
F·O·U·R·T·H
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FUNDAMENTALS OF FINANCIAL ACCOUNTING

Glenn A. Welsch

College of Business Administration
The University of Texas at Austin

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Harvard University

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**FUNDAMENTALS OF FINANCIAL
ACCOUNTING**

The Robert N. Anthony/Willard J. Graham Series in Accounting

*To
Irma, Katherine, Maryrose,
Jennifer, and Heather*

Preface

This Fourth Edition retains all of the features favorably commented upon by numerous faculty members who used the prior editions. It has been updated in all respects, and approximately 80 percent of the assignment material has been replaced or revised. Additional problems/cases contribute a measure of greater depth and analytical substance.

Chapter 17, Financial Reporting and Changing Prices, has been completely rewritten to emphasize the underlying concepts of *FASB Statement No. 33*. The authors present unique illustrations of constant dollar restatement and current cost application especially designed to be understandable to beginning accounting students. Also, a special supplement on income taxes has been added.

To lend an unusual level of flexibility in use and to increase readability, chapters have been divided into two or more separate parts. The objectives of each part are concisely delineated, and the questions for discussion, exercises, and problems/cases are grouped separately by part (both in the text and the Solutions Manual). A complete list of important terms defined in the chapter, and key words in the definition, with specific page citations, is given at the end of each chapter. The demonstration cases, with solutions, at the end of the various chapters have been carefully selected and written to provide a comprehensive overview of the chapter.

Major portions of each chapter have been rewritten to incorporate the latest developments in financial accounting and to increase comprehension. Numerous illustrations are provided to supplement the written discussions. A unique format has been introduced for many of the exhibits. This format presents the *(a)* illustrative data *(b)* analysis, and *(c)* accounting entries and/or reporting, all in one single exhibit. All of the new features significantly increase the level of flexibility of the text in use.

The prior extensive list of teaching and student aids has been expanded and revised. In addition to the textbook, these aids are:

Available to students:

1. Study Guide (coordinated with the sequence of each chapter; includes comprehensive outlines, illustrations, and sample examination questions with answers).
2. Working Papers (includes all forms, with captions, needed for solving all exercises and problems/cases).
3. Practice Set (application of the complete accounting information processing system as discussed in the textbook).

Available to the instructor:

4. Comprehensive Teachers Manual (includes answers to all questions for class discussion, exercises, and problems/cases; also, includes suggested course plans, assignment schedules, and instructional ideas).
5. List of Check Figures that includes check figures for exercises and problem/cases (available in quantity for distribution to students).
6. Bank of Examination Questions (coordinated by chapter).
7. Teaching Transparencies (as used by the authors for mass sections).

Many accounting instructors prefer to divide the fundamentals course in accounting into two parts—the first semester focusing on financial accounting and the second on management accounting. Many texts, however, are not arranged so that such an approach is feasible with a single text.

This volume and its companion, *Fundamentals of Management Accounting*, are designed to provide material for a fully coordinated fundamentals course. As the titles indicate, this volume deals with the fundamentals of financial accounting, and its companion with the fundamentals of management accounting. Each volume can be used either for a one-semester or a one-quarter course. Both are designed to provide maximum flexibility for the instructor in the selection and order of materials for the classroom. They emphasize those aspects of accounting we believe essential for interpretation and use of accounting information. Mechanical and procedural details are minimized, while the conceptual, measurement, and communication aspects are emphasized.

This book is an introduction to **financial accounting**, which has as its primary subject the communication of relevant financial information to external parties. We strongly believe that a certain level of knowledge of the accounting model, the measuring processes involved, the data classifications, and terminology is essential to the interpretation and effective use of financial statements. We have provided the necessary information in this volume. The key to effective use of financial statements is to understand what they do and do not say, the measuring approaches used, and the standards observed in their development. This is the case both for students who will continue their study of accounting and for those who will not. The materials are arranged to meet the requirements of a wide range of academic institutions and curricula.

This volume represents a significant departure from the traditional financial accounting textbook in several respects. First, it makes possible a high level of *flexibility* for the instructor by presenting separately designated comprehensive discussions of a broad range of subject areas rather than the bare minimum. This approach means that more materials are presented than usually can be covered in the *undergraduate* financial course in accounting (however, it is completely adequate for such a graduate course). Importantly, this coverage gives the instructor a great amount of flexibility to select those topics appropriate to the situation. In contrast, a textbook that provides only the minimum materials imposes on the instructor the unfortunate choice of having to (a) present a *de minimus* course or (b) devote considerable time developing supplementary textual and homework assignments. Secondly, this text provides additional flexibility because it discusses

a number of topics not traditionally included in an elementary textbook. In our judgment, much of the traditional material is essential; however, the recent thrusts and changes in financial accounting make it imperative that certain significant topics be accorded comprehensive treatment. This volume avoids superficial treatment of these new directions by giving special emphasis to concepts, rationale, measurement, and reporting. Certain special issues and traditional procedural topics are presented in chapter *supplements* should coverage of some or all of them be desired.

The primary features of this book and the instructional materials that accompany it are as follows:

- The characteristics of the environment in which the accounting process operates are emphasized in the first chapter and are integrated throughout the other chapters.
- In the first chapter, the student is presented with a comprehensive description of the end products of the financial accounting process—the external financial statements and related disclosures. This emphasis is continued throughout the other chapters.
- This volume presents the maximum amount of material that can ordinarily be covered in a one-semester undergraduate course. Therefore, some choices must be made by the instructor to reduce the coverage of selected topics.
- Accounting is presented as an information processing model designed to enhance communication by the entity to the users of its financial reports.
- The discussions emphasize concepts, standards, and generally accepted accounting principles as the rationale for the way certain things are done in accounting.
- Throughout the chapters, the measuring approaches used in accounting and reporting to decision makers are emphasized.
- Throughout, the focus is on the corporation rather than on the sole proprietorship or the partnership. Actual case examples are utilized. As a consequence, income taxes, dividends, earnings per share, capital stock, the *APB Opinions*, and the *FASB Statements* are discussed.
- Relevant topics, not ordinarily treated in a first course, are discussed. These include cash flow, present value, consolidated statements, purchase versus pooling, statement of changes in financial position (both working capital and cash bases), compensating balances, price level effects, income taxes, and current value.
- One or more *supplements* follow some of the chapters. These supplements focus on special topics including the clerical and mechanical aspects of the accounting process such as special journals, subsidiary ledgers, payrolls, and petty cash. Separation in supplements facilitates their exclusion, or order of selection, without affecting the continuity of the course.
- A special supplement presents an overview of income taxes for the individual taxpayer and for corporations.

- A special supplement presents the 1982 annual report of Johnson & Johnson. Reference to this report is integrated throughout the discussions and problems/cases in the various chapters.

These features are of particular importance to nonaccounting majors because the first semester usually is their only exposure to the fundamentals of financial accounting. For example, most of the external financial statements coming to the attention of the nonaccounting majors, both in school and in real life, will be consolidated statements. Similarly, an understanding of the effects of general inflation and specific price changes on financial information is essential in these times to the interpretation of reported results.

Answers to questions such as how much time should be spent on each chapter, how much homework should be required, and what materials should be omitted depend on the objectives of the particular course, the time constraints, and the backgrounds of the students. As mentioned above, we have arranged the topical materials to permit maximum flexibility in selecting among various options and in giving varying topical emphasis to fit practically all situations; supplements, parts of chapters, and even entire chapters may be omitted without adversely affecting the continuity of the course. The Solutions Manual includes comments and suggestions that are particularly helpful in selecting among a number of possible options.

The subject matter of the 17 chapters and 17 supplements that comprise this volume has been arranged in what we believe to be a pedagogically sound sequence; nevertheless, considerable rearrangements can be made if the instructor so desires. Each chapter has a summary, and almost all have a demonstration case with a suggested solution. The purpose of the demonstration cases is to tie together the various subtopics discussed in the chapter. Following each chapter are study materials classified as (a) discussion questions, (b) short exercises (suitable for homework, class illustrations, and examinations), and (c) comprehensive problems/cases. Each of these groups of study materials is arranged to follow the topical sequence of the chapter.

The list of students and faculty members to whom the authors feel a sense of gratitude for ideas and suggestions is too long to enumerate here. With respect to this volume, we are particularly grateful to the following individuals who devoted considerable time in discussions, reviewing parts of the manuscript, and testing materials:

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Finally, we express our thanks to numerous users of the prior editions for their valuable suggestions.

Our thanks to the American Institute of Certified Public Accountants, American Accounting Association, Financial Accounting Standards Board, and the authors identified by citations for permission to quote from their publications. To Johnson & Johnson, our special thanks for permission to use selected materials from its annual reports. We also appreciate the permission by Commerce Clearing House, Inc. to use selected materials from their 1983 U.S. Master Tax Guide.

Suggestions and comments on the text and the related materials are invited.

Glenn A. Welsch
Robert N. Anthony
Daniel G. Short

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