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Survey of Financial Accounting

SCHUGART
BENJAMIN
FRANCIA
STRAWSER

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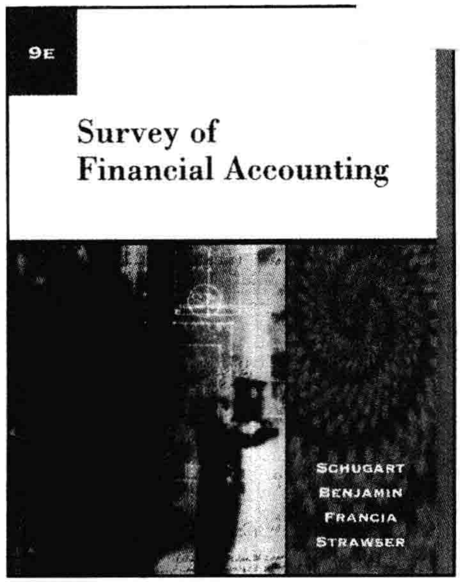

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Survey of Financial Accounting

Ninth Edition

TO THE STUDENT: *Study Guide, Working Papers*, and *Student Solutions Manual* are available through your bookstore. The purpose of the Study Guide is to assist you in studying and reviewing the text material and provide you with a means of self-test by the study of the detailed outline and use of the true-false questions, multiple choice questions, matching and completion statements, and exercises included in the *Study Guide*. These may be used both in your initial study of the chapter material and in your subsequent review. The *Working Papers* have prepared forms and check figures for your problem assignments. The *Student Solutions Manual* has complete solutions for the even numbered problems, check figures for the odd numbered problems, and sample examinations with answers. If the *Study Guide*, *Working Papers*, or *Student Solutions Manual* are not in stock in your bookstore, ask the bookstore manager to order copies for you.

PREFACE

SURVEY OF FINANCIAL ACCOUNTING (SFA) is a unique textbook which has been prepared for the introductory or survey course in accounting. It is ideal for use in either a one or a two-term first course (depending on the material selected and the depth of coverage desired) at the undergraduate or graduate level.

SFA has been written to provide a broad overview of all aspects of accounting from basic concepts, through the accounting information system to financial statements and special reports, emphasizing the interpretation of these statements and reports. Considerations of theory and practice are blended, and numerous illustrations and examples are included, all to enhance student understanding. Learning objectives provide an overview of what should be achieved after studying each chapter. A mini-component (described below) introduces the student to each chapter. A wealth of end-of-chapter materials (Summaries, Key Definitions, Questions, and Problems) are available to reinforce student comprehension.

The initial chapter is the annual report of PepsiCo, Inc. No doubt everyone is familiar with many of PepsiCo's products—e.g., Pepsi-Cola, Lay's potato chips, Tropicana orange juice, and Frito-Lay snack chips. The PepsiCo Annual Report is presented as Chapter 1 to provide students with a broad overview of accounting as communications—the language of business!

The basic approach used in SFA is illustrated by the second chapter which describes the activities of a small business in the initial month of its operations. A complete set of financial statements, including a balance sheet, income statement, statement of owner's equity, and statement of cash flows, is prepared without use (or mention) of debits, credits, accounts, or journal entries. In subsequent chapters, this illustration is again used to consider transaction analysis and the accounting cycle after basic concepts and principles have been illustrated and explained.

Eighteen comprehensive chapters have been prepared to permit maximum flexibility in topic selection without any loss of continuity or instructional benefit. The material has been prepared and is presented in a manner that allows the instructor to "pick and choose" individual topics and/or reorder subject matter without detracting from the usefulness of the text. Most, if not all, of the financial accounting material presented in all introductory principles, survey, and/or financial texts is included.

SFA presents a balanced perspective of practice and theory emphasizing decision-making using accounting information. A direct, straightforward approach achieves completeness of coverage using simple but accurate terms, examples and illustrations. SFA is a usable text geared to the understanding of basic concepts, principles, and practices. It emphasizes financial statement understanding and analysis, and decision-making using financial information. The basic intention is to address the needs and requirements of the users of financial data. Again, the analysis of this data by financial statement users is the primary focus.

A brief descriptive outline of the text and its contents follows:

1. Presents the annual report of a major U.S. corporation, PepsiCo, Inc.
2. Discusses and illustrates the preparation of a complete set of financial statements for a small company without mentioning (or using) debits and credits.
3. Introduces the basic accounting concepts and discusses the basic financial statements, including the balance sheet, income statement, and statement of cash flows.
4. Discusses the basic financial statements and introduces the accounting equation.
5. Traces and explains the process of recording transactions, end of period adjustments and the preparation of financial statements.
6. Discusses adjusting entries and uses the worksheet as an overview of the accounting process.

7. Discusses the different types of organizations that engage in business activities and focuses on the analysis of corporate financial statements.
8. Illustrates the operational differences among companies with special emphasis on the differences between retailing and service organizations and considers the alternative methods for accounting for inventories.
9. Discusses the procedures used for recording, allocating and disposing of long-term assets and the accounting for intangibles and natural resources, including oil and gas accounting. MACRS procedures for computing depreciation for tax purposes are discussed.
10. Discusses the accounting procedures which are used to record and control cash accounts and notes receivable and current liabilities.
11. Discusses the accounting for bonds payable and investments in corporate securities and explains and illustrates the preparation and use of consolidated financial statements.
12. Considers the issues related to the accounting for firms organized as sole proprietorships, partnerships, and corporations. Discusses the issues related to the formation of a corporation, the issuance of capital stock, the retained earnings and the dividends of a corporation.
13. Discusses and illustrates alternative methods of revenue recognition.
14. Discusses and illustrates the basic techniques of analyzing and using the information presented in financial statements.
15. Explains and illustrates the procedures employed in preparing the statement of cash flows.
16. Presents a general discussion of the federal income tax. Explanation and illustration of both interperiod and intraperiod tax allocation are included.
17. Discusses the accounting for foreign currency transactions and foreign currency translation, as well as efforts to achieve uniform international accounting standards.
18. Presents a discussion of disclosures for pensions, other postretirement benefits, leases, segment reporting, interim reporting, management's discussion and analysis, and the auditor's report.

The authors thank Roger A. Enrico, Chairman and Chief Executive Officer of PepsiCo, for his permission to use PepsiCo's Annual Report. We are indebted to many students and colleagues for their assistance, comments, and constructive criticisms which assisted in making SFA a reality. We would like to thank Jeffrey W. Strawser of Sam Houston State University for his careful review of the text and for his suggestions. A necessary ingredient in the writing of any text is the environment in which the effort took place. Our special thanks to John M. Ivancevich and Sara M. Freedman of the University of Houston, Jerry A. Strawser, A. Benton Coconougher, William H. Mobley, William V. Muse and the late John E. Person of Texas A&M University, and N. Ross Quarles and R. Dean Lewis of Sam Houston State University for providing us with encouragement in our efforts and with environments in which this book could be created.

July 2001

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Learning Objectives

Chapter 1 presents an annual report to shareholders of a major U.S. corporation. Studying this chapter should enable you to:

1. Describe the general content of an annual report to shareholders.
2. List and briefly describe the major financial statements included in an annual report.
3. Describe and compare the financial and other information and disclosures contained in an annual report to shareholders.

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Chapter 1

An Annual Report to Shareholders

Chapter 1 of this text presents the annual report to the shareholders of PepsiCo, Inc., a major U.S. corporation doing business not only in the United States and Canada, but also worldwide. PepsiCo is indeed a major player in the global mass marketplace. Of course, you are no doubt familiar with PepsiCo. The company sells such products as Pepsi-Cola, Lipton tea, Mountain Dew, Lay's potato chips, and Tropicana orange juice.

This informative report contains a wealth of information—narrative and descriptive as well as quantitative—concerning every aspect of PepsiCo's operations. The Annual Report for PepsiCo is an excellent example of the information U.S. businesses, both large and small, make available to their owners and interested others. While much of this information is accumulated and prepared by accountants, the report is intended to meet the needs of a wide variety of users ranging from sophisticated financial analysts to individuals who know very little, or perhaps even nothing, about accounting and accountants.

The PepsiCo, Inc. Annual Report is included as Chapter 1 of this text so you can read through it now and obtain a broad, overall perspective of the nature of the information dealt with by both accountants and users of accounting information. Throughout your accounting course, you will, no doubt, return to consider various aspects of the details included in this report and you will learn that accounting is communications—the language of business!

The authors and the many students using this text thank Roger A. Enrico, Chairman and Chief Executive Officer of PepsiCo, for his permission to use PepsiCo's Annual Report.

PepsiCo, Inc. 2000

EAT...

DRINK...

TOTAL RETURN TO SHAREHOLDERS 43%

AND BE MERRY!

Financial Highlights

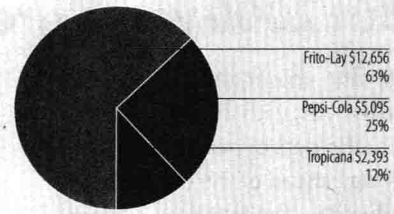
PepsiCo, Inc. and Subsidiaries
($ in millions except per share amounts; all per share amounts assume dilution)

	As Reported			Pro Forma[b]		
	2000	1999	% Chg[a]	**2000**	1999	% Chg[a]
Summary of Operations						
Net sales	**$20,438**	$20,367	–	**$20,144**	$18,666	8
Segment operating profit	**$ 3,550**	$ 3,068	16	**$ 3,482**	$ 3,080	13
Net income	**$ 2,183**	$ 2,050	6	**$ 2,139**	$ 1,850	16
Net income per share	**$ 1.48**	$ 1.37	8	**$ 1.45**	$ 1.24	17
Other Data						
Net cash provided by operating activities	**$ 3,911**	$ 3,027	29			
Share repurchases	**$ 1,430**	$ 1,285	11			
Dividends paid	**$ 796**	$ 778	2			
Long-term debt	**$ 2,346**	$ 2,812	(17)			
Capital spending	**$ 1,067**	$ 1,118	(5)			

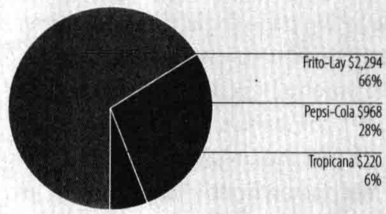
(a) Percentage changes are based on unrounded amounts.

(b) PepsiCo's fiscal year ends on the last Saturday in December and, as a result, a fifty-third week is added every 5 or 6 years. The fiscal year ended December 30, 2000 consisted of fifty-three weeks. For comparative purposes, the pro forma information for 2000 excludes the impact of the fifty-third week. The pro forma information for 1999 also gives effect to the bottling transactions described in Note 2 to the financial statements as if the transactions occurred at the beginning of PepsiCo's 1998 fiscal year. In addition, the 1999 pro forma results exclude the Frito-Lay impairment and restructuring pre-tax charge of $65 million ($40 million after-tax), the pre-tax gain on the sale of a chocolate business in Poland of $28 million ($25 million after-tax), the pre-tax net gain on the PBG and Whitman bottling transactions of $1 billion ($270 million after-tax) and the income tax provision of $25 million related to the PepCom transaction. The pro forma information does not purport to represent what PepsiCo's results of operations would have been had such transactions been completed as of the dates indicated nor does it give effect to any other events.

Pro Forma PepsiCo Net Sales
Total: $20,144
$ In Millions



Pro Forma Segment Operating Profit
Total: $3,482
$ In Millions



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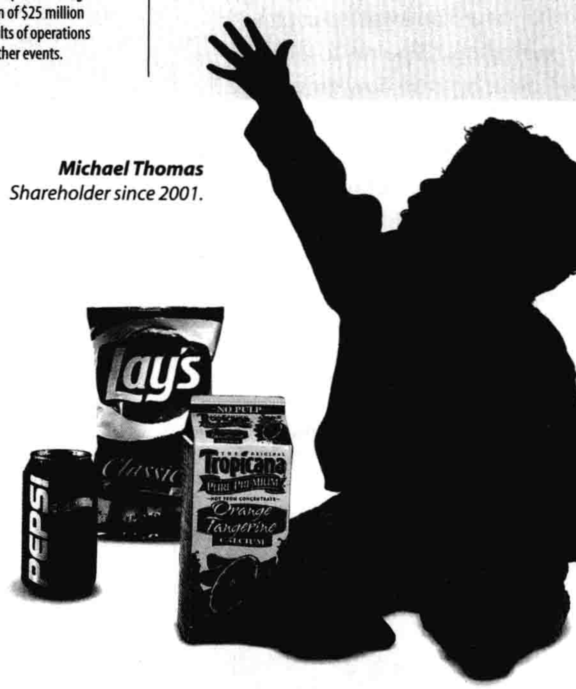


Michael Thomas
Shareholder since 2001.

To help us toast a great year, we invited several PepsiCo shareholders to pose for a few pictures eating, drinking and being merry. As you'll see, they very kindly obliged.

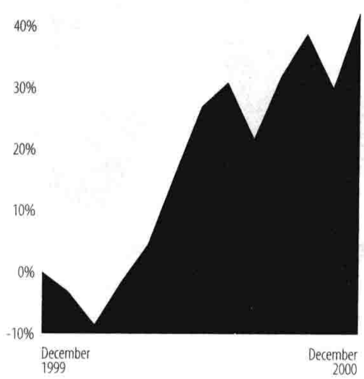
Dear Friends: I admit our cover could be more subtle. But 2000 was a great year for PepsiCo.

We rang up our best performance since 1995, with a total return to shareholders of nearly 43%. That put us way ahead of the Dow Jones Industrials, the Standard & Poor's 500, the S&P Food Index and the S&P Beverage Index.

Strong business results drove that healthy return, as the highlights on the facing page show. On a pro forma basis, revenue growth of 8%, a rate rare among big consumer packaged goods companies, led the way. And that's just the beginning:

- We posted double-digit growth in segment operating profit and earnings per share every quarter.
- Our return on invested capital moved up 2.5 points to 23%.
- Operating cash flow grew to $2.7 billion. That's *after* capital expenditures and other investments.
- Our balance sheet remained very strong, with a relatively low net debt of $1.1 billion.
- We returned some $2.2 billion to shareholders in dividends and share repurchases.

Total Return to Shareholders
Stock appreciation plus dividends reinvested



Especially exciting is the *breadth* of our performance. If you'll pardon the metaphor, we've been firing on all cylinders:

- Every operating division posted volume gains.
- Every operating division posted revenue gains.
- Every operating division increased its market share.
- Every operating division delivered solid growth in operating profit, with four out of five posting *double-digit* gains.

Good news spanned the globe. There are lots of examples.

Our Sabritas unit in Mexico, posted salty snack volume growth of 17%. In Thailand, Pepsi-Cola volume grew 12%. In the United States, volume of Tropicana's flagship Pure Premium brand surged 12%.

A Top Consumer Products Company

So the numbers were good. Our strength was broad-based. We had lots of momentum. And our sights are set squarely on the vast global opportunity in convenient foods and beverages.

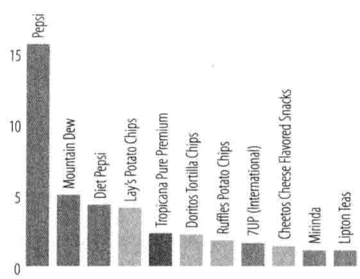
Roger A. Enrico
Chairman and
Chief Executive Officer

And, as our stock chart suggests, investors noticed. More and more recognized that PepsiCo's performance puts it among the world's top consumer products companies. More important, they recognized that PepsiCo is well positioned to *continue* posting healthy, consistent results.

That's crucial. At PepsiCo, we aspire to be among the best of the best — the companies that deliver solid, dependable growth every year.

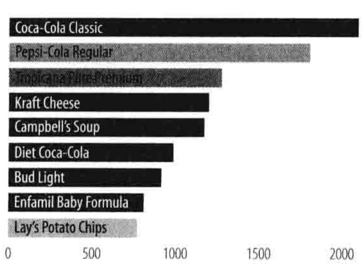
That's the ambitious destination we've chosen. And we're well on our way. Today PepsiCo is highly disciplined and sharply focused, with so many great things going for us:

Largest PepsiCo Brands
Retail Sales, $ in Billions



PepsiCo brands generate retail sales of more than $52 billion. These 11 brands have sales of over $1 billion each. Four more – Tostitos tortilla chips, Aquafina bottled water, Fritos corn chips and Mug root beer and cream soda – have sales of more than $500 million each.

Largest Food Brands in U.S. Supermarkets
$ Sales in Millions



Three of PepsiCo's brands are among the largest of *all* food brands in U.S. supermarkets, the largest distribution channel.

- ***We're in the industry sweet spot: convenient foods and beverages.*** The trend is clear and global. Time-pressed consumers want great-tasting foods and drinks that are convenient to buy and consume. They spend hundreds of billions of dollars a year on these products, and that's growing. With decades of experience selling and creating great-tasting convenient foods and beverages, we're well-equipped to succeed.
- ***We hold strong market positions.*** As the world's #1 salty snack company, the world's #2 refreshment beverage company and the world's #1 maker and marketer of branded juices, we operate from a position of strength. And our marketplace experience, technical expertise and innovation capabilities reflect our market leadership.
- ***We own big, "growable" brands.*** Our brands have the ability to connect with consumers almost anywhere in the world. Today 15 of our brands generate retail sales of more than $500 million each, including 11 that generate more than $1 billion each. And since there's practically no limit to how much of our products you can eat or drink, there's also no real limit on our growth opportunity.
- ***We have powerful distribution systems.*** One key to selling nonessential impulse products is making them widely available and fun to buy. There we have a big advantage. Most of our sales are through our own direct store distribution (DSD) systems, where we actually take the products to stores and put them on the shelf. Our systems reach hundreds of thousands of outlets, from the tiniest bodega to the mightiest club store — and they get bigger each year. Unlike many competitors, our DSD systems give us the ability to merchandise our products for maximum appeal to consumers.
- ***We benefit from an increasingly global portfolio.*** We already have a strong position in many markets around the globe. In snacks, for example, we are the leader in 30 countries. In beverages, we're either number one or number two in some 60 markets. So the appeal of our products has been widely demonstrated. Yet virtually every one of our markets offers the opportunity for dramatic growth.
- ***We help our retail customers make lots of money.*** As retailers continue merging to gain scale and improve efficiency, they look for products that provide clear, measurable benefits to their bottom line. Ours do — on a grand scale. Among big U.S. retailers, for example, PepsiCo is the #1 contributor to their sales growth and the #1 contributor to their profit growth.

Perhaps that's why in *Progressive Grocer's* annual ProGro awards, Pepsi-Cola and Frito-Lay each earned the top spot in their respective categories.

New Platforms for Growth

Add it all up and we could probably generate respectable results for years. But we want to do even better. So we are also adding *new* platforms for growth — that strengthen our portfolio and enhance our vitally important innovation capabilities.

For example, in January 2001 we acquired a majority of the South Beach Beverage Company, whose

SoBe line of drinks adds to the Pepsi-Cola portfolio some of the fastest-growing brands in the fastest-growing segment of the industry, non-carbonated beverages.

We also began or completed several snack transactions that vault Frito-Lay to the top of the salty snack market in three more countries. They also give us the scale to operate more efficiently and grow the salty snack category.

But without question the biggest step we've taken to ensure a bright future of growth for PepsiCo is our planned merger with The Quaker Oats Company, which we expect to complete in the second quarter of 2001.

The merger will make PepsiCo an even more effective competitor in the expanding market for convenient foods and beverages. It will add two very powerful brands to our portfolio, Gatorade and Quaker, and create new opportunities for every PepsiCo division. The combined enterprise will rank among the world's five largest consumer product companies. (For more details, see page 4.)

A Wealth of Talent

There's another reason I am confident PepsiCo will achieve its goal: our people. We have a wealth of talent across this corporation. It starts with our exceptional frontline team, the people out there serving our customers 365 days a year, and it extends to our corporate staff. To me, that says we have not only big opportunities, but the skills, experience, dedication and intellectual horsepower to make the most of them.

Nowhere is that strength more evident than in the people who will lead PepsiCo into the 21st century.

This year, Steve Reinemund, our president and chief operating officer, will succeed me as chairman of the board and chief executive officer. Chief Financial Officer Indra Nooyi will add the role of PepsiCo president and will be nominated for election to our board of directors.

I'm a big fan of Steve and Indra, and I'm not alone. *BusinessWeek* magazine recently said that together they may be one of the most powerful management teams in Corporate America. I *know* they are.

In 16 years at PepsiCo, Steve has proven to be an exceptional leader. He sees opportunities others miss, and he can rally a team to seize them. He certainly proved that at Pizza Hut, where he built the world's largest pizza delivery business from scratch. As head of Frito-Lay, he took one of the most successful food companies on Earth and made it even better. And as PepsiCo president and chief operating officer, he has been a prime mover in our delivering healthy, consistent earnings while building a foundation for the future.

Indra is outstanding in her own right. She joined PepsiCo seven years ago as senior vice president of strategic planning and is a principal architect of the highly focused corporation you see today. She has been at the forefront of all our big financial transactions. And over the last year, she has distinguished herself as chief financial officer.

When Steve and Indra move up, I'll become a PepsiCo vice chairman. At the time of the merger, Bob Morrison, Quaker's chairman, president and chief executive officer, will join our board, also with the title of vice chairman. Bob and I intend to help ensure that the merger of our companies fulfills its great promise.

Three Outstanding Directors

Speaking of promise fulfilled, let me pay tribute to one of our great leaders, Karl von der Heyden. After a distinguished career that included six years at PepsiCo and culminated as co-chairman and chief executive officer of RJR Nabisco, Karl rejoined PepsiCo as chief financial officer and vice chairman of our board in 1996. He signed on for "about a year" — and stayed until January 2001.

I'm delighted that he did. Karl has been a true friend to PepsiCo and a great resource for me. He played a crucial role in revitalizing this corporation. From all of us at PepsiCo, I want to say thanks and best wishes.

Let me also thank two other outstanding PepsiCo directors, Roy Vagelos and Arnold Weber, who retired in May 2000. Roy had served on our board eight years and Arnie, 22. In that time they provided invaluable counsel and guidance to me, my predecessors and scores of other PepsiCo senior managers. I thank them immensely for their wisdom and support.

As I think about what the future holds for PepsiCo, I am very optimistic. We are in the heart of a growing consumer market rich with opportunity. We have strong, global brands, powerful distribution systems and vast financial resources. Most of all, we have a team of bright, highly motivated people with the skills, experience and commitment to make the most of the opportunity before us.

Roger Enrico
Chairman of the Board and
Chief Executive Officer

QUAKER

PepsiCo to Merge with The Quaker Oats Company

On December 4, 2000 PepsiCo and The Quaker Oats Company announced plans to merge. The agreement calls for PepsiCo to exchange 2.3 shares of its stock for each Quaker share, up to a maximum value of $105 for each Quaker share.

This historic merger will bring together two of the food and beverage industry's strongest companies and many of its most recognized brands. The merger also will provide an array of strategic and financial benefits.

From a financial perspective, the deal is expected to:

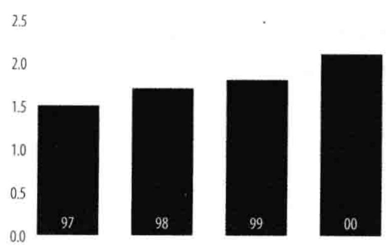
- add to PepsiCo's earnings per share in the first full year and thereafter;
- immediately improve PepsiCo's return on invested capital by two percentage points, and
- strengthen PepsiCo's ongoing sales and profit growth.

Strategically, the merger creates important new growth platforms:

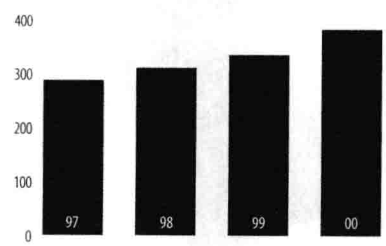
- Quaker's powerful Gatorade brand, the world's number one sports drink, will make PepsiCo the clear leader in the United States in non-carbonated beverages, the fastest growing sector of the beverage industry. Gatorade has been growing every year since it was acquired by Quaker in 1983 and shows no signs of slowing. Plus the scale of Gatorade's vast warehouse distribution system will help Tropicana's non-refrigerated juice and juice drink brands to become stronger and more profitable.
- Quaker's rapidly expanding snack business — including granola bars, rice snacks and fruit and oatmeal bars — is highly complementary to Frito-Lay, the world leader in salty snacks. The Quaker brand, a symbol of healthy, wholesome eating, will extend PepsiCo's reach into morning on-the-go foods, snacks aimed at kids and grain-based snacks. Adding Quaker snacks to Frito-Lay's vast distribution system will create very substantial growth opportunities in the United States and internationally.
- Quaker's highly profitable non-snack food business (with leading brands like Quaker oatmeal, Life and Cap'n Crunch cereals, Rice-A-Roni and Aunt Jemima syrup) generates hundreds of millions of dollars in cash. Through greater innovation and efficiencies, it can continue providing steady profit growth and lots of free cash flow.

The transaction is expected to be tax-free and accounted for as a pooling-of-interests. It requires the approval of PepsiCo and Quaker shareholders. It also requires the issuance of approximately 315 million new PepsiCo shares to Quaker shareholders.

Gatorade Sales
$ In Billions



Quaker Snack Sales
$ In Millions



North America

Frito-Lay North America had an excellent year. Pound volume grew a very solid 4%, outpacing the salty snack category, while revenues grew 7%. Frito-Lay's market share grew by nearly two percentage points to 58%.

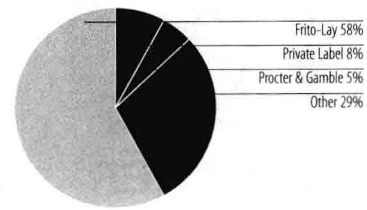
That healthy underlying growth led to a 10% gain in operating profit. In fact, the fourth quarter of 2000 marked Frito-Lay's *eighth* consecutive quarter of double-digit profit growth.

Strong performance in core brands — like Lay's, Ruffles, Tostitos and Cheetos — contributed to the growth. So did innovation, an area in which Frito-Lay excels. A few examples: Fritos and Tostitos brand snack kits that combine a container of chips and a container of dip; Ruffles *Flavor Rush* potato chips, in flavors more intense than traditional Ruffles; new flavors of Doritos tortilla chips and Cheetos Xs and Os. Frito-Lay's innovation efforts generated some $1 billion in retail sales in 2000. More important, they reflect the company's extraordinary ability to bring excitement to the marketplace quickly and drive growth year after year.

Frito-Lay also grew by exploiting underdeveloped distribution channels, with particularly strong gains in mass merchandisers and convenience stores as well as in the vending and foodservice channel.

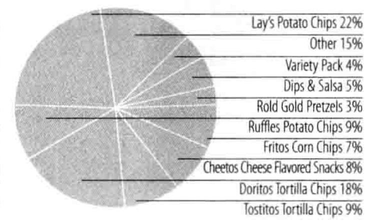
And a relentless focus on improving productivity and using its vast system to the greatest advantage helped Frito-Lay raise operating margins to an all-time high.

U.S. Snack Chip Industry
% Volume
Includes potato chips, tortilla chips, extruded snacks and pretzels.



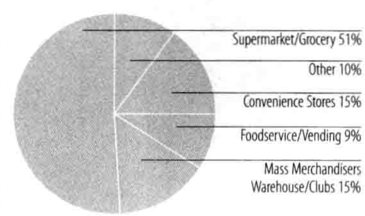
Frito-Lay gained nearly two share points.

Frito-Lay North America Product Mix
% Sales

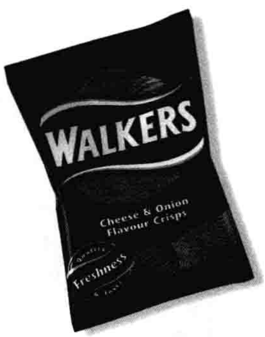


Frito-Lay products in the United States and Canada account for $9.9 billion in retail sales.

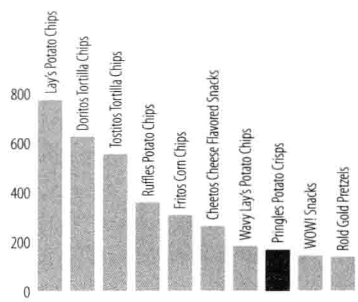
U.S. Frito-Lay Distribution Channels
% Sales



Frito-Lay sales grew in every channel, with strong increases in mass merchandising/warehouse/club stores.

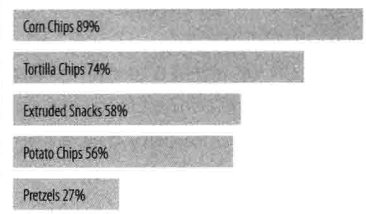


Top-Selling Snack Chip Brands in U.S. Supermarkets
$ Sales in Millions



Frito-Lay sells nine of the top-10 snack chip brands in supermarkets.

Frito-Lay Share of Major Snack Chip Categories in U.S. Supermarkets and Other Measured Channels
% Volume



Frito-Lay's market share grew in nearly every major snack chip category.

International

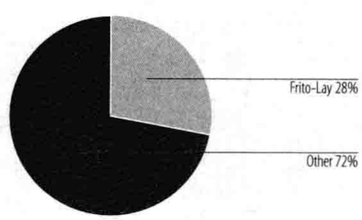
Frito-Lay International (FLI) had excellent results, posting its highest volume growth in six years. Salty snack kilos grew 13%, which fueled revenue growth of 14% and operating profit growth of 19%.

Well-executed marketing programs drove powerful growth, particularly the highly successful Pokemon and money-in-the-bag promotions.

With a leading market share of 28%, FLI has both a strong position and vast opportunities, particularly in the many underdeveloped markets. The key is to achieve sufficient scale in those markets to operate efficiently and expand the salty snack industry. So we continue to acquire or merge with other snack producers. In 2000 we made excellent progress:

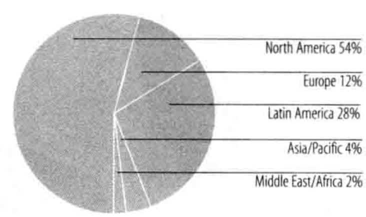
- Our Latin American snack joint venture's acquisition of the Margarita snack business boosted

International Snack Chip Industry
% Retail Sales
Excludes United States and Canada.
Includes potato chips, tortilla chips and extruded snacks. Excludes pretzels.



Frito-Lay, the largest snack chip company in the world, sells $5.9 billion worth of snack chips outside North America.

Worldwide Frito-Lay Volume by Region
% Volume



Frito-Lay manufactures its products in 45 countries and makes them available in 120 countries.

Members of the Dinamat Investment Club

Nancy O'Brien
Shareholder since the 1980s.

Lorna Miner
Shareholder since 1995.

Joan Tolette
Shareholder since 1993.

Josephine Moseley
Shareholder since 1984.