

# INTRODUCTION TO FINANCIAL ACCOUNTING

*A User Perspective*



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# Introduction to Financial Accounting



**A User Perspective**

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**The authors dedicate this book  
to their families.**



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# Preface

As the twenty-first century approaches, we need to reassess the way we are preparing our students for the business world of tomorrow. Clearly, technological advances have changed the skills required in the business world, and advances we can not yet imagine will affect the skills required in the future. Although computers are taking over many of the more repetitive business tasks, business people must still do all the things only people can do — in particular, communicating, thinking, and making decisions. Decision making is *the* critical skill in today's business world, and *Introduction to Financial Accounting: A User Perspective* helps its users to better use accounting information and improve their decision-making skills.

This text provides an introduction to accounting within the context of business and business decisions. Readers will explore accounting information's role in the decision-making process, and learn how to use various types of accounting information found in financial statements and annual reports. Seeing how accounting information can be used to make better business decisions will benefit all students, regardless of their major course of study or chosen career.

We agree with the recommendations made by the Accounting Education Change Commission in its *Position Statement No. Two: The First Course In Accounting*. We believe the course should be a broad introduction to accounting, rather than introductory accounting as it has traditionally been taught, and it should be taught from the perspective of the user, not the preparer. It should emphasize *what* accounting information is, *why* it is important, and *how* it is used by economic decision makers.

As you work with this text, you will find it focuses heavily on the uses of accounting information rather than the preparation of the information. This, however is only one characteristic which distinguishes *Introduction to Financial Accounting: A User Perspective* from other texts you may have used in the past.

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## SUPPORT FOR THE INTERACTIVE CLASSROOM

We believe this text will help get students more involved in their learning process. The conversational tone of the text, its user perspective, and the logical presentation of topics all contribute to the ability of this text to meet that goal. However, several features are particularly important in developing a classroom atmosphere in which students share ideas, ask questions, and relate their learning to the world around them.

Throughout each chapter of the text, you will find **Discussion Questions (DQs)**. In most cases, answers to the DQs require thought beyond the surface of the written text. They are NOT review questions for which the students can scan a few pages of the text to locate an answer. Many of the DQs provide a starting point in relating students' own experiences to the knowledge they are gaining through the text.

The DQs will be very useful in the classroom because of their versatility. They can be used in several different ways:

- Many of the DQs will provide the basis for lively classroom discussions. Many of them require students to think about issues and formulate their own opinions.
- If your students are working in groups, some of the DQs may be used as group assignments (in or out of the classroom). This approach is a good initial step into cooperative learning.
- DQs may be assigned as individual written assignments to be collected and graded. Our students will certainly benefit from the opportunity to practice their writing skills.
- Often, a combination of individual and group work is best. When students come to class with their individual written responses to the DQs, have them get into groups, debate the issues, and come to an answer based on group consensus. When there is no "right" or "wrong" answer, group discussions will get *very* lively!
- Having students keep a journal of their responses to ALL the DQs (whether or not they are used in another way) is a good approach to take advantage of the questions which require solitary pondering.

The DQs are a critically important part of the text. Even if they are not formally used as part of the required work for your course, they should not be ignored. We have designed the DQs to emphasize important points that students may otherwise skim across in their reading. Students will gain a greater understanding of the issues discussed if they will take the time to ponder each question as they reach it in their reading.

Another way to open up your classroom and get students enthused about accounting is to relate topics to the real world. Rockwell International's 1994 annual report is shrink-wrapped with our text, providing your students with the "real thing." We have found that this feature of our text generates enthusiasm among the students, because they can immediately see the relevance of the knowledge they are gaining.

Chapter 13 introduces students to the two major outputs of financial reporting — the annual report and Form 10-K. The chapter walks students through the Rockwell annual report. After this guided tour through one annual report, your students will be better able to handle others. Chapter 14 focuses on ratio analysis, and uses the financial information from the Rockwell annual report in its examples. Although specific text reference to the Rockwell report is not made until Chapter 13, you may have your students explore it even earlier in their work.

Sara Lee Corporation's 1994 annual report is reproduced in the appendix of the text. End-of-chapter assignments related to this annual report and Rockwell's are included in Chapters 13 and 14.

Both Chapters 13 and 14 provide students with help in using library resources to learn about companies. You may find this feature particularly useful if you send your students out on the adventure of gathering and analyzing accounting information. Adventures into *real* information about *real* companies always raises student interest!

In addition to these features which help to foster an open, interactive environment in the classroom, a major distinction of this text is its total separation of the *use* of accounting information and its preparation.

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## SEPARATION OF ACCOUNTING AND BOOKKEEPING

Our text has no debits or credits whatsoever. Is this an indication we think a knowledge of bookkeeping skills is unnecessary? On the contrary, bookkeeping is the nuts and bolts that holds our accounting systems together. What we've learned, though, is that beginning accounting students can't digest the use of financial statements, the role of accounting information, the world of business, and the details of bookkeeping simultaneously. Once students have a basic knowledge of the other topics, however, details of the recording process are much easier for them to learn, and by that time they even know WHY they are learning it.

Separating accounting and bookkeeping makes both subjects easier to grasp and more enjoyable to learn. This approach also allows the timing and degree of coverage of the recording process to be at the discretion of individual instructors and institutions. Some schools may choose to have all students learn basic recording procedures; others may only require accounting majors to acquire these skills.

To facilitate the separation of accounting and bookkeeping, we have developed a separate short text. *Accounting Procedures: The Recording Process* offers a clear, concise introduction to the basic procedures of recording business transactions. This new, modular text covers the recording process in detail from debits and credits, through adjusting, closing, and reversing entries. Additionally, it covers journals, ledgers, and other accounting documents in detail. The modular format of *Accounting Procedures: The Recording Process* allows instructors to pick and choose the topics they wish to cover, and when.

*Accounting Procedures: The Recording Process* can be used in a variety of ways. Some schools have chosen to provide a one-hour class to accompany the second term of introductory accounting. In this setting, *Accounting Procedures: The Recording Process* and its optional software support is an ideal choice for teaching debits and credits to accounting majors, business majors, or all students in the introductory accounting course sequence.

In many cases, a separate class may not be feasible or desirable. In this situation, we suggest devoting three to four weeks of class time to accounting procedures. We have found that once students have a firm understanding of

the financial statements and their use, grasping the “behind the scenes” process leading up to the production of that accounting information is made much easier. We would suggest that the recording process not be introduced before students have handled the income statement, statement of owners’ equity, balance sheet and the concepts underlying accrual accounting. Therefore, *Accounting Procedures: The Recording Process* should be covered **sometime** after the students have worked through Chapter 7 of this text.

Some schools have chosen to end the first term of introductory accounting with this material. Other schools are setting aside three to four weeks during the second term to cover the recording process. Other approaches are to incorporate accounting procedures into a systems course or simply provide students the procedural knowledge they need during the first few weeks of the intermediate accounting course.

Regardless of the implementation scheme, *Accounting Procedures: The Recording Process* provides a well-written exploration of the accounting cycle from an accounting information preparer’s point of view.

In addition to the decision to focus on the uses of accounting information rather than the details of accounting procedures in this text, we have made several other deliberate and important choices about topical coverage.

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## TOPICS COVERED

The decision to include or exclude a topic from this text was made in keeping with the overall goal of teaching students how to understand and use the accounting information found in financial statements and annual reports to make decisions. Because our focus is introducing students to accounting information and its uses in decision making, we could not simply follow the traditional coverage of topics. During the development of the book, we had no map to follow, no pattern to copy. This offered us a challenge and an opportunity. The challenge was to determine which topics should be included and how they should be presented. As we considered individual topics, we continually explored whether their inclusion would enhance a student’s ability to interpret and use accounting information throughout his or her life — both professional and personal. The opportunity this gave us was to create a book that would provide students with more useful accounting knowledge and the skills to use that knowledge. The result is that *Introduction to Financial Accounting: A User Perspective* does not cover every topic that may be included in some traditional texts.

For example, we cover the calculations of only two depreciation methods — straight-line and double-declining-balance. By limiting the coverage of detailed calculations to these two depreciation methods, we can focus on the really important issues related to accounting for depreciable assets, and offer an interesting comparison between straight-line and accelerated methods. Students will not only know how to calculate depreciation expense, but also understand *why* they are calculating it and how to use those calculations in making business decisions. In the chapter, students learn how to properly



interpret gains and losses. Most of them are surprised to find out that two companies buying identical assets for the same price can sell them later for exactly the same amount and have quite a difference in results—one company can have a gain and the other a loss.

Another example of the important choices made in topic coverage is in the subject of inventory and cost of goods sold. We describe both periodic and perpetual inventory systems, but we cover calculations of inventory values under the FIFO, LIFO, and average cost methods only for a perpetual system. Again, by limiting the attention given to detailed calculations, students can focus their attention on the issues crucial to their use of this accounting information. They can see the importance of inventory method choice, and the impact it has on financial statements. Again, our approach focuses on enhancing the students' skills in using accounting information to make wise business decisions.

Throughout the development process, we seriously considered not only what has traditionally been covered, but also many topics not usually included. The decisions made to include or exclude items were difficult at times, but we believe you will be pleased with the choices made. The topics we cover and our method of presentation help students to see the difference between reality and the measurement of reality!

In addition to the choices regarding the selection of topics to cover, we designed a sequence of these topics which helps to make them more understandable.

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## SEQUENCE OF COVERAGE

The sequence of topic presentation in this text is different than that of other books. We developed the chapters in a logical sequence that follows the students' need to know. The role of accounting information in the decision-making process is a theme carried throughout the book. As the chapters unfold, students see how to use each new piece of accounting information they learn about.

In writing this book, we set out to present accounting information in the context of how it is used: to make decisions. To effectively present the user perspective, we developed a more logical flow of topics so that each chapter builds on what the student has already learned. Students can easily understand how the topics fit together logically and how they are all used together to make good decisions. Moreover, students can see that accounting and the information it provides is not merely something that exists unto itself, but rather it is something developed in response to the needs of economic decision makers.

If you could read the entire text before using it in your classroom, you would have a very clear picture of the experience awaiting your students. However, even a short tour through the material covered in each chapter will show you how we have structured our presentation of the topics to maximize student learning:



**Chapter 1** provides a brief overview of business, setting the stage for the introduction of accounting information. Without the world of business, there would be no need for accounting information or the accounting profession.

**Chapter 2** presents an introduction to decision making. Because the stated purpose of financial accounting information is to provide information to be used in making decisions, we believe an understanding of the decision-making process is not only appropriate, but essential.

**Chapter 3** extends the topic of decision making begun in Chapter 2 to focus on economic decisions. We explore the characteristics crucial to making accounting information useful in the decision-making process.

**Chapter 4** introduces the balance sheet as the first of several financial tools developed to present accounting information in a useful form. In this chapter, we focus on how equity financing affects businesses and how its results are reflected on balance sheets.

**Chapter 5** continues the exploration of the balance sheet, this time examining the impact of debt financing. We present notes and bonds as financing options for businesses.

**Chapter 6** presents the income statement and statement of owners' equity as additional financial tools. Now that students have been introduced to the first three financial statements used by economic decision makers, they can see how the statements relate to one another.

**Chapter 7** compares the cash basis and accrual basis of accounting. Basic knowledge of the cash basis is important for two reasons. First, students should realize that accrual accounting is *one* basis of measurement and not *the* measurement basis. Second, understanding the weaknesses of cash basis accounting makes the logic of accrual accounting much easier to grasp.

**Chapter 8** explores issues surrounding the acquisition, depreciation, and disposal of long-lived tangible assets under accrual accounting. As previously mentioned, this chapter examines effects of depreciation method choice, using straight-line and double-declining-balance as examples. We also show students how to properly interpret gains and losses.

**Chapter 9** explores another challenging issue arising from the use of accrual basis accounting — merchandise inventory and inventory cost flow methods. Students learn how to calculate amounts under LIFO, FIFO and average cost methods. More importantly, they learn how the choice of method affects the accounting information provided on income statements and balance sheets.

**Chapter 10** returns to the balance sheet and income statement, taking a closer look at the way these two financial statements are organized. We explore the information provided in a classified balance sheet and an expanded multistep income statement in detail.

**Chapter 11** introduces the statement of cash flows as another financial tool. After using the information provided by the other three financial statements, prepared under accrual accounting, students see the need to refocus their attention on cash. With an understanding of the purpose of the statement of cash flows in hand, students find its creation and use easier to understand.

**Chapter 12** presents the basic concepts underlying generally accepted accounting principles (GAAP) and the types of outside assurance (audit, review, and compilation) available. GAAP provide a set of standards for the preparation of financial statements, and the audit function provides external decision makers with the assurance that these standards have been consistently applied.

**Chapter 13** takes an in-depth look at the annual report to the stockholders and the Form 10-K required by the Securities and Exchange Commission. The 1994 annual report of Rockwell International Corporation, shrink-wrapped with this text, provides students with an example of a real annual report. Sara Lee Corporation's 1994 annual report is reproduced as an appendix in the text.

**Chapter 14** explains the importance of gathering various types of information in order for the results of financial statement analysis to be most useful. Ratio analysis is the featured technique; information from Rockwell International's annual report is used to illustrate the computations, comparisons, and analyses throughout the chapter.

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## OTHER IMPORTANT FEATURES OF THIS TEXT

In addition to the DISCUSSION QUESTIONS and the inclusion of the ROCKWELL ANNUAL REPORT, discussed in detail above, our text offers other features which will enhance the learning process:

- **LEARNING OBJECTIVES** - Previewing each chapter with these objectives allows students to see what direction the chapter is taking, making the journey through the material a bit easier.
- **MARGINAL GLOSSARY** - Students often find learning accounting terminology to be a challenge. As each new key word is introduced in the text, it is shown in bold and also defined in the margin. This feature offers students an easy way to review the key terms and locate their introduction in the text.

- **SUMMARY** - This concise summary of each chapter provides an overview of the main points, but is in no way a substitute for reading the chapter.
- **KEY TERMS** - At the end of each chapter, a list of the new key words and their definitions is provided. This list also directs students to the page on which the key word or phrase was introduced.
- **REVIEW THE FACTS** - Students can use these basic, definitional questions to review the key points of each chapter. The questions are in a sequence reflecting the coverage of topics in the chapter.
- **APPLY WHAT YOU HAVE LEARNED** - Our end-of-chapter assignment materials include a mix of traditional types of homework problems, as well as innovative assignments requiring critical thinking and writing. Many of the requirements can be used as the basis for classroom discussions. You will find matching problems, short essay questions, and calculations. Assignments dealing directly with the use of financial statements are also included. Many of these applications also work well as group assignments.

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## **SUPPLEMENTS FOR Use BY THE INSTRUCTOR**

Additional support for your efforts in the classroom is provided by our group of supplements:

- **INSTRUCTOR'S MANUAL** - For each chapter, we provide: (1) a chapter overview, giving you a sense of how the chapter fits with your students' prior knowledge, and where we will be taking them in the chapter; (2) the learning objectives, to give you a set of goals for the skills you want your students to acquire; (3) a topical outline indicating the DQs and applications for each topic; (4) a more detailed chapter outline with teaching tips based on our experiences with the material; (5) a quick quiz, designed to indicate whether the student has read the chapter; (6) suggested solutions to the Discussion Questions, which may help guide your class discussions and anticipate some of the responses your students will offer.
- **SOLUTIONS MANUAL** - Solutions to the end-of-chapter applications are provided in a clear and easy-to-use format. Transparencies may be made from these pages, or from the disk version of the solutions manual.
- **DISK COPY OF THE SOLUTIONS MANUAL** - The entire solutions manual is available in an ASCII format which can be imported and converted for use within the word processing software of your choice. With this product, you can edit solutions to emphasize points or make variations to suit your presentation of the material. Then use the files to make handouts or transparencies.

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