting Period 182
- Work Sheet of a Merchandising Concern 184
- Income Statement Illustrated 192
- Interpreting Financial Information: Sears vs.
K mart 201
- Financial Decision Case: Jefferson Jeans
Company 210

6 ACCOUNTING SYSTEMS AND SPECIAL-PURPOSE JOURNALS 212

- Accounting Systems Installation 212
- Principles of System Design 213
- Data Processing: Three Perspectives 215

- Computer Data Processing 216
- Manual Data Processing: Journals and
Procedures 219
- Interpreting Accounting Information: B. Dalton
and Waldenbooks 243
- Financial Decision Case: Buy-Rite Foods
Company 253

*The following practice sets may be used
after Chapter 6:*

Micro-Tec Practice Set, Second Edition
Oak Shoppe—Audit Problem
The Book Loft—Shoebox Practice Set

7 INTERNAL CONTROL AND MERCHANDISING TRANSACTIONS 255

- Internal Control: Basic Principles and
Policies 255
- Internal Control over Merchandising
Transactions 257
- Banking Transactions 265
- Petty Cash Procedures 272
- The Voucher System 273
- Interpreting Accounting Information: J. Walter
Thompson 287
- Financial Decision Case: Gabhart's 296

8 GENERAL PURPOSE EXTERNAL FINANCIAL STATEMENTS 297

- Objectives of Financial Information 297
- Qualitative Characteristics of Accounting
Information 299
- Conventions to Aid Interpretation of Financial
Information 301
- Classified Balance Sheet 304
- Forms of the Income Statement 309
- Other Financial Statements 312
- Using Classified Financial Statements 312
- The Annual Report of a Major Corporation 316
- Interpreting Accounting Information: General
Mills 333
- Financial Decision Case: First National
Bank 340

PART THREE

MEASURING AND REPORTING ASSETS AND CURRENT LIABILITIES 343

9 SHORT-TERM LIQUID ASSETS 344

- Accounting for Cash and Short-Term Investments 344
- Accounting for Accounts Receivable 347
- Accounting for Notes Receivable 356
- Interpreting Accounting Information: Colgate Palmolive Co. 369
- Financial Decision Case: Elliot Electronics, Inc. 376

The following computer-assisted business simulations may be used after Chapter 9:

Lawson's Supply Center: Accounts Receivable
Lawson's Supply Center: Cash

10 INVENTORIES 377

- Nonmonetary Assets and the Matching Rule 377
- Inventories and Income Determination 378
- Inventory Measurement 381
- Pricing the Inventory at Cost 383
- Application of the Perpetual Inventory System 390
- Valuing the Inventory at the Lower of Cost or Market (LCM) 393
- A Note on Inventory Valuation and Federal Income Taxes 395
- Valuing Inventory by Estimation 395
- Interpreting Accounting Information: Hershey Foods Corporation 402
- Financial Decision Case: RTS Company 410

11 CURRENT LIABILITIES AND PAYROLL ACCOUNTING 412

- Nature and Measurement of Liabilities 412

- Common Categories of Current Liabilities 413
- Contingent Liabilities 420
- Introduction to Payroll Accounting 421
- Interpreting Accounting Information: Chrysler Corporation 434
- Financial Decision Case: Highland Television Repair 440

The following practice set may be used after Chapter 11:

*College Words and Sounds Store,
Second Edition*

The following computer-assisted business simulations may be used after Chapter 11:

Lawson's Supply Center: Payroll
Lawson's Supply Center: Accounts Payable

12 LONG-TERM ASSETS: ACQUISITIONS AND DEPRECIATION 442

- Long-Term Assets 442
- Acquisition Cost of Property, Plant, and Equipment 445
- Accounting for Depreciation 447
- Methods of Computing Depreciation 448
- Special Problems of Depreciating Plant Assets 453
- Control of Plant Assets 458
- Interpreting Accounting Information: Inland Steel 465
- Financial Decision Case: Primary Computer Company 472

13 LONG-TERM ASSETS: OTHER ISSUES AND TYPES 473

- Capital Expenditure and Revenue Expenditures 473
- Disposal of Depreciable Assets 475
- Accounting for Natural Resources 481
- Accounting for Intangible Assets 483
- Interpreting Accounting Information: Pan American World Airways 494
- Financial Decision Case: Piercy Enterprises 500

PART FOUR

ACCOUNTING FOR PARTNERSHIPS AND CORPORATIONS 503

14

ACCOUNTING FOR PARTNERSHIPS 504

- Partnership Characteristics 504
- Accounting for Partners' Equity 506
- Distribution of Partnership Income and Losses 508
- Dissolution of a Partnership 515
- Liquidation of a Partnership 520
- Interpreting Accounting Information: Meriweather Clinic 532
- Financial Decision Case: L & T Oyster Bar 538

15

CONTRIBUTED CAPITAL 540

- The Corporation 540
- Organization Costs 544
- The Components of Stockholders' Equity 545
- Accounting for Stock Issuance 552
- Interpreting Accounting Information: United Airlines 566
- Financial Decision Case: Northeast Servotech Corporation 571

16

RETAINED EARNINGS AND CORPORATE INCOME STATEMENTS 573

- Retained Earnings Transactions 573
- Statement of Stockholders' Equity 581
- Stock Values 582
- Appropriation of Retained Earnings 584
- Corporate Income Statements 586
- Interpreting Accounting Information 16-1: Lockheed Corporation 602
- Interpreting Accounting Information 16-2: NBI, Inc. 603
- Financial Decision Case: Metzger Steel Corporation 609

17

LONG-TERM LIABILITIES 611

- Nature of Bonds 611
- Accounting for Bonds Payable 613
- Retirement of Bonds 625
- Conversion of Bonds into Stock 626
- Bond Sinking Fund 626
- Other Long-Term Liabilities 628
- Interpreting Accounting Information: Franklin Savings Association 640
- Financial Decision Case: Gianni Chemical Corporation 645

PART FIVE

SPECIAL REPORTS AND ANALYSES OF ACCOUNTING INFORMATION 647

18

STATEMENT OF CHANGES IN FINANCIAL POSITION: WORKING CAPITAL AND CASH BASES 648

- Working Capital and Cash Bases Distinguished 648
- Changes in Working Capital 649
- Effects of Transactions on Working Capital 652
- Preparing the Statement of Changes in Financial Position: Working Capital Basis 657
- Preparing the Statement of Changes in Financial Position: Cash Basis 670
- Interpreting Accounting Information: Federal Express 684
- Financial Decision Case: Estes Jewelers, Inc. 693

19

FINANCIAL STATEMENT ANALYSIS 695

- Objectives of Financial Statement Analysis 695
- Standards for Financial Statement Analysis 697
- Sources of Information 698
- Evaluating a Company's Quality of Earnings 701
- Tools and Techniques of Financial Analysis 703
- Survey of Commonly Used Ratios 710