FINANCIAL ACCOUNTING

Tenth Edition

BENJAMIN FRANCIA STRAWSER

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TO THE STUDENT

A *Study Guide*, and *Working Papers*, are available through your bookstore. The purpose of the *Study Guide* is to assist you in studying and reviewing the text material and provide you with a means of self-test by the study of the detailed outline and use of the true-false questions, multiple choice questions, matching and completion statements, and exercises included in the guide. These may be used both in your initial study of the chapter material and in your subsequent review. The *Working Papers* have prepared forms and check figures for your problem assignments. If the *Study Guide* or *Working Papers* are not in stock in your bookstore, ask the bookstore manager to order copies for you.

Preface

This textbook introduces the student to all aspects of accounting from the basic concept of the transaction, through the financial information system to financial statements and special reports, into the interpretation and analysis of these statements and reports. It is intended for use in the beginning or principles of accounting course for both business and non-business majors. The text includes a balanced presentation of the procedures, techniques and fundamental principles underlying accounting, reporting, and decision-making. Up-to-date pronouncements of the accounting profession (FASB, SEC, etc.) are considered throughout the text and integrated in a clear illustrative manner, not just quoted verbatim.

The 1990 Financial Statements of the International Business Machines Corporation (IBM) are included at the beginning of the text. Included are the Report of Management, the Report of the Independent Accountants, Consolidated Financial Statements, Notes to the Consolidated Statements, Management Discussion, Five-Year Comparison of Selected Data, and Selected Quarterly Data.

A clear and concise introduction to the accounting process is developed in the early chapters of the text as a basis for special consideration given in later chapters to contemporary topics such as the statement of cash flows, financial statement analysis, accounting principles, financial statement disclosures, and international accounting. Constant dollar accounting, current value accounting, business combinations, and income tax considerations are also covered.

The text is intended to present a balanced perspective of accounting prac tice, theory, and decision-making using accounting information. The approach used is straightforward; completeness of coverage is achieved using simple but accurate terms and examples. It is a teachable text geared to student understanding of the basic concepts and practices.

The initial chapter introduces the functions of accounting and includes a brief discussion of the objectives of financial accounting, the qualitative characteristics of accounting information, and basic accounting concepts. The accounting process is presented and illustrated in the next three chapters. The transactions of a single company for the initial month of its operations are used in illustrating transactions analyses and, then, the entire accounting process. The authors have found that this repetition greatly enhances student understanding of the basic concepts. An outline of the text, with comments on chapter content, follows:

1. Introduces financial and managerial accounting and the basic accounting concepts. Introduces and discusses the objectives of financial reporting, the qualitative characterisics of accounting information and the elements of financial statements.
2. Discusses the balance sheet, income statement, and statement of capital.
3. Traces and explains the basic steps in the recording process.
4. Illustrates the use of the worksheet in facilitating statement preparation and discusses the common types of adjusting entries.
5. Discusses the accounting for a merchandising business and considers the basic concepts of revenue and expense recognition, alternative methods of revenue recognition and illustrates certain of the operational differences among companies, with special emphasis on the differences between retailing and service organizations.
6. Introduces a model of an accounting system and discusses the basic components of such a system.
7. Discusses the accounting procedures used to record and control cash.
8. Discusses the procedures used to account for receivables and payables.
9. Considers the alternative methods of accounting for inventories.
10. Discusses the accounting procedures used for recording and allocating the cost of plant and equipment.
11. Considers the accounting for the disposition of plant and equipment and the procedures for accounting for intangible assets and natural resources.
12. Considers the issues related to the accounting for sole proprietorships and partnerships.

13. Discusses issues relating to the formation of a corporation and the issuance of capital stock.
14. Considers matters relating to the retained earnings and dividends of a corporation.
15. Discusses the accounting for bonds payable and investments in corporate securities.
16. Discusses and illustrates the use of consolidated financial statements.
17. Illustrates the procedures used in preparing the cash flow statement.
18. Discusses common techniques of analyzing information presented in financial statements. The Appendix to the chapter examines the issues relating to the inclusion of current value and constant dollar or price-level information in financial statements.
19. Presents a general discussion of the federal income tax including "inter" and "intra" period tax allocation.
20. Discusses issues relating to foreign currency transactions and translating the financial statements of a foreign subsidiary company. Differences in accounting standards and disclosure requirements among companies are discussed.
21. Discusses in-depth concepts that underlie the financial reporting process and examines disclosures that must be made in financial reporting.

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We have received invaluable assistance, ideas, comments and constructive criticisms from both our students and our colleagues. A necessary ingredient in the writing of any textbook is the environment in which the effort took place. In this regard, our special thanks go to A. Benton Cocanougher of Texas A&M University and John M. Ivancevich of the University of Houston.

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We appreciate the permissions received from the American Institute of Certified Public Accountants and the Institute of Management Accounting of the National Association of Accountants allowing us to use problem materials from past Uniform CPA Examinations and CMA Examinations, respectively. Of course, the authors are responsible for any shortcomings of this text.

July, 1991

James J. Benjamin
Arthur J. Francia
Robert H. Strawser

REPORT OF MANAGEMENT

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in conformity with generally accepted accounting principles, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. We believe this structure provides reasonable assurance that transactions are executed in accordance with management authorization, and that they are appropriately recorded, in order to permit preparation of financial statements in conformity with generally accepted accounting principles and to adequately safeguard, verify and maintain accountability of assets. An important element of the control environment is an ongoing internal audit program.

To assure the effective administration of internal control, we carefully select and train our employees, develop and disseminate written policies and procedures, provide appropriate communication channels, and foster an environment conducive to the effective functioning of controls. We believe that it is essential for the company to conduct its business affairs in accordance with the highest ethical standards, as set forth in the IBM Business Conduct Guidelines. These guidelines, translated into numerous languages, are distributed to employees throughout the world, and re-emphasized through internal programs to assure that they are understood and followed.

Price Waterhouse, independent accountants, are retained to examine IBM's financial statements. Their accompanying report is based on an examination conducted in accordance with generally accepted auditing standards, including a review of the internal control structure and tests of accounting procedures and records.

The Audit Committee of the Board of Directors is composed solely of outside directors, and is responsible for recommending to the Board the independent accounting firm to be retained for the coming year, subject to stockholder approval. The Audit Committee meets periodically and privately with the independent accountants, with our internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.

John F. Akers — Chairman of the Board

Frank A. Metz, Jr. — Senior Vice President, Finance & Planning

REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders and Board of Directors of
International Business Machines Corporation

January 29, 1991

In our opinion, the accompanying consolidated financial statements, appearing on pages 34, 35, 36, 37 and 43 through 58, present fairly in all material respects the financial position of International Business Machines Corporation and its subsidiaries at December 31, 1990 and 1989, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1990, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion thereon based on our audits. We conducted our audits in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether such statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in the note regarding Taxes on page 50, the company changed its method of accounting for income taxes in 1988. We concur with this change.

Price Waterhouse

Price Waterhouse
153 East 53rd Street
New York, N.Y. 10022

CONSOLIDATED STATEMENT OF EARNINGS

For the year ended December 31:	1990	1989	1988
(Dollars in millions except per share amounts)			
Revenue:			
Sales	$43,959	$41,586	$39,959
Support services	11,322	9,858	9,285
Software	9,952	8,424	7,927
Rentals and financing	3,785	2,842	2,510
	69,018	62,710	59,681
Cost:			
Sales	19,401	18,001	17,499
Support services	6,617	5,701	4,971
Software	3,126	2,694	2,110
Rentals and financing	1,579	1,305	1,068
	30,723	27,701	25,648
Gross Profit	38,295	35,009	34,033
Operating Expenses:			
Selling, general and administrative	20,709	21,289	19,362
Research, development and engineering	6,554	6,827	5,925
	27,263	28,116	25,287
Operating Income	11,032	6,893	8,746
Other Income, principally interest	495	728	996
Interest Expense	1,324	976	709
Earnings before Income Taxes	10,203	6,645	9,033
Provision for Income Taxes	4,183	2,887	3,542
Net Earnings before Cumulative Effect of Accounting Change	6,020	3,758	5,491
Cumulative Effect of Change in Accounting for Income Taxes	—	—	315
Net Earnings	$ 6,020	$ 3,758	$ 5,806
Per share amounts:			
Before cumulative effect of accounting change	$10.51	$6.47	$9.27
Cumulative effect of change in accounting for income taxes	—	—	.53
Net earnings	$10.51	$6.47	$9.80

Average number of shares outstanding:
1990—572,647,906
1989—581,102,404
1988—592,444,409

The notes on pages 43 through 58 are an integral part of this statement.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

At December 31:	1990	1989
(Dollars in millions)		
Assets		
Current Assets:		
Cash	$ 1,189	$ 741
Cash equivalents	2,664	2,959
Marketable securities, at cost, which approximates market	698	1,261
Notes and accounts receivable—trade, net of allowances	20,988	18,866
Other accounts receivable	1,656	1,298
Inventories	10,108	9,463
Prepaid expenses and other current assets	1,617	1,287
	38,920	35,875
Plant, Rental Machines and Other Property	53,659	48,410
Less: Accumulated depreciation	26,418	23,467
	27,241	24,943
Investments and Other Assets:		
Software, less accumulated amortization (1990, $5,873; 1989, $4,824)	4,099	3,293
Investments and sundry assets	17,308	13,623
	21,407	16,916
	$87,568	$77,734

Liabilities and Stockholders' Equity		
Current Liabilities:		
Taxes	$ 3,159	$ 2,699
Short-term debt	7,602	5,892
Accounts payable	3,367	3,167
Compensation and benefits	3,014	2,797
Deferred income	2,506	1,365
Other accrued expenses and liabilities	5,628	5,780
	25,276	21,700
Long-Term Debt	11,943	10,825
Other Liabilities	3,656	3,420
Deferred Income Taxes	3,861	3,280
Stockholders' Equity:		
Capital stock, par value $1.25 per share	6,357	6,341
Shares authorized: 750,000,000		
Issued: 1990—571,618,795; 1989—574,775,560		
Retained earnings	33,234	30,477
Translation adjustments	3,266	1,698
	42,857	38,516
Less: Treasury stock, at cost (Shares: 1990—227,604; 1989—75,723)	25	7
	42,832	38,509
	$87,568	$77,734

The notes on pages 43 through 58 are an integral part of this statement.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the year ended December 31:	1990	1989	1988
(Dollars in millions)			
Cash Flow from Operating Activities:			
Net earnings	$ 6,020	$ 3,758	$ 5,806
Adjustments to reconcile net earnings to cash provided from operating activities:			
Depreciation	4,217	4,240	3,871
Amortization of software	1,086	1,185	893
Loss (gain) on disposition of investment assets	32	(74)	(133)
(Increase) in accounts receivable	(2,077)	(2,647)	(2,322)
Decrease (increase) in inventory	17	(29)	(1,232)
(Increase) in other assets	(3,136)	(1,674)	(1,587)
Increase in accounts payable	293	870	265
Increase in other liabilities	1,020	1,743	519
Net cash provided from operating activities	7,472	7,372	6,080
Cash Flow from Investing Activities:			
Payments for plant, rental machines and other property	(6,509)	(6,414)	(5,390)
Proceeds from disposition of plant, rental machines and other property	804	544	409
Investment in software	(1,892)	(1,679)	(1,318)
Purchases of marketable securities and other investments	(1,234)	(1,391)	(2,555)
Proceeds from marketable securities and other investments	1,687	1,860	4,734
Net cash used in investing activities	(7,144)	(7,080)	(4,120)
Cash Flow from Financing Activities:			
Proceeds from new debt	4,676	6,471	4,540
Payments to settle debt	(3,683)	(2,768)	(3,007)
Short-term borrowings less than 90 days—net	1,966	228	1,028
Payments to employee stock plans—net	(76)	(29)	(11)
Payments to purchase and retire capital stock	(415)	(1,759)	(992)
Cash dividends paid	(2,774)	(2,752)	(2,609)
Net cash used in financing activities	(306)	(609)	(1,051)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	131	(158)	(201)
Net Change in Cash and Cash Equivalents	153	(475)	708
Cash and Cash Equivalents at January 1	3,700	4,175	3,467
Cash and Cash Equivalents at December 31	$ 3,853	$ 3,700	$ 4,175
Supplemental Data:			
Cash paid during the year for:			
Income taxes	$ 3,315	$ 3,071	$ 3,405
Interest	$ 2,165	$ 1,605	$ 1,440

The notes on pages 43 through 58 are an integral part of this statement.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Dollars in millions)	Capital Stock	Retained Earnings	Translation Adjustments	Treasury Stock	Total
Stockholders' Equity, January 1, 1988	$6,417	$29,016	$2,865	$ (35)	$ 38,263
1988					
Net earnings		5,806			5,806
Cash dividends declared		(2,609)			(2,609)
Capital stock issued under employee plans (1,321,697 shares)	92				92
Purchases (8,140,101 shares) and sales (8,117,596 shares) of treasury stock under employee and stockholder plans—net		(128)		(1)	(129)
Capital stock purchased and retired (8,611,396 shares)	(93)	(899)			(992)
Tax reductions—employee plans	26				26
Translation adjustments			(948)		(948)
Stockholders' Equity, December 31, 1988	6,442	31,186	1,917	(36)	39,509
1989					
Net earnings		3,758			3,758
Cash dividends declared		(2,752)			(2,752)
Capital stock issued under employee plans (824,026 shares)	60				60
Purchases (8,202,058 shares) and sales (8,423,155 shares) of treasury stock under employee and stockholder plans—net		(133)		29	(104)
Capital stock purchased and retired (16,085,900 shares)	(177)	(1,582)			(1,759)
Tax reductions—employee plans	16				16
Translation adjustments			(219)		(219)
Stockholders' Equity, December 31, 1989	6,341	30,477	1,698	(7)	38,509
1990					
Net earnings		6,020			6,020
Cash dividends declared		(2,774)			(2,774)
Capital stock issued under employee plans (686,159 shares)	47				47
Purchases (8,448,626 shares) and sales (8,296,745 shares) of treasury stock under employee and stockholder plans—net		(117)		(18)	(135)
Capital stock purchased and retired (3,842,924 shares)	(43)	(372)			(415)
Tax reductions—employee plans	12				12
Translation adjustments			1,568		1,568
Stockholders' Equity, December 31, 1990	$6,357	$33,234	$3,266	$ (25)	$ 42,832

The notes on pages 43 through 58 are an integral part of this statement.

MANAGEMENT DISCUSSION

Results of Operations The financial results achieved in 1990 are a substantial improvement over 1989. They reflect the execution of management's strategy to transform the company by increasing emphasis on quality and customer solutions, improving the competitiveness of IBM's products and services, and achieving greater efficiencies from cost and expense management and strategic restructurings.

Worldwide revenue in 1990 totaled $69.0 billion, an increase of 10.1 percent over 1989. The rate of growth continued to be stronger outside the United States, but U.S. operations showed the highest year-to-year revenue growth rate since 1984. Revenue from U.S. operations was $27.1 billion in 1990, an increase of 5.4 percent, following a 1.7 percent increase in 1989 over 1988. Revenue from non-U.S. operations was $41.9 billion, up 13.3 percent from 1989. This was primarily attributable to strong performance in the Europe/Middle East/Africa area, where revenues increased 17.5 percent over 1989. As a percent of total revenue, non-U.S. revenue has grown from 50.3 percent in 1986 to 60.7 percent in 1990.

Net earnings for the year were $6.0 billion compared with $3.8 billion in 1989 and $5.8 billion in 1988. The 1989 earnings were impacted by a $2.4 billion pre-tax charge for actions taken to reduce costs, expenses and structure. Earnings before tax in 1988 were impacted by an $870 million charge related to consolidations of manufacturing and headquarters operations. In addition, a 1988 change in an accounting principle related to income taxes resulted in additional net earnings of $315 million in that year.

Revenue from sales was $44.0 billion, an increase of 5.7 percent compared with a 4.1 percent increase in 1989. Sales revenue from U.S. operations increased slightly in 1990 after a 2.3 percent decline in 1989. While sales revenue remained the largest single category at 63.7 percent of total revenue, the rate of growth in software and services continued to outpace that of hardware. Worldwide revenue from support services increased 14.9 percent in 1990. Maintenance services, the largest component of support services, increased 9.9 percent after declines of 3.8 percent in 1989 and 4.5 percent in 1988. Revenue from maintenance services in the U.S. declined 2.5 percent in 1990 reflecting the transfer in the third quarter of 1989 of IBM's ROLM service operations to a venture owned jointly by IBM and Siemens AG. U.S. maintenance service revenue increased 11.8 percent in the fourth quarter of 1990 compared with the same period in 1989.

Software revenue of $10.0 billion was up 18.1 percent over 1989 with strong growth in both U.S. and non-U.S. operations. In 1989, growth over 1988 was less strong in part because 1988 software revenue included payments made by Fujitsu to IBM as a result of arbitration between the two companies. Revenue from rentals and financing increased more than 30 percent in both the U.S. and non-U.S. areas.

Information on industry segments and classes of similar products or services is presented on page 57.

Revenue from processors increased 1.2 percent in 1990. The extremely well-received midrange models of the new Enterprise System/9000 family and continued strong sales of the Application System/400 more than offset declines in the high-end processors as customers anticipated availability in 1991 of new high-end models of the Enterprise System/9000 family. Processor revenue from U.S. operations declined 3.3 percent.

In workstations, revenue from personal systems increased 14.7 percent worldwide and 6.0 percent in the U.S. Personal systems include the new RISC System/6000 workstation, which has been very well-received in the marketplace, as well as the new Personal System/1 home computer. The increase of 3.4 percent in other workstations revenue is primarily attributable to point-of-sale products.

Revenue from peripherals increased 15.1 percent worldwide and 20.2 percent in the U.S. These increases are due, in large part, to the strong performance of the IBM 3390 Direct Access Storage Device, which the company began to ship in the fourth quarter of 1989.

The gross profit margin of 55.5 percent in 1990 was .7 percentage points below 1989 after adjusting for the restructuring charge recorded in 1989. This decrease is the result of lower gross profit margins on sales, primarily driven by product mix. Revenue from higher margin processors was less in 1990 than in 1989. Profit margins of support services decreased .6 percentage points, primarily due to the continued rapid growth of other support services, whose gross profit margins are lower than those for maintenance. However, gross profit margins of maintenance service increased in 1990 over 1989.

After adjusting for the 1989 restructuring charge, software gross profit margins declined 1.9 percentage points in 1990. This decline is primarily the result of higher service costs associated with the large number of new software products introduced in 1990. Gross profit margins of rentals and financing grew 4.2 percentage points in 1990.

Selling, general and administrative expenses, as reported, showed a decrease of 2.7 percent in 1990 from 1989 and an increase of 10.0 percent in 1989 over 1988. Both 1989 and 1988 were marked by unusual charges which are described in the restructuring note on page 47. If adjusted for these charges, the year-over-year changes would have been a 6.5 percent increase in 1990 and a 5.2 percent increase in 1989. While the effect of currency translation had a favorable impact on overall financial results, it contributed to increased expenses of the non-U.S. operations. In addition, the company incurred somewhat higher than normal expenses for ongoing restructuring actions taken in a number of countries. Expenses in U.S. operations decreased in 1990 as the benefits of past actions to become a more efficient and responsive organization began to show in the financial results.

Expenditures for research, development and engineering amounted to $6.6 billion in 1990, or 9.5 percent of revenue. These expenditures increased 1.6 percent over 1989 after adjusting for the 1989 restructuring charge. These investments are vital for IBM to remain a leader in a highly competitive industry.

Other income decreased 32.0 percent in 1990 to $495 million. This decline is attributable to a 1989 gain on the sale of IBM's interest in Discovision Associates and to lower levels of cash equivalents and marketable securities in 1990.

Interest expense increased 35.7 percent in 1990 to $1.3 billion. The increase is primarily the result of high interest rates on short-term borrowings in subsidiaries whose economic environment is highly inflationary. Exchange gains from currency revaluation on these borrowings largely offset this growth in interest expense. The year-to-year growth rate in interest expense has been abating all year. Interest expense for the fourth quarter was 2.8 percent above the comparable period in 1989.

The effective tax rate of 41.0 percent for 1990 was lower than the 43.4 percent in 1989 primarily as a result of the relative proportion of earnings from

MANAGEMENT DISCUSSION

U.S. operations, which are taxed at a lower rate. These earnings were influenced by the restructuring charge taken in the fourth quarter of 1989 and significantly improved earnings from U.S. operations in 1990.

For the quarter ended December 31, 1990, worldwide revenue was $23.1 billion, up 12.7 percent from the prior year's $20.5 billion. Worldwide net earnings for the three months were $2.5 billion in 1990 compared with $.6 billion in 1989. The strong revenue growth in the quarter was in all categories, with growth in the services area especially strong.

In 1990, the company continued its strategy of improving its competitiveness and profitability by streamlining operations and reducing the rate of growth of costs and expenses.

Much of the 1990 activity involved executing initiatives covered by the charge taken against earnings in the fourth quarter of 1989. These included a transition payment program in the U.S. that resulted in a sizable reduction in the U.S. work force. As a result, the company reduced its worldwide population by nearly 9,500 to a year end total of 373,816 people and reduced its U.S. population over 10,000 to 205,533, surpassing the U.S. target it had set for itself. IBM has reduced its worldwide population by more than 33,000 people from its peak in 1986. These reductions were accomplished largely through retirement and incentive programs carried out selectively in countries around the world.

Also in 1990, the company established a wholly owned subsidiary consolidating its typewriter, keyboard, personal printer and related supplies operations. At the same time the company began negotiations with Clayton & Dubilier, Inc., which are expected to lead to the creation of a new information products company in 1991.

The majority of this new company, LEXMARK International, would be owned by Clayton & Dubilier. IBM would have a 10 percent continuing equity interest. This action is consistent with IBM's strategy to concentrate its resources on markets and opportunities where long-term growth prospects are most attractive. The transaction is not expected to have a material effect on the company's financial results. Similar actions in recent years included the sale of IBM's copier sales and service operations, its educational publishing subsidiary and its interest in Discovision Associates.

Management is pleased with the financial results reported in 1990. They represent a continuing pattern of improved financial performance and were achieved under trying economic circumstances.

Growing markets, advancing technologies and expanding uses of computing systems will continue to drive the industry and contribute to IBM's success in the 1990s.

At the same time, uncertainties in the world's economies and intensifying pressures from formidable competitors require that IBM manage its business prudently as it pursues its objective of long-term growth and profitability.

Strengthened ties to customers, geographic diversity, a strong product line and a reduced cost and expense structure provide a healthy financial underpinning and will allow the company to participate fully in the opportunities ahead.

Financial Condition During 1990, IBM continued to make those investments necessary to ensure its success in the information industry in the future. In an increasingly competitive international environment, sustained investments in basic research and applied development are essential to maintain a steady flow of innovative new products that provide