

Stice + Stice + Diamond

FINANCIAL ACCOUNTING

REPORTING & ANALYSIS

6 EDITION



FINANCIAL ACCOUNTING

REPORTING & ANALYSIS

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PREFACE

We have worked hard to make *Financial Accounting: Reporting and Analysis*, sixth edition, the most interesting, relevant, and understandable financial accounting text available. The objective of *Financial Accounting: Reporting and Analysis* is to prepare students to succeed as future business managers. Therefore, the important themes of the text are the business context of accounting, the interaction between accounting and business, and financial statement analysis. The target audience for the book is first-year MBA students. We believe that the book will also be attractive for use in high-quality undergraduate programs. We have consciously written the text for future business managers, not for future accountants.

Through this textbook, we attempt to convince students that financial statements are a useful and interesting tool for diagnosing a company's problems (or strengths) and for making loan, investment, acquisition, employment, political decisions, and so on. We also hope to convince students that the economic and political forces operating on practicing accountants, Big 5 auditors, and accounting standard setters (both in the U.S. and internationally) make the field of financial accounting an intellectually fascinating one.

Along with many other instructors, we have learned through experience that the way to teach financial accounting is to repeatedly hammer home the business relevance of accounting. The beautiful thing about teaching financial accounting is that actual examples from real companies are available daily through the business press and through public disclosure of financial reports (increasingly made over the Web). We take advantage of this wealth of material by building each chapter around the most recent financial statements of a well-known company. Using actual financial statements in this way has at least two benefits. First, just the mention of a real company name (McDonald's, Microsoft, DuPont, Sears) creates an image in the student's mind and increases attentiveness. Second, we can take advantage of students' everyday consumer experiences to link accounting terminology and practice with actual events that they already understand very well. For example, the concept of unearned revenue is easy for students to understand when they remember the last time they bought air tickets from Delta or United and consider the practical accounting implications of the delay between the ticket purchase and the actual flight.

We have attempted to make our writing intuitive and lively. Our objective (or dream) is that students will actually enjoy reading the chapters. We have found in teaching that our excitement and enthusiasm about accounting motivates students to listen more carefully, to study a little harder, and to retain a little better. We have tried to accomplish the same thing in writing this book.

Text Features

Early Coverage of Financial Statement Analysis. We believe that MBA students should be exposed to financial statement analysis in the early chapters of an introductory financial accounting text. We introduce students to some simple analysis in chapters 1 and 2. Chapter 3 (Introduction to Financial Statement Analysis) provides a simple, yet effective, framework for analyzing financial statements. Each subsequent chapter contains analytical techniques related to the chapter concepts. Finally, chapter 16 highlights the impact that accounting assumptions have on the values of financial ratios.

Financial Analysis Cases. After each major part of the text, a Financial Analysis Case reinforces and emphasizes the accounting issues covered in that part. Each case is based on current data for real companies. The cases are one to two pages long and include questions for students and three or four additional pages of accounting information. The five companies examined in the cases are:

IBM Procter & Gamble Intel AT&T Coca-Cola

Increased Coverage of Statement of Cash Flows. We introduce the statement of cash flows in chapter 2, cover it in detail in chapter 6, and include relevant cash flow material in each of the later chapters. We believe that our coverage of the statement of cash flows is more complete and pervasive than in any other financial accounting textbook.

Integrated International Topics. We integrate international topics into each chapter. Examples of the type of topics we include are:

Interpreting foreign financial statements
Harmonization of international accounting standards
Accounting issues faced by U.S. multinationals
Cross-border transactions

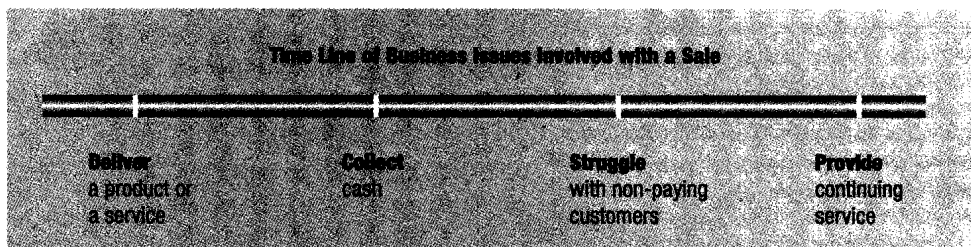
Less Emphasis on Journal Entries and the Accounting Cycle. Journal entries are not covered or used in the text discussion until chapter 7. After that, they are used sparingly. We emphasize the journal entry as a Tool of Analysis.

Key Points. The Key Points are a small but, we think, significant twist on the standard "Learning Objectives" found at the beginning of chapters. The purpose of the Key Points is twofold: to outline what is covered in the chapter and also to briefly teach some of the main points to be covered. For example, a Key Point not only notifies the student that something called the "balance sheet" is covered in the chapter, but also very briefly explains what a "balance sheet" is.

Business Profile. These profiles are thumbnail sketches of the history and current operations of prominent real companies. The business environment of the company profiled is tied into one or more of the accounting issues to be covered in the chapter. Companies spotlighted in these profiles include:

Berkshire Hathaway	Dow Jones	Home Depot
Boeing	DuPont	McDonald's
Circle K	Exxon Mobil	Safeway
DaimlerChrysler	General Electric	Sears
Disney	General Motors	Wal-Mart

Activity Timeline. Each timeline illustrates the sequence of the primary business events underlying the accounting issues explained in a chapter. An example for the Revenue Cycle (chapter 8) is given below.



The timeline is then used to explain how these business issues naturally require accountants to develop accounting procedures and estimates in order to properly represent the business activities of the company in the financial statements. For example, the accounting issues associated with the Revenue Cycle Timeline are as follows:

- When should revenue be recognized: when the good or service is provided, when the cash is collected, or later, when there is no longer any chance that the customer will return the product or demand a refund because of faulty service?
- What accounting procedures are used to manage and safeguard cash as it is collected?
- How do you account for bad debts, that is, customers who don't pay their bills?
- How do you account for the possibility that sales this year may obligate you to make warranty repairs and provide continuing customer service for many years to come?

Relationship Among the Financial Statements. This graphical exhibit is a schematic representation of the three primary financial statements (balance sheet, income statement, and statement of cash flows). This exhibit highlights the specific financial statement items to be covered in the chapter. For example, in the inventory chapter (chapter 9), the items highlighted are Inventory (on the balance sheet), Cost of Goods Sold (on the income statement), and Cash Paid for Purchases (on the statement of cash flows). The exhibit also reiterates the relationships among the three primary financial statements: the statement of cash flows explains the balance sheet change in cash, the income statement (along with dividends) explains the balance sheet change in retained earnings, and operating cash flow and net income are related by the accrual adjustments that accountants make to the raw cash flow data.

FYI. The FYI items are interesting little tidbits of information to be boxed into margin notes.

Test Your Intuition. The Test Your Intuition items are short questions requiring students to ponder the economic and business implications of the accounting material just discussed. These items will require the student to use intuition to extrapolate beyond the text material. Solutions are provided in the instructor's solutions manual.

Caution. The Caution items are warnings about common student misunderstandings. We develop these items based on experience we have had with our own students.

Business Context. The Business Context items provide interesting supplemental material, related to the text but outside the flow of the text discussion. Each Business Context item is an original essay between a half page and a page in length. Business Context items in the text include:

- Market Efficiency: Can Financial Statement Analysis Help You Win in the Stock Market?
- Do Accountants Record the Most Important Events?
- Net Income vs. EVA®
- Check Kiting
- Strategic Timing of Stock Repurchases
- How Do Foreign Companies List in the United States?

Data Mining. The Data Mining items contain summary financial statement information for a selection of famous companies, along with brief assignments requiring students to analyze the data. These are simple but informative and fun. For example, in chapter 2 (Introduction to the Financial Statements), the students are given a list of the ten U.S. companies with the highest net incomes in 2000 (according to the Fortune 500 list). The students are also given the total market value for each of these companies. The varying relationship between net income and market value for the ten companies illustrates that investors are willing to pay more for the earnings of some companies than for the earnings of others—they will pay \$30 for each dollar of current earnings for Microsoft but only \$11 for each dollar of current earnings for Verizon. Students are asked to go beyond the numbers and think about why this might be. Other Data Mining items from the text include:

- Book-to-Market Ratios for the ten U.S. companies with the highest market values
- Identifying LBO Targets using cash flow data
- Efficient Use of Working Capital, a comparison of 1993 and 2000 numbers for five large retailers
- Valuing a Foreign Currency Portfolio, an examination of the fluctuation in the value of the U.S. dollar over the past 40 years
- Derivatives: Fair Value and Notional Value, a look at the grossly inflated notional values often reported in the financial press
- Microsoft's Stock Splits, an attempt to identify the level of Microsoft's price per share that appears to trigger a stock split by the company
- The Inflation-Adjusted Cost of Postage, an application of the consumer price index to see whether the price of stamps is increasing or decreasing

Web Search. Each Web Search is a short in-text exercise that takes students to an Internet site related to some point in the text discussion.

Review of Key Points. The Key Points from the beginning of the chapter are repeated, along with a short summary of the text discussion related to that Key Point.

Key Terms. All new terms are boldfaced in the text and listed with page references at the end of each chapter. A glossary of all key terms is provided in Appendix C.

End-of-Chapter Material

We are extremely proud of our end-of-chapter material. In addition to high quality exercises and problems, we provide analysis, research, writing, and presentation assignments that are ideal for MBAs.

Questions. These are short questions, usually with no numerical content, that lead students on a sequential review of the text material.

Exercises. The Exercises are usually numerical and cover one specific topic introduced in the chapter.

Problems. The Problems are more involved than are the Exercises and often include coverage of two or more topics introduced in the chapter. In addition, almost all of the Problems include one sub-part labeled “Analysis” that requires students to use the data given in the Problem to make a business decision. A sample of “Analysis” questions associated with the Problems in chapter 2 (Overview of the Financial Statements) is given below:

- **ANALYSIS** On October 31, 2003, it is announced that Superior Computer Corporation has declared bankruptcy. The assets of Superior will be liquidated, and all debts will be repaid within 60 days. Discuss how the numbers in the balance sheet prepared on October 31, 2003, will be affected by this bankruptcy news.
- **ANALYSIS** You looked at the income statement of Anasonic’s chief competitor and found that the competitor’s cost of goods sold is 48% of sales. Compute this percentage for Anasonic, and discuss what might be causing the difference between Anasonic and its competitor.
- **ANALYSIS** Item (f) states that Ocra paid \$15,000 in cash dividends in its first six months of operations. How else might Ocra have used this \$15,000? Do you think it was a good idea to pay this cash dividend so soon after Ocra began business? Explain your answer.

Applications & Extensions

Deciphering Actual Financial Statements. These Deciphering problems use actual data (from the most recent year available) for real companies. The problems have students apply the concepts learned in the chapter to real data. Students are also asked to think about how the reported financial numbers, and the relationships among them, relate to the underlying business of the real company. Financial statements examined in the Deciphering problems include those from the following companies:

Archer Daniels Midland
Boston Celtics
Citicorp
Coca-Cola

Delta Air Lines
Disney
General Motors
FedEx

Lockheed Martin
McDonald’s
Sara Lee
Wells Fargo

International Financial Statements. These problems are very similar to the Deciphering problems, with the added twist that the data are from non-U.S. companies. These problems allow students to see statement formats and terminology that are different from those illustrated in the chapter. In addition, these problems are excellent vehicles through which to discuss the difference between U.S. GAAP and the accounting principles used in other countries. In our opinion, by considering the rationale behind the accounting practices in other countries, students will better understand U.S. practice. International financial statement problems include financial statement information from the following companies:

BMW	Nestlé	Sony
BP Amoco	Polygram	Swire Pacific
British Telecommunications	Samsung	Telefonos de Mexico
Cadbury Schweppes	Shanghai	(TELMEX)
Glaxo Wellcome	Petrochemical	Thorn EMI

Business Memo. These exercises establish some sort of business scenario and then ask students to write a brief (one-page) memo explaining an accounting principle and suggesting a course of action.

Research. The research projects require students (either individually or in groups) to gather data (press releases, financial statements, news articles), perform some kind of analysis, and then report their results, either orally or in writing.

Ethics Dilemma. The Ethics Dilemmas give students a role in a hypothetical scenario involving questionable judgment on an accounting issue. These Dilemmas are good learning exercises on many dimensions—they provide an interesting setting to review accounting concepts, they illustrate that real business people will go to great lengths to manage their financial statements, and they provide a realistic setting in which students can consider their personal ethics.

The Debate. The Debates are based on a polarizing accounting issue covered in the chapter, often reflecting actual debates that have occurred as part of the accounting standard-setting process. This is a group project, with the group being divided into two teams. The teams are instructed as follows: Your teams are NOT to make even-handed, reasonable arguments. Each team is an advocate for a position and should do everything possible (short of lying, of course) to present a convincing case.

Cumulative Spreadsheet. The spreadsheet exercise builds in each chapter. It is based on cash flow difficulties faced by Home Depot at the end of 1985, but a fictitious name (Handyman) is used—we reveal the Home Depot connection in the last chapter. The early assignments simply have the students construct a spreadsheet balance sheet and do a couple of simple manipulations, ratio calculations, and so on. By the end of the text, the spreadsheet will have grown to a five-year forecast of operating cash flow that depends on assumptions about different operating parameters (speed of receivables collection, inventory efficiency, interest rates, sales growth, profitability).

Internet Search. In most cases, the Internet Search asks students to go to the Web to find current financial information about the company featured in the Business Profile at the beginning of the chapter.

Ancillary Materials

New to this edition is a convenient **Instructor's Resource CD (IRCD)** (0-324-15056-3). This disk contains the following resources:

- A solutions manual, in MSWord®, that consists of the detailed solutions, including the intermediate calculations, to questions, exercises, problems, and other text assignments. The solutions manual has been independently verified for accuracy.
- Selected solutions, prepared in large type, are provided for use in lectures. These contain the quantitative and tabular parts of the solutions manual. These are also available in printed solution transparency form (0-324-15052-0) upon request.
- The Excel solutions to the Cumulative Spreadsheet Projects.
- A test bank, in rich text format (rtf), that contains over 1,000 test items, including statement completion, multiple choice, matching, short problems, and short essay questions. These items are closely matched to and support the user-focus of the text. Detailed solutions to all questions are included, along with explanations and computations where applicable.
- PowerPoint® Presentation slides that provide a comprehensive lecture resource including summaries and explanations of key chapter concepts.

ExamView® Pro (0-324-15054-7) is a user-friendly electronic form of the test bank described above. This easy-to-use product allows instructors to create exams by selecting provided testing items, modifying existing items, and adding their own items.

WebTutor™ on either WebCT or Blackboard allows the instructor to provide interactive reinforcement that helps students grasp complex concepts. WebTutor also offers the following benefits:

- Customized support so you can develop and teach your way—online.
- Powerful communication tools like e-mail, discussion forums, and chat rooms for greater interaction and involvement.
- Real-world, Web savvy links for timely content.

Personal WebTutor™ is an easy-to-use Web-based learning tool that reviews critical text material chapter-by-chapter. Concepts and terminology are reinforced through self-testing, flashcards, and more.

The text's **Web site** (<http://stice.swcollege.com>) contains many resources for both the instructor and the student, and is available without charge. For example, the site includes the PowerPoint Presentation files, the Data Mining activities and solutions, the content of the IRCD excluding the test bank files, check figures, quizzes, and hotlinks to sites identified in the text. The instructor's section of the site is password protected.

The Financial Reporting Project (0-324-12580-1), by Baldwin and Hock, is a workbook that can supplement any financial accounting text. It requires users to obtain and analyze "live" financial statements from publicly-traded firms. Accounting

textbooks often use uncomplicated, make-believe examples that isolate specific issues to illustrate a specific point. The result is that readers do not “learn” that “real” financial statements do not always appear as neat and tidy as those in textbook examples. *The Financial Reporting Project* brings financial statements to life, letting readers experience up-to-date “live” financial statements “in their natural habitat.”

INTACCT for Financial Accounting, by Rama, is a completely on-line, innovative, Internet-based tutorial that is designed for use in the financial accounting course or in any course where a review of key concepts and terminology is needed. The program offers a visual, user-friendly way to reinforce financial accounting principles with tutorials, demonstration problems, exercises, and an interactive glossary. Users receive an access code that allows them to complete the on-line tutorial during the full term of a course.

The Accounting System (0-324-02361-8), by Ruland, is a self-paced workbook that is designed to supplement a financial accounting course. The workbook helps financial accounting users who may have had little or no exposure to the accounting system and accounting mechanics.

Interactive Cases in Financial Analysis (0-538-86739-6), by Pratt, Ramesh, and Foster, is a multimedia, interactive CD-ROM that offers three case studies to prepare students for real-world lending decisions. These cases simulate the lending process by requiring students to analyze actual financial statements, press releases of the company, prominent business journal commentary, and industry data. Based on this analysis, they must determine whether to extend a letter of credit to the company and write up the recommendations based upon their research. This prepares students for the demands and risks they are likely to encounter in banking careers.

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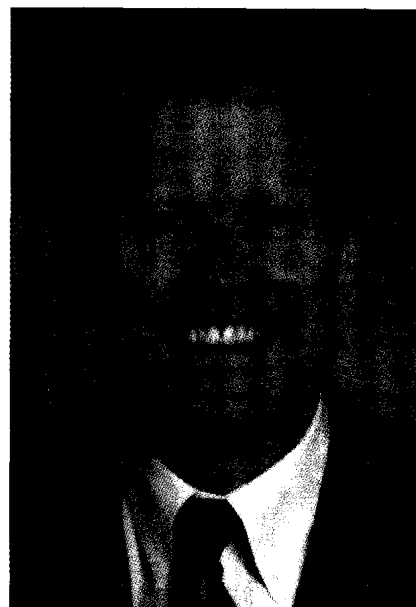
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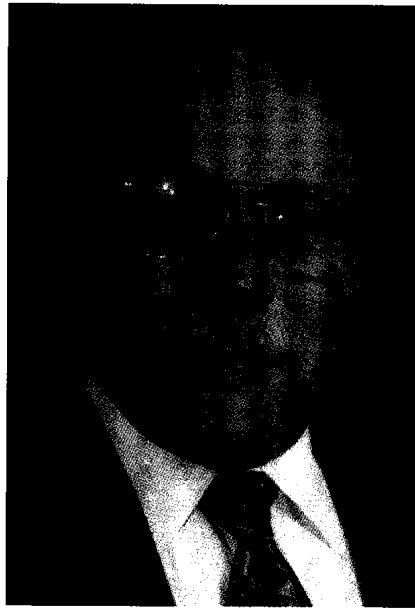
Earl K. Stice is the PricewaterhouseCoopers Professor of Accounting in the School of Accountancy and Information Systems at Brigham Young University. He holds bachelor's and master's degrees from Brigham Young University and a Ph.D. from Cornell University. Dr. Stice has taught at Rice University, the University of Arizona, and Cornell University, and the Hong Kong University of Science and Technology (HKUST). He won the Phi Beta Kappa teaching award at Rice University and was twice selected at HKUST as one of the ten best lecturers on campus. Dr. Stice has also taught in a variety of executive education and corporate training programs in the United States, Hong Kong, China, and South Africa. He has published papers in the *Journal of Financial and Quantitative Analysis*, *The Accounting Review*, *Review of Accounting Studies*, and *Issues in Accounting Education*, and his research on stock splits has been cited in *Business Week*, *Money*, and *Forbes*. Dr. Stice has presented his research results at seminars in the United States, Finland, Taiwan, Australia, and Hong Kong. He is co-author of *Intermediate Accounting*, 14th edition; *Accounting: Concepts and Applications*, 8th edition; and *Financial Accounting: Reporting and Analysis*, 6th edition. Dr. Stice and his wife, Ramona, are the parents of five children: Derrald, Han, Ryan Marie, Lorien, and Lily.



James D. Stice

James D. Stice is the Distinguished Teaching Professor in the Marriott School of Management at Brigham Young University. He is also the Associate Director of the Marriott School's MBA Program. He holds bachelor's and master's degrees from BYU and a Ph.D. from the University of Washington, all in accounting. Dr. Stice has been on the faculty at BYU since 1988. During that time, he has been selected by graduating accounting students as "Teacher of the Year" on numerous occasions, he was selected by his peers in the Marriott School to receive the "Outstanding Teaching Award" in 1995, and in 1999 he was selected by the

University to receive its highest teaching honor, the Maeser Excellence in Teaching Award. In 2000, BYU's MBA students voted Dr. Stice "Professor of the Year." Professor Stice has published articles in *The Journal of Accounting Research*, *The Accounting Review*, *Decision Sciences*, *Issues in Accounting Education*, *The CPA Journal*, and other academic and professional journals. In addition, he is co-author of three textbooks: *Intermediate Accounting*, 14th edition; *Accounting: Concepts and Applications*, 8th edition, and *Financial Accounting: Reporting and Analysis*, 6th edition. In addition to his teaching and research, Dr. Stice has been involved in executive education for such companies as IBM, Bank of America, and Ernst & Young. Dr. Stice and his wife, Kaye, have seven children: Crystal, J.D., Ashley, Whitney, Kara, Skyley, and Cierra.



Michael A. Diamond

Michael A. Diamond serves as Vice President and Executive Vice Provost of the University of Southern California. Prior to that, Dr. Diamond served as Vice Provost for Planning and Budget, as dean of the Leventhal School of Accounting, and as director of the school's SEC and Financial Reporting Institute. During that time period, the Leventhal School of Accounting was consistently ranked as one of the top five accounting programs in the country.

Dr. Diamond is a leader in the accounting education reform movement. He has lectured throughout the United States, Europe and Asia on business and accounting education innovation. His articles have appeared in the *Harvard Business Review*, *Accounting Horizons* and the *Journal of Accounting*. Over the

last five years, Dr. Diamond has turned his attention to issues of academic leadership and change: he published this in *Change* and co-authored two monographs on academic leadership.

Mike has served as president of the American Accounting Association, taught at California State University, Los Angeles, and been a visiting professor at the University of California, Berkeley, and the University of California, Los Angeles. He also has taught in executive education programs for a number of international accounting firms as well as Fortune 500 companies. Dr. Diamond is the recipient of the California Society of CPAs Faculty Excellence Award for 1993 and was named as one of the "Top 100 Most Influential People in Accounting" in both the fall 1997 and 1998 issues of *Accounting Today*.

With Michael Moore, Dr. Diamond developed the Strategic Planning Partnership, an initiative of the Ernst & Young Foundation. This program assists selected business schools and other academic organizations in strategic planning and change management processes.

Mike received his BA degree at the University of California, Berkeley, and his MS and Ph.D. degrees from the University of California, Los Angeles. He and his wife, Elaine, have one son, Jacob, currently attending Drew University in New Jersey.

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