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Financial Accounting

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*Warren
& Fess*

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*Third
Edition*

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Financial Accounting

Third Edition

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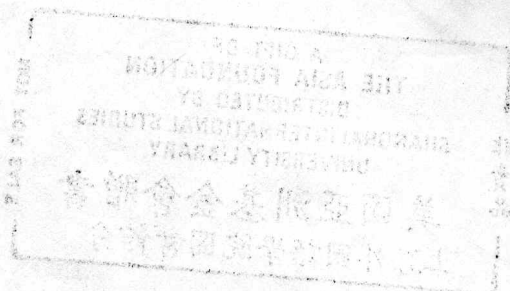
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Preface

The third edition of FINANCIAL ACCOUNTING is a student-oriented text. It presents the fundamental accounting concepts and principles in a logical, concise, and clear manner. FINANCIAL ACCOUNTING provides a solid educational foundation that allows instructors to focus on clarifying issues and increasing the student's understanding of accounting and its uses.

Fundamental accounting concepts and principles are presented in the text in a business setting that allows students to understand accounting as it is applied in serving not only the business world but all of society. Such an approach meets the needs of students planning careers in accounting as well as in business administration, in liberal arts areas, in law, or in other disciplines.

IMPORTANT FEATURES OF THE THIRD EDITION

The basic foundation of FINANCIAL ACCOUNTING has been retained in the third edition. However, many new features have been added. The most significant new features and the quality features introduced in previous editions are:

Accounting Cycle

The accounting cycle for a merchandising enterprise is presented in the first four chapters. In Chapter 1, the unique presentation integrates the accounting equation with the accounts and journal entries.

Form of Business Organization

The corporate form of business organization is used in the illustrations and discussions of accounting concepts and principles beginning in Chapter 1. The concepts and principles applicable to the sole proprietorship and partnership are presented in Chapter 10.

Accounting for Merchandise Inventory

The discussion of accounting for merchandise inventory has been revised to facilitate student understanding.

- The accounts *Purchases Returns and Allowances* and *Transportation In* are used in the discussion of accounting for merchandise enterprises.
- An alternate method of handling merchandise inventory at the end of an accounting period has been added as Appendix B. This method, sometimes referred to as the adjusting method, can be used instead of the method presented in the merchandising chapters. The Solutions Manual includes solutions for both approaches.
- The discussion of the periodic and perpetual methods of accounting for merchandise inventories has been revised and expanded. A comparison of the journal entries under each method has been added. Also, a discussion of the use of the perpetual inventory system in computerized environments is included.

Long-Term Liabilities and Investments in Stocks and Bonds

The discussion of accounting for investments in bonds has been separated from the discussion of accounting for investments in stocks, with the latter moved to the succeeding chapter, which also includes the discussion of consolidated statements and international accounting. The long-term liabilities and bond investments chapter has been revised to include a discussion of present and future values.

Statement of Cash Flows

The discussion of the statement of cash flows replaces the presentation of the statement of changes in financial position, in keeping with the Financial Accounting Standards Board pronouncement requiring a statement of cash flows.

Price-Level Changes

The discussion of price-level changes has been condensed and is now integrated into Chapter 15, "Financial Statement Analysis and Annual Reports."

Financial Statement Analysis and Annual Reports

The financial statement analysis presentation in Chapter 15 has been revised to include a chart summarizing solvency and profitability measures. In addition, a section on corporate annual reports has been added.

Income Taxes

The coverage of income taxes has been condensed and is presented in Appendix D. This appendix, which incorporates the 1986 changes in the tax law, provides students with an understanding of the basic nature of the federal income tax system and its effects on personal and business income.

Chapter Objectives

The chapter objectives have been revised and expanded to enable students and instructors to integrate the chapter materials with the overall learning objectives more successfully.

Illustrations

Many additional charts, graphs, and diagrams have been added throughout the text to enable students to visualize important concepts and principles more efficiently. These charts, graphs, and diagrams are highlighted with color to enhance the learning process.

Real-World Examples

Real-world business examples have been integrated throughout the text to provide students with a flavor for the real-world impact of accounting. These examples add concrete meaning to concepts and principles which might otherwise appear abstract. Many of these examples were taken directly from the latest annual reports of companies such as Pepsico and General Motors. In addition, the American Institute of Certified Public Accountants' publication, *Accounting Trends & Techniques*, is cited where appropriate to indicate the frequency with which alternative accounting presentations and methods are used in the real world.

Enrichment Material

Excerpts from well-known business periodicals, such as the *Journal of Accountancy*, the *Wall Street Journal*, and *Forbes*, have been added to each chapter. Each excerpt was adapted and designed to stir the students' interest and enrich their learning experience by providing real-world information relevant to the topics that are discussed in the chapter.

Chapter Reviews

A chapter review has been added at the end of each chapter. The chapter reviews are designed to increase and enhance student retention of important chapter concepts and principles. Each chapter review includes key points, key terms, self-examination questions, and an illustrative problem and solution.

- The **key points** summarize the major concepts presented in a chapter. By studying the key points, students can quickly review the major concepts and principles of each chapter.
- Each **key term** listed in the chapter review is followed by the page number indicating where the key term was first presented in color and discussed in the chapter. Students may also refer to Appendix A, where all the key terms in the text are listed alphabetically and defined.
- Five **self-examination questions** are provided for each chapter. After studying the chapter, students can answer these questions and compare their answers with the correct ones that appear at the end of the chapter. An explanation of both the correct and incorrect answers for each question is provided in order to increase students' understanding and enhance the learning process further.
- The **illustrative problem** with suggested solution focuses on the concepts and principles discussed in the chapter. Students can use these problems as a means of building confidence in their ability to apply a chapter's concepts and principles to a problem situation.

End-of-Chapter Materials

The end-of-chapter exercises and problems have been carefully written and revised to be both practical and comprehensive. The variety and volume of the assignment materials presented at the end of each chapter provide a wide choice of subject matter and range of difficulty. In addition, selected problems may be solved using general ledger and spreadsheet software that is available from South-Western Publishing Co. As in previous editions, each chapter contains a mini-case for stimulating student interest. Each case, which presents situations with which students can easily identify, emphasizes important chapter concepts and principles.

Real-World Focus Questions

A discussion question that requires students to interpret and respond to a real-world business situation is contained in each chapter. In some chapters, a real-world exercise is also included. These questions and exercises, which are labeled "Real World Focus," are based on actual business data.

Comprehensive Problem

A comprehensive problem has been added at the end of Chapter 4 to integrate and summarize the concepts and principles of the first four chapters.

Alternate Problems

The alternate problems appear at the end of each chapter in order to facilitate student and instructor usage.

Check Figures

Check figures are presented at the end of the textbook for student use in solving end-of-chapter problems. Agreement with the check figures is an indication that a significant portion of the solution is basically correct.

SUPPLEMENTARY MATERIALS

FINANCIAL ACCOUNTING is part of a well-integrated educational package that includes materials designed for the instructor's use and for the students' use. These materials are carefully prepared and reviewed to maintain consistency and high quality throughout.

Available to Instructors

Solutions Manual. This manual contains solutions to all end-of-chapter materials, including the discussion questions, exercises, problems, mini-cases, and comprehensive problem.

Spreadsheet Applications, prepared by Gaylord N. Smith of Albion College. This template diskette is used with Lotus™ 1-2-3™¹ for solving selected end-of-chapter exercises and problems that are identified with the symbol at the right. This diskette, which also provides a tutorial and "what if" analysis, may be ordered upon adoption from South-Western Publishing Co.



Instructor's Manual. This manual contains a summary of the chapter objectives, terminology, and concepts. In a section organized according to chapter objectives, a basis for developing class lectures and assigning homework is provided. In addition, exercise and problem descriptions, estimated time requirements for the problems, and suggestions for use of the appendixes and other supplementary items are included.

Transparencies. Transparencies of solutions to all exercises and problems are available.

Teaching Transparencies. The teaching transparencies are designed to aid the instructor's focus on key concepts and principles discussed in the text.

Test Bank. A collection of examination problems, multiple-choice questions, and true or false questions for each chapter, accompanied by solutions, is available in both printed and microcomputer (MicroSWAT II) versions. The Test Bank is designed to save time in preparing and grading periodic and final examinations. Individual items may also be selected for use as short quizzes. The number of questions is sufficient to provide variety from year to year and from class section to class section.

Achievement Tests. Two sets of preprinted objective tests are available. Each test covers a group of chapters and may be machine graded. A comprehensive test is also included.

¹Lotus™ 1-2-3™ are trademarks of the Lotus Development Corporation. Any reference to Lotus or 1-2-3 refers to this footnote.

The Administrator. A software management package is available to adopters. This package is specifically designed for use in maintaining a grade book, creating an interactive testing and/or study guide file, and generating tests.

Available to Students

Solutions: Financial Applications Software, prepared by Warren W. Allen and Dale H. Klooster of Educational Technical Systems. This software, which may be ordered with the textbook, is a general ledger program tailored specifically to FINANCIAL ACCOUNTING. It may be used with the IBM PC, IBM PCjr² and the Tandy® 1000³ microcomputers to solve selected end-of-chapter problems and the comprehensive problem, which are identified with the symbol at the right.



Working Papers. Appropriate printed forms on which to work end-of-chapter problems and mini-cases are available.

Study Guide, prepared by James A. Heintz. The Study Guide is designed to assist in comprehending the concepts and principles presented in the text. This publication includes an outline and a glossary for each chapter as well as brief objective questions and problems. Solutions to these questions and problems are presented at the back of the Study Guide.

Microcomputer Study Guide. The microcomputer version of the manual Study Guide may be used with the IBM PC, the IBM PCjr, and the Tandy 1000.

Practice Set, prepared by Herman R. Address of Santa Fe Community College. The short practice set requires the recording, analysis, interpretation, and reporting of accounting data for a corporation. It is available in either a manual or computerized version.

ORGANIZATION OF THE THIRD EDITION

FINANCIAL ACCOUNTING has been organized to facilitate the learning of accounting and the overall educational process. Concepts and principles are introduced in a logical, step-by-step way and are reinforced by applications from the business world.

Each chapter builds on the terminology, concepts, and principles introduced in previous chapters. The chapter objectives provide students with a basis for beginning their study of each chapter. In turn, each chapter is organized around the chapter objectives in an educationally sound approach. The chapter reviews provide students with a means for review and a basis for assessing their knowledge of each chapter. The end-of-chapter discussion questions, exercises, problems, and mini-cases provide a vehicle for the instructor to assess the students' knowledge of each chapter's concepts and principles. Periodic giving of examinations provides instructors with a means for assessing students' cumulative knowledge.

The organization of the third edition of FINANCIAL ACCOUNTING is briefly summarized in the following paragraphs.

²IBM is a registered trademark of International Business Machines Corporation. Any reference to the IBM Personal Computer or the IBM PCjr refers to this footnote.

³Tandy® 1000 is a registered trademark of the Radio Shack Division of Tandy Corporation. Any reference to the Tandy 1000 microcomputer refers to this footnote.

Introduction: Evolution of Accounting

The introduction presents a summary of the beginnings of accounting in 1494 and its development to the present. Emphasis is given to the present-day profession of accountancy and its future. This overview provides students of all backgrounds an excellent perspective on the importance and influence of accounting on all phases of society.

Part 1—Fundamentals of Financial Accounting

- Chapter 1 presents basic financial accounting concepts and principles, including the rules of debit and credit, the use of accounts, the preparation of a trial balance, and the preparation of financial statements for a corporate form of organization.
- Chapter 2 reinforces the principles and concepts introduced in Chapter 1 by discussing basic financial principles and concepts in the context of merchandising enterprises.
- Chapters 3 and 4 complete the accounting cycle by discussing the adjusting process and periodic reporting.

Part 2—Accounting Systems

- Chapters 5–9 begin with a brief discussion of the basic concepts of accounting systems design. Financial accounting principles for cash, receivables and temporary investments, inventories, plant and intangible assets, and payroll and other current liabilities are then discussed in depth in balance sheet order.

Part 3—Accounting for Equity Rights

- Chapters 10 and 11 discuss alternative forms of business organization—sole proprietorships and partnerships—and complex business transactions affecting stockholders' equity.
- Chapter 12 discusses long-term liabilities and investments in bonds. Present value concepts are integrated throughout this chapter.
- Chapter 13 discusses principles and concepts involving long-term investments in stocks, consolidations, and accounting for international operations. Accounting for international operations is increasing in importance as more and more businesses of all sizes engage in foreign transactions.

Part 4—Additional Statements and Analyses

- Chapter 14 emphasizes the principles and conceptual logic of the statement of cash flows. Appendixes are provided for those instructors who wish to use a work sheet for preparing the statement of cash flows and to emphasize the direct method of reporting cash flows from operations.
- Chapter 15 presents a discussion of solvency and profitability and related analytical procedures useful in assessing these financial statement concepts. It also includes a discussion of corporate annual reports and the effects of changes in price levels on financial statements.

Part 5—Nonprofit Organizations

- Chapter 16 presents accounting concepts and principles related to nonprofit organizations.

Appendixes

- Appendix A contains a glossary of the key terms.
- Appendix B presents an alternative method of recording merchandise inventory at the end of an accounting period. This method is sometimes referred to as the adjusting method. Solutions to problems using this method are presented in the Solutions Manual.
- Appendix C discusses and illustrates special journals and subsidiary ledgers.
- Appendix D discusses income taxes for individuals and business enterprises. Question and exercise materials are included with the appendix.
- Appendix E discusses and illustrates the direct method of reporting cash flows from operations.
- Appendix F presents a work sheet approach to the preparation of the statement of cash flows. The Solutions Manual includes solutions to problems using the work sheet.
- Appendix G presents complete present value and future value tables.
- Appendix H contains selected financial statements for real companies.

ACKNOWLEDGMENTS

Throughout the textbook, relevant professional statements of the Financial Accounting Standards Board and other authoritative publications are discussed, quoted, paraphrased, or footnoted. We are indebted to the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the National Association of Accountants for material from their publications.

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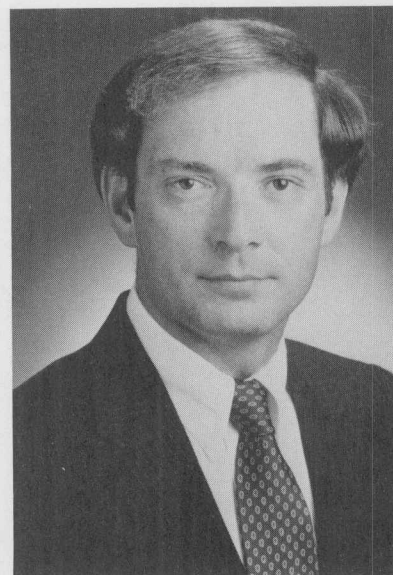
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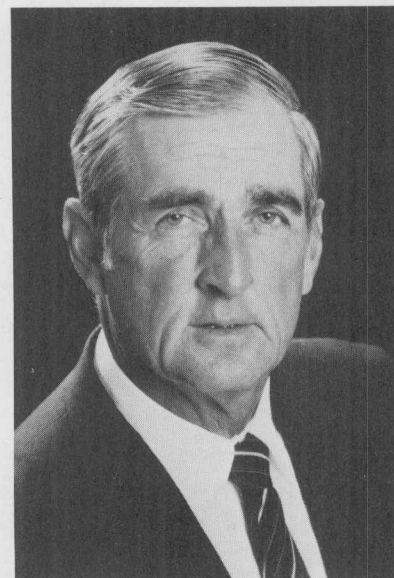
Professor Warren resides in Athens, Georgia, with his wife, Sharon, and two children, Stephanie (age 14) and Jeffrey (age 12). Professor Warren's hobbies include coaching Little League Baseball, golf, tennis, and fishing.



Professor Philip E. Fess is the Arthur Andersen & Co. Alumni Professor of Accountancy at the University of Illinois, Champaign-Urbana. Professor Fess received his PhD from the University of Illinois and has been involved in textbook writing for over twenty years. In addition to having more than 30 years of teaching experience, he has won numerous teaching awards, including the University of Illinois, College of Commerce Alumni Association Excellence in Teaching Award and the Illinois CPA Society Educator of the Year Award.

Professor Fess is a CPA and a member of the American Institute of CPAs and the Illinois Society of CPAs. He is also a member of the National Association of Accountants and the American Accounting Association. He has served many professional associations in a variety of ways, including a term as a member of the Auditing Standards Board, editorial advisor to the *Journal of Accountancy*, and chairperson of the American Accounting Association Committee on CPA Examinations. Professor Fess has written more than 100 books and articles, which have appeared in such journals as the *Journal of Accountancy*, the *Accounting Review*, the *CPA Journal*, and *Management Accounting*. He has also served as an expert witness before the U.S. Tax Court and is a member of the Cost Advisory Panel for the Secretary of the Air Force.

Professor Fess resides in Champaign, Illinois, with his wife, Suzanne. He has three daughters: Linda, who is completing a PhD in accounting at Arizona State University; Ginny, who is a CPA and is employed by Baxter-Travenol; and Martha, who is majoring in finance at the University of Illinois. Professor Fess' hobby is tennis, and he has represented the United States in international tennis competition.



Note to Students

This text was written with the objective of preparing you for your future professional career. Accounting is a stimulating, rewarding field of study. To be effective, professionals in all areas of business, such as finance, production, marketing, personnel, and general management, must have a good understanding of accounting. In addition, men and women whose careers are in nonbusiness areas can use a knowledge of accounting to perform more effectively in society.

As you begin your study of accounting, you may find the following suggestions helpful:

- Read each chapter objective before you begin studying a chapter.
- Take a few minutes and scan the chapter to get a flavor of the material before you begin a detailed reading of the chapter.
- As you read each chapter, you may wish to underline points that you feel are especially important. Also, you should give special attention to key terms which are identified in color when they first appear in the chapter.
- After reading the text of the chapter, carefully study the Chapter Review, giving special attention to the following items:

Key Points. You should thoroughly understand each of the key points presented in the chapter. If you have difficulty understanding any of the key points, review the section of the chapter where the key point is discussed and illustrated. The key points are organized as major chapter headings that appear sequentially throughout the chapter.

Key Terms. You should be able to define each key term. If you cannot, refer to the page of the chapter where the key term is first presented and discussed. You may also refer to Appendix A, where all of the key terms are listed in alphabetical order and defined.

Self-Examination Questions. Answer each of the self-examination questions and check your answers by referring to the answers at the end of the chapter. These answers explain the correct response.

Illustrative Problem. Study the illustrative problem and its suggested solution. Each illustrative problem applies the concepts and principles discussed in the chapter to a problem situation. If you have difficulty understanding the illustrative problem, refer to the section of the chapter where the applicable concepts and principles are discussed and illustrated.

- Work all assigned homework. In many cases, the homework is related to specific chapter illustrations, and you may find it helpful to review the relevant chapter sections before you begin a homework assignment.
- Take notes during class lectures and discussions and give attention to the topics covered by your instructor.
- In reviewing for examinations, keep in mind those topics that your instructor has emphasized, and review your class notes and the text.
- If you feel you need additional aid, you may find the Study Guide that accompanies this textbook helpful. The Study Guide can be ordered from South-Western Publishing Co. by your college or university bookstore.

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