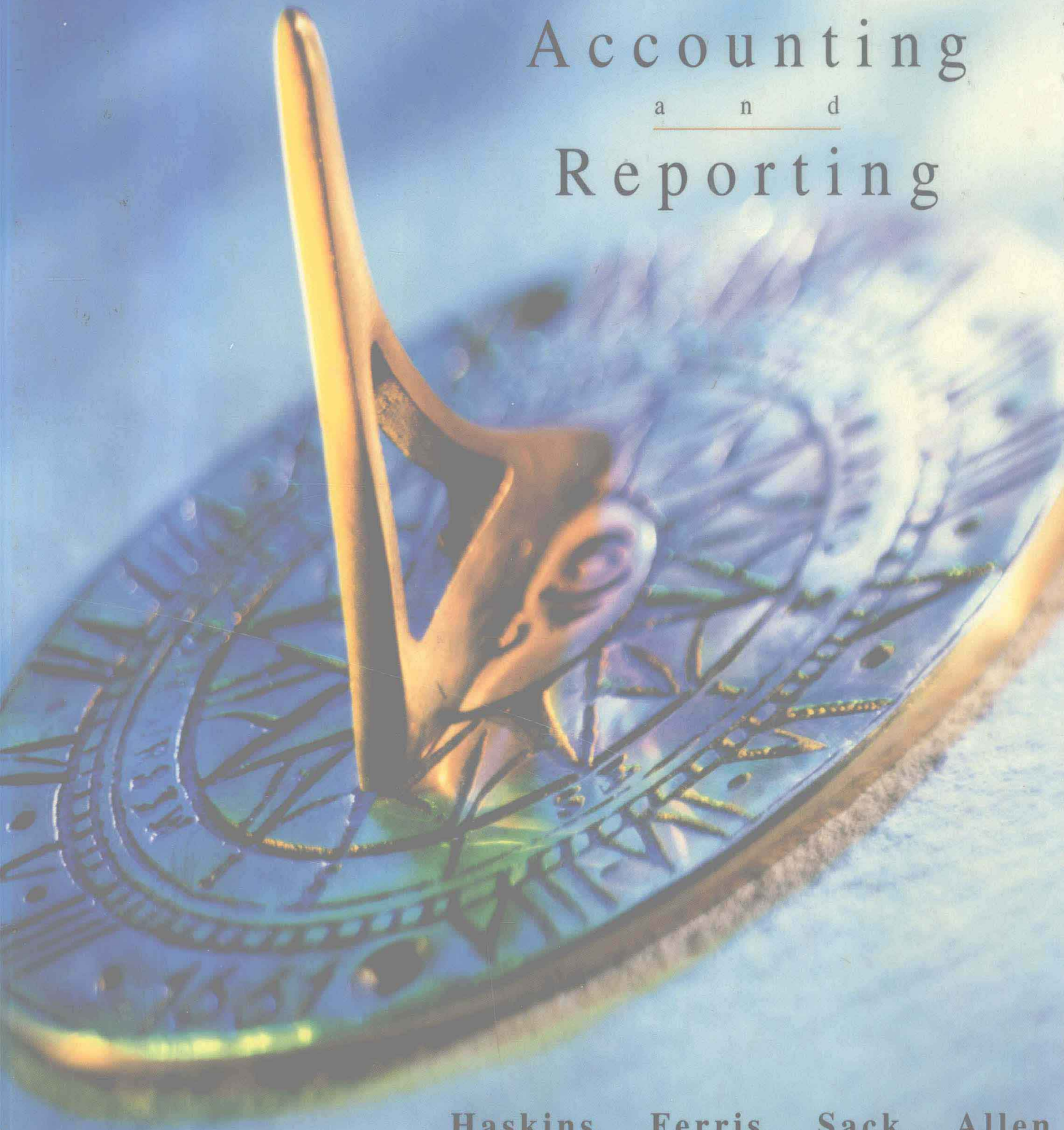


S e c o n d E d i t i o n

Financial Accounting a n d Reporting



Haskins Ferris Sack Allen

FINANCIAL ACCOUNTING

A · N · D

REPORTING

Second Edition

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IRWIN

Chicago ■ Bogotá ■ Boston ■ Buenos Aires ■ Caracas
London ■ Madrid ■ Mexico City ■ Sydney ■ Toronto

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Irwin Book Team

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Interior designer: Michael Warrell
Cover designer: Stuart Patterson, Image House Design
Cover photo: Peter Dazely, Tony Stone Images
Prepress buyer: Charlene R. Perez
Compositor: Shepard Poorman Communications Corporation
Typeface: 10/12 Times Roman
Printer: Von Hoffmann Press, Inc.



Library of Congress Cataloging-in-Publication Data

Financial accounting and reporting / Mark E. Haskins . . . [et al.]. —
2nd ed.

p. cm.

Includes index.

ISBN 0-256-16713-3

1. Financial statements. 2. Corporations — Accounting.

I. Haskins, Mark E.

HF5681.B2F456 1997

657'.3 — dc20

96-3743

Printed in the United States of America


1 2 3 4 5 6 7 8 9 0 VH 3 2 1 0 9 8 7 6

FINANCIAL ACCOUNTING

A · N · D

REPORTING

To our students, who have sought to know more
and in doing so have challenged us to find
better ways to teach.



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PREFACE

STATEMENT OF PURPOSE

In a past issue of the *Saturday Review*, an article titled “18,000,000 Books Nobody Reads” cited corporate annual reports as very low in interest, clarity, and understandability. This text’s primary objective is, to a large extent, to confront this problem by developing future business leaders’ financial statement literacy and to do so in a way that incorporates the abilities to (1) understand the nature of business transactions, (2) identify relevant economic events for reporting, (3) determine the most appropriate financial measures for those events, and (4) analyze the effects of those events in firm performance and financial condition. To this end, an underlying theme of the text is that accounting is not divorced from the world it describes or from the behaviors it measures and influences.

Philosophically, we believe that an introductory accounting text, whether used at the undergraduate or MBA level, does not need to explore every nuance of accounting practice and thought. Rather, the most important and predominant contemporary and classical accounting conventions are our foci. In this regard, the goal is to expose and discuss the underlying rationales of those practices and evaluate their effectiveness in providing useful information for decision making. Foremost among the practices investigated are those that purport to portray corporate financial position, operating results, cash flows, manager performance, and financial strength.

Even though the rule orientation of accounting practice cannot be ignored, both the classroom and the boardroom are appropriate places for questioning and debating those rules and conventions. Such scrutiny is crucial because it is important for students to develop an understanding of the management choices that must be made regarding what information to report, how best to report it, when to do so, and where controls are needed to assure reliable and relevant reporting. A critical aspect of these choices, dealt with in this text, is a concern for (1) the characteristics of information that make it most useful for decision making; (2) the characteristics of decision makers that also influence the usefulness of information; and (3) the subsequent behavior of managers, subordinates, and external constituencies that can be expected as a result of implementing certain reporting choices.

There are two reasons for our management/user approach. First, it allows us to deal comprehensively with a complex topic. Second, it helps the student retain a focus on concepts and ideas rather than on procedures. This approach requires considerable discipline on the part of the student, to mentally delegate his or her time to an understanding of business issues and a mastery of the basic financial reporting concepts without becoming too preoccupied with accounting mechanics. Thus, this text is designed primarily for those courses and student groups where the focus is on a balance between the understanding and use of accounting information and its preparation. Provided with a backdrop of contemporary management and financial concerns, students will see that accounting is a significant part of the world it purports to portray rather than an end in itself. On the contrary, students are provided the perspective that accounting information is a critical instrument in presenting a corporation’s financial

picture to important external constituencies. The raising of issues and concerns springing from this orientation facilitates a focus on substance and also frames students' learning because they have the comfort of a more familiar general business context for thinking about the accounting issue at hand.

KEY FEATURES

Real world based. The authors view accounting as an integral part of corporate decision making and financial analysis. Thus, accounting is not an end but a means to achieving relevant and reliable insights about business conditions, results, and opportunities. Like the first edition, the second edition repeatedly grounds the discussion of accounting issues and methods in contexts of management decision making, financial analysis, management judgments and estimates, behavioral consequences, and/or the political arena, whichever context is most germane. Such an approach poses accounting as a vital, dynamic phenomenon rather than a sterile, procedural set of mechanics. To this end, the text contains *nearly 100* excerpts from recent annual reports that serve to highlight the realities of the issue at hand and to exemplify the fact that the financial reporting issues presented are pertinent to the day-to-day information concerns faced by real-world managers, lenders, investors, and financial statement users in general.

Holistic business approach. The book's managerial orientation frequently leverages the discussion of a particular topic via linkages with strategic and other functional area concerns typically encountered by managers. For example, receivables issues involve credit and collection policies in addition to the accounting issues. Inventory topics include operations concerns such as JIT and standard costing. In addition, the second edition discusses the international aspects germane to many of the financial reporting issues covered in the chapters.

Opportunities for student involvement. The end-of-chapter materials provide opportunities for a well-rounded student experience. Discussion questions provide issues for thought and debate where "solutions" are well-reasoned, integrated views as opposed to looking up the chapter paragraph that provides the answer. Problems are structured to provide ample opportunities for polishing one's procedural skills as well as for developing a feel for the differences in results when different methods, assumptions, and/or judgments are invoked. The cases provide real-world settings for exploring the usefulness of accounting information to decision makers who have different perspectives and purposes, come from different environments, and value different outcomes.

Group work and communication skills. Many of the cases lend themselves to group assignments and/or classroom presentation and write-up. Instructors are presented with materials that provide lots of degrees of freedom in this regard.

Ethics and international. Haskins and Sack have been actively engaged in the development and teaching of ethics materials and courses. Such a perspective is imbedded throughout the text. Haskins and Ferris teach international financial reporting courses and provide a chapter dedicated to that topic, a chapter that has also benefited from the many years of international work experience of Sack and Allen.

Key terms. The language involved in financial reporting encompasses many new terms. Each time a new key term is used in the text, it appears in blue type. In addition, a listing of key terms appears at the end of each chapter, and an extensive glossary appears at the end of the text.

Appendixes. In order to provide instructors a number of degrees of freedom regarding the depth with which to explore a topic, many chapters contain appendixes that provide opportunities for exploring a particular topic in a more detailed manner. It is important to note, however, that a comprehensive, powerful course can be constructed without having to use the appendixes.

ORGANIZATION

This text consists of four major parts and is organized not unlike other texts in its basic sequencing. Do not, however, conclude that it is just like other texts. As has already been pointed out, the orientation taken toward topics, the emphasis placed on certain facets of the topics, and the integration with a larger context make this text distinctive.

Part I. These introductory chapters provide the background for the entire text. In particular, the first chapter's presentation of the PepsiCo annual report sets the financial reporting agenda and "creates the need to know." During its discussion, students realize that accounting quickly transcends the necessary but mundane concerns of a green-eye-shaded bookkeeper to encompass those of key managers interested, among other things, in knowing what has been achieved, identifying what remains to be done, monitoring and motivating people better, and efficiently, effectively, and inexpensively raising capital from external sources.

Using generally familiar business contexts, a variety of basic skills are then developed in the remaining Part I chapters. Paramount among the skills developed are (1) the double-entry method of recording transactions; (2) preparation of basic balance sheets and statements of income and owners' equity; (3) familiarity with the language of accounting; and (4) an understanding of some of the fundamental concepts of accounting (e.g., accrual vs. cash, matching, historical costs, materiality) and of the process by which accounting standards are set.

The objective of these three chapters is for students to become comfortable defining a users' information needs, report the most pertinent information in the most useful way, interpret the story reflected by the information, identify the key assumptions underlying the information being reported, and consider the alternative interpretations that would arise with certain changes in some of the key assumptions. Establishing such a dialectical process at a text's outset is important because students must continually consider such an array of issues in order to appreciate and understand the evolutionary nature of contemporary accounting practice.

Part II. The four chapters in this section of the text introduce in more detail the three basic financial statements — the balance sheet, income statement, and statement of cash flows — and provide students with some classical financial analysis tools. All four chapters draw heavily on the concepts, language, and concerns raised in Part I. Moreover, all four chapters integrate the PepsiCo annual report presented in Chapter 1 into their discussions as well as utilizing other corporate annual report examples.

An explicit premise running through these chapters is that management has a great deal of influence over the results presented. That is, the financial statements are discussed in such a way as to highlight the fact that they are a part of management's thinking as they make decisions throughout the years. We believe such an orientation not only is valid but also ascribes a great deal of vitality to the statements: They are not merely a sterile codification of numerous transactions whose total implications and results are not known until year-end.

The purpose of dealing so intensely with these financial statements and their analysis at this point in the text is that subsequent chapter topics can then be

discussed and debated as to their impact on the three financial statements. Such an objective parallels the manager concerns raised in the chapters and poses very effective learning opportunities for students' recognition of both the key accounting *and* managerial concerns.

Part III. The chapters in this part are centered on the theme of measuring, reporting, interpreting, and using financial information pertaining to assets, liabilities, and owners' equity. In these chapters students really begin to see clearly and powerfully that accounting simply describes events and circumstances, and those descriptions are a joint product of certain official guidelines, and, more importantly, of the assumptions, actions, and judgments of managers. These chapters consider the financial reporting issues surrounding some of the daily and strategic concerns of managing assets, liabilities, and owners' equity. Moreover, they explore the tension between reporting the "most favorable" versus the "most realistic" picture.

As an example, the text and some of the end-of-chapter materials pertaining to marketable securities bring to light the issues of (1) distinguishing the relative merits of reporting historical costs versus current market values and (2) dealing with the prescriptive nature of FASB rules. Both issues underlie much of financial reporting. In particular, the first issue is often viewed by the uninformed as a shortcoming of financial reporting. We believe students should be sensitive to the pros and cons of reporting costs *and* current values and should be able to identify situations where one or the other may be more appropriate. In regard to the second issue, students become acutely aware of the volatility that is possible in reported earnings if how things are to be reported is simply left to the discretion of management. They thus realize a need for constraining the discretion available to managers in reporting their companies' financial position and results of operations. This is not to say that the need for management judgments and the consequences of such decisions become less important; on the contrary, a thorough knowledge of official guidelines (constraints) is merely an important prerequisite to identifying viable reporting options, structuring business transactions compatibly with the most desirable ways of reporting them, and factoring into one's decisions the information needs of the interested constituencies.

Besides grounding an accounting issue in the context of a business decision or users' information needs, the chapters also leverage students' understanding of other topics to help in their learning of particular financial reporting topics that may be new to them. For example, anticipating the potentially overwhelming nature of the bonds, leases, and pension topics, the text builds on a thread common to all three topics and familiar to most business students at this point in their education — the present value of a stream of future cash flows. As each of these three topics is introduced via this touchstone, the awesomeness of dealing with the technical aspects of their financial reporting requirements fades. In fact, for most students, the literacy threshold for these three topics, which at the outset seems unachievably distant, becomes reachable with the use of the present value perspective building block already familiar and mastered by most.

Part IV. This final section of the book provides students with an opportunity to consider some of the specific challenges involved in understanding the financial reporting practices of non-U.S. companies as well as some of the nuances inherent in communicating the more qualitative aspects of a company's financial well-being. To these ends, Chapter 15 provides a brief overview of the financial reporting environment and practices in two other countries — Japan and the United Kingdom. This chapter contains recent annual reports from Kawasaki Steel Corporation and Rolls-Royce Plc. We view this chapter as integral to a first course in financial reporting

because it provides one more opportunity for students to digest the details of an annual report and to then articulate (1) their understanding of the company, (2) the key accounting conventions used, and (3) how those conventions might have been different for that particular company and how they differ, if at all, from U.S.-based practices. Pedagogically, stark contrasts in settings (i.e., foreign versus U.S.) are used to highlight the financial reporting concerns that transcend borders and those that do not. The PepsiCo annual report can also be revisited to provide a basis for review and compare/contrast with the Kawasaki and Rolls-Royce reports.

The final chapter focuses on some of the interesting challenges and opportunities chief financial officers are likely to encounter as they seek to provide the financial markets with the disclosures that are perceived to be of vital importance in portraying the real depth and breadth of a company's financial health and prospects. Many of the issues are outside the purview of current GAAP but are in many ways tied to efforts to complement, enhance, or clarify the presently required GAAP disclosures.

SUPPLEMENTAL MATERIALS

An *Instructor's Manual* is available to accompany the text. The manual provides "solutions" and suggestions for class discussion. In addition, the manual provides several possible course outlines with pertinent assignments.

Two other supplements are available. Some instructors may find the companion *Test Bank*, both printed and computerized, a useful resource. Finally, PowerPoint software, called *ReadyShows*, has been created to facilitate classroom lectures; the software provides instructors with an interactive alternative to traditional teaching transparencies. For a small fee, students may purchase a printed notebook (called *ReadyNotes*) that follows the PowerPoint presentations to help them in their notetaking.

ACKNOWLEDGMENTS

We gratefully acknowledge the following individuals for the helpful insights they provided us:

Professor Paul K. Chaney
Vanderbilt University

Professor Marshall K. Pittman
University of Texas/San Antonio

Professor Roger H. Chope
University of Oregon

Professor Joseph H. Bylinski
University of North Carolina

Professor Richard G. File
University of Nebraska

Professor Dennis Murray
University of Colorado

Professor Albert A. Schepanski
University of Iowa

Professor Janet I. Kimbrell
Oklahoma State University

Professor Philip M. J. Reckers
Arizona State University

Professor Robert Kneckel
University of Florida.

Professor Peter Wilson
Duke University

Over the years we have benefitted from the ideas and contributions of our colleagues E. R. Brownlee II, C. Ray Smith, and numerous research assistants. Their help has been invaluable. Invaluable too has been the help of several people at Irwin — Karen Nelson, Michael Warrell, George Werthman, and Martin Quinn. Their support has been indispensable.

Mark E. Haskins
Kenneth R. Ferris
Robert J. Sack
Brandt R. Allen

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