

FINANCIAL ACCOUNTING

999
262
000



ANTLE &
GARSTKA

Financial Accounting

Rick Antle

Yale University

Stanley J. Garstka

Yale University

SOUTH-WESTERN
★
THOMSON LEARNING

Australia · Canada · Mexico · Singapore · Spain · United Kingdom · United States

Financial Accounting, by Antle and Garstka
Publisher: Dave Shaut
Acquisitions Editor: Steve Hazelwood
Developmental Editor: Ken Martin
Marketing Manager: Dan Silverburg
Production Editor: Tamborah Moore
Manufacturing Coordinator: Doug Wilke
Internal Design: Liz Harasymczuk Design
Cover Design: Tin Box Studio, Inc.
Photo Manager: Deanna Ettinger
Production House: Pre-Press Company, Inc.
Compositor: Pre-Press Company, Inc.
Printer: RR Donnelley & Sons Company,
Willard Manufacturing Division

Photo Credits follow index.

COPYRIGHT © 2002 by South-Western, a division of Thomson Learning. The Thomson Learning logo is a registered trademark used herein under license.

The text of this publication, or any part thereof, may be reproduced for use in classes for which *Financial Accounting* by Antle and Garstka is the adopted textbook. It may not be reproduced in any manner whatsoever for any other purpose without written permission from the publisher.

Printed in the United States of America

1 2 3 4 5 04 03 02 01

For more information contact South-Western, 5101 Madison Road, Cincinnati, Ohio, 45227 or find us on the Internet at <http://www.swcollege.com>

For permission to use material from this text or product, contact us by

- **telephone:** 1-800-730-2214
- **fax:** 1-800-730-2215
- **web:** <http://www.thomsonrights.com>

ISBN: 0-538-84671-2 (core text package)

ISBN: 0-324-15596-4 (core text only)

Library of Congress Cataloging-in-Publication Data

Antle, Rick

Financial accounting / Rick Antle, Stanley J. Garstka.

p. cm.

Includes bibliographical references and index.

ISBN 0-538-84671-2

1. Accounting. I. Garstka, Stanley J.

HF5635 .A723 2001

657—dc21

2001042605

Dedicated to

Nancy, Elizabeth, and Benjamin

Janet, Jennifer, Stan, and Andrew

Preface

“This text reads more like a story than it does a traditional accounting text.”

Leonard Stokes,
Siena College

Why write another introductory financial accounting textbook? It is a question we are often asked. The publisher asked us when we proposed this text. Our colleagues asked us every time we told them what we were doing. We asked ourselves whenever we tired of the effort. After all, there is certainly no shortage of formidable competition. And there are only so many things one can do in an introductory text.

We have written this text because we wanted to do things differently. In particular, we wanted to present three things in a way that we had not found them presented in other textbooks. First, we wanted to give a thorough, yet concise, introduction to the basic financial statements and the techniques of accounting. Second, we wanted to include a rich variety of real financial reports. Third, and most importantly, we wanted to develop and apply a coherent conceptual structure that would knit the book together.

Organization of the Text

We have organized the content of the text into three parts: fundamentals of accounting, economic concepts, and topics in financial reporting.

Part One: Fundamentals of Accounting

The five chapters that make up Part One provide a comprehensive introduction to the basic accounting statements and techniques. Our experience in teaching financial statement analysis has taught us that this material should not be given short shrift. Cash flow statements and the articulation of financial statements are especially important, particularly for students interested in valuation. Many valuation methods begin with cash flow projections. Income statements and balance sheets are projected and analyzed to find the implied cash flows. Detailed knowledge of complex financial reporting alternatives is not required to do this kind of analysis, but understanding the articulation of balance sheets, income statements, and cash flow statements is vital. Part One lays this foundation.

Part Two: Economic Concepts

Part Two develops a conceptual framework for the traditional financial accounting topics. Two main factors are identified as being at the heart of accounting problems: time and uncertainty. The first chapter in Part Two develops the economic concepts of present value and expected value that are used to attack problems involving time and uncertainty. The second chapter of Part Two ties these economic concepts to accounting through an exploration of market-to-book ratios and returns on equity. The advantages of taking the time to develop both present value and expected value become apparent: They allow us to develop the important benchmark of normal earnings and to explain why the generation of abnormal earnings is the key to creating value.

“The definitions of accrual accounting and the notion of accrual and deferral are the best I have ever encountered . . .”

Matthew Anderson,
Michigan State University

Part Three: Topics in Financial Reporting

In many ways, Part Three is the payoff for the investment in techniques and concepts that we made in Parts One and Two. The chapters in Part Three address traditional and important areas in financial accounting, such as receivables, inventories, long-term assets, liabilities, and income taxes. We use a set structure within each of these chapters, beginning with a discussion of what the item is and what its place is in an organization. Next, the economic concepts of present value and expected value are used to explore its economic value. We then present the major accounting conventions for the item and its financial statement presentation. This allows a comparison of accounting values and economic values. Finally, we conclude each chapter in Part Three by presenting the major financial ratios involving that item.

The organization of these chapters is intended to accomplish several things. It gives the students a sense of the commonality of the issues involved in accounting problems. It enables you, the instructor, to cut preparation time by making the book's coverage more memorable and predictable. It consistently reinforces the application of the valuation framework developed in Part Two. Finally, it allows for flexible use of the book. You may, for example, assign selected sections of each chapter if you desire to cover only the accounting conventions.

Features of the Text

We have included many features, such as a variety of tables and illustrations, which we believe will help students master the text's concepts as well as stimulate and maintain their interest in accounting. The accrual accounting table shown below is an example of how the text helps students visualize and synthesize concepts.

Figure 3.4

Accrual Accounting (Revenues and expenses need not coincide with cash flows.)

Cash Flow Before Revenue or Expense Recognition

Some revenues are prepayments before good is given up or service provided. For example, Company receives prepaid magazine subscriptions, Company is given a retainer to provide future services.

Many expenses are "prepaid." For example, the cost of inventory, plant, and equipment, the prepayment of rent or insurance.

Income Statement

Revenues

-
-
-
-
-

Expenses

-
-
-
-
-
-
-
-
-
-

Net Income

Cash Flow After Revenue or Expense Recognition

Payment received after good given up or service provided. For example, normal sales on credit.

Many expenses are paid after the expense is recognized. For example, the value of wages or interest already consumed, but not yet paid for.

Questions, Exercises, Problems, and Cases

The student activities that accompany the text are provided in a separate booklet. We believe that this arrangement will permit much greater flexibility in their use as well as frequent updating. Many of these activities are based on real company data.

Use of Real Financial Reports

Real financial reports are used throughout the text as illustrations and as the basis for problem material. Our extensive use of these reports is intended to provide an accurate impression of the ultimate tasks that await students in their accounting, finance, or other business careers. We use the most recent examples that suit our purposes, but we do not shy away from using an “older” example if it is particularly relevant. For example, Chapter 5 focuses on America Online, Inc.’s, financial reports for 1997 because we find them to be especially useful.

Exhibit 5.2

America Online, Inc.

Consolidated Statement of
Operations

*Two categories of
revenues*

Largest expense

Second largest expense

Unusual item

Large net loss

America Online, Inc.
Consolidated Statement of Operations for the Year Ended June 30, 1997
(Amounts in thousands, except share data)

| | | |
|--|--|---------------------|
| Revenues: | | |
| Online service revenues | | \$1,429,445 |
| Other revenues | | <u>255,783</u> |
| Total revenues | | <u>\$1,685,228</u> |
| Costs and expenses: | | |
| Cost of revenues | | \$1,040,762 |
| Marketing | | |
| Marketing | | 409,260 |
| Write-off of deferred subscriber acquisition costs | | 385,221 |
| Product development | | 58,208 |
| General and administrative | | 193,537 |
| Acquired research and development | | — |
| Amortization of goodwill | | 6,549 |
| Restructuring charge | | 48,627 |
| Contract termination charge | | 24,506 |
| Settlement charge | | <u>24,204</u> |
| Total costs and expenses | | <u>\$2,190,874</u> |
| Income (loss) from operations | | \$ (505,646) |
| Other income (expense), net | | 6,299 |
| Merger expenses | | — |
| Income (loss) before provision for income taxes | | (499,347) |
| Provision for income taxes | | — |
| Net income (loss) | | <u>\$ (499,347)</u> |
| Earnings (loss) per share: | | |
| Net income (loss) | | \$ (5.22) |
| Weighted average shares outstanding | | 95,607 |

See accompanying notes.

Our goal of providing students with an accurate impression of real reports means that we edit them less than is typical in an introductory text. We leave in any item that we would be willing to discuss in class within the context of the material covered to that point. If we would have answered a question about an item with, “We will get to that later,” we have edited that item. For example, in the early chapters, we do not present financial statements that include the equity account, “Unrealized gains (losses) from available-for-sale securities.” We do not, however, shield students from the variety of assets and liabilities that we find in real financial statements.

Debits and Credits

“... What is different [about the way the text shows the effect of transactions on the accounting equation], and I think adds to the explanatory effect, is the use of the concept of incremental change, which is represented by a delta.”

Janet Kimbrell,
Oklahoma State University

Although we did not write this text in order to train students as bookkeepers, we believe that students need to be exposed to the techniques that underlay financial reports. Thus, we do not shy away from presenting debits, credits, T-accounts, and journal entries.

- On January 1, 2000, Websell paid \$2,000 for an unlimited-service cellular phone contract for one year.

| | |
|---------------------------------|-------|
| Prepaid Telephone (asset) | 2,000 |
| Cash | 2,000 |

- On January 1, 2000, Websell acquired the rights to various software programs. The software consists of word processors and accounting programs in support of basic office functions, as well as technical packages to be used in developing its own products. Websell paid \$50,000 cash for these rights that are expected to last for 2 years.

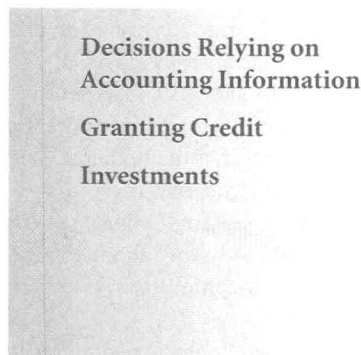
| | |
|------------------------|--------|
| Software (asset) | 50,000 |
| Cash | 50,000 |

In-Text Study Notes and Definitions of Terms

To assist students in their study of what is sometimes complex material, we provide study notes and definitions in the margin. Students may use these notes to review the exhibits in the text and to help them recall the concepts learned by reading the material and participating in class.

Sales revenue is the dollar value of all the products Novell sold during the period (the inflow of resources from sales).

Cost of sales is the resources (wages to workers and cost of materials) that went out of Novell in order to generate the sales.



From AOL's 10K: "Cost of revenues includes network-related costs, consisting primarily of data network costs, costs associated with operating the data centers and providing customer support, royalties paid to information and service providers, the costs of merchandise sold, and product development amortization expense."

Review Questions

At appropriate points, we provide thought-provoking questions that test students' ability to apply the concepts that have just been discussed.

Review Questions

1. Define assets, liabilities, and equities. Give an example of each. How are assets valued? How are liabilities valued?
2. Explain what is meant by the entity concept.
3. A company signs a ten-year employee contract with a vice president. The salary is \$500,000 per year, guaranteed. Is this contract an asset? Would it appear on the balance sheet? Explain.
4. A company purchased a parcel of land 10 years ago at a cost of \$300,000. The land has recently been appraised at \$900,000. At what value is the land carried in the balance sheet? How does the appraisal affect the carrying value in the balance sheet?

Supplements for the Instructor

The supplements described below are available on a single CD-ROM as well as in print form. In addition, except for the Test Bank, these supplements can be downloaded from the text's web site. Visit the Antle home page (<http://antle.swcollege.com>) to see the power of the Internet in accounting education for both you and your students. You may download instructor resources, including sample syllabi and author notes. In addition, you may read or submit great ideas for teaching financial accounting. Your students have links to EdgarScan for current company information, to cases for which they can e-mail their solutions, and to interactive quizzes.

- **Instructor's Manual.** Each chapter contains a list of key terms, a lecture outline, a selected bibliography of current readings, transparency masters, class participation ideas, supplemental examples and illustrations, and selected group learning activities.
- **Solutions Manual.** The Solutions Manual contains answers to all questions, exercises, problems, and cases in the text.
- **Test Bank.** The Test Bank contains a wealth of short-answer questions, problems, and discussion questions, with complete solutions.
- **Computerized Test Bank.** A computerized version of the Test Bank allows instructors to quickly and easily customize tests for their students.
- **PowerPoint Lecture Presentations.** These presentations enhance lecture quality and shorten preparation time. Each chapter's slides outline the chapter content and feature key exhibits from the text.

Supplements for Students

Several study aids for students are available free of charge at the text's web site (<http://antle.swcollege.com>). These include self-quizzes, PowerPoint slides, an EdgarScan Demo that facilitates the retrieval of current financial reports, and hot links to related sites and materials.

The following supplements are available for student purchase through the college bookstore or at the Antle web site:

- **Study Guide.** The Study Guide includes lecture outlines, extra problems, mastery problems, and study tips for additional study and review of chapter content.
- **EdgarScan.** EdgarScan technology provides access to actual SEC quarterly and annual filings (10-Qs and 10-Ks). Students can efficiently extract specific information in common formats, create bar or pie charts comparing the performance of selected companies, and even download them as Excel charts.

- **Interactive Cases in Financial Analysis.** Featuring three distinct case studies, this interactive CD-ROM by Jamie Pratt, K. Ramesh, and David Foster prepares students for real-world decisions by having them actually make the decisions. Each case is delivered in a compelling style, allowing student recommendations to be based on an in-depth analysis of real financial statements, press releases, commentary, and industry data.
- **Interactive Accounting Tutorial.** INTACCT is an online tutorial by Dasaratha Rama and K. Raghunandan of the University of Massachusetts at Dartmouth. This self-paced and fully interactive tutorial reinforces the mechanics of the accounting cycle to foster a deeper understanding of the key financial concepts and terminology. It contains practice assignments, homework assignments, and student instructions, along with an ingenious automatic feedback function that enables students to e-mail results directly to their instructor.

Acknowledgments

Many, many people contributed to this book. Some, like Frank Heflin and Kathy Sevigny, contributed material. Frank wrote many of the problems and cases that appear in the book, as well as the first draft of Chapter 11. Kathy wrote a great deal of the questions, exercises, problems and cases for Chapters 5 through 16.

Joel Demski, Frank Heflin, and Stephen Ryan contributed extensively to our thinking about this material, which has its roots in our efforts to teach the “right” first course in accounting at the Yale School of Management. Stephen and Joel helped us realize the opportunity for building some economic concepts into the book. Frank contributed greatly to our ability to incorporate actual financial statement material throughout.

Bill Beaver made a very brief but important contribution. We were discussing with him the idea of writing a text that connected economics and accounting and Bill said, “You’ll never do it until you incorporate uncertainty.” It took a while, but we eventually decided he was correct, and the structure of Chapter 6 is part of the result.

Three people deserve acknowledgment for different sorts of contributions. Steve Ross provided insight and experience on how to write a textbook, as well as a lot of encouragement. Oscar Hills knows what he did, and we are thankful for it. Georgia Thompson’s proofing skills were invaluable.

Many of our students tolerated our various approaches during our search for the right path through this material. Some, like Jason Silvers, provided valuable, detailed editorial comments.

Several reviewers provided valuable comments on the manuscript.

Anwer Ahmed
Syracuse University

Matt Anderson
Michigan State University

Lanny Chasteen
Oklahoma State University

Martha Doran
San Diego State University

Janet Kimbrell
Oklahoma State University

Donald Leonard
Nichols College

Robin McClintock
North Carolina State University

Kevin Misiewicz
University of Notre Dame

Donald Raux
Siena College

Leonard Stokes
Siena College

John Surdick
Xavier University

W. T. Wrege
Ball State University

We are very thankful for the efforts of the supplements authors. Dave Marcinko produced the student Study Guide, Joe DaDamo and Carleton Donchess wrote the Test Bank, and Scott Colvin wrote the Instructors' Manual.

Many current and former South-Western employees have been invaluable. Orv Haberman and Ken Martin have supplied a steady stream of help, encouragement, and support. Rochelle Kronzek helped get us moving and helped sharpen our concept of the market for the book. Steve Hazelwood and Dan Silverburg pitched in with energy and enthusiasm. Dave Shaut, the original “believer” in the book, will finally, we hope, achieve vindication for supporting our efforts.

About the Authors

Rick Antle

Rick Antle is Professor of Accounting and Senior Associate Dean at the Yale School of Management. Professor Antle received his Ph.D. from Stanford University, and he was formerly a member of the faculty at the University of Chicago. He is an expert in areas involving the interface of accounting and economics. He has published widely on topics such as auditor independence, auditors' incentives, the economics of accounting firms, managerial compensation and performance evaluation, capital investment decisions, and transfer pricing. His consulting engagements have involved valuation, evaluation of cost accounting systems, auditing and accounting standards, auditor independence, and capital budgeting. Professor Antle is on the editorial boards of *Contemporary Accounting Research*, *Review of Accounting Studies*, and *The British Accounting Review*.

Stanley J. Garstka

Stan Garstka is Professor in the Practice of Management and Deputy Dean at the Yale School of Management. He received his Ph.D. from Carnegie Mellon University. He was a Coopers and Lybrand Faculty Research Fellow in 1976, and he was the recipient of a National Defense Education Act Fellowship from 1966–1970. Professor Garstka is an expert in the bankruptcy process and has written on ways to reform it. His interests also include the restructuring of troubled companies and contemporary issues in accounting. Professor Garstka's current research is focused on the practice of active investing (MBOs, LBOs, IPOs, etc.), how that practice is informed by modern financial theory, and where institutional constraints cause current theories to be impractical. Professor Garstka currently serves on the board of directors for MBA Enterprise Corps, Foote School, and Danielson Holding Corporation.

Brief contents

| | |
|--|------------|
| Part One: Fundamentals of Accounting | 1 |
| 1. Introduction to Financial Accounting | 2 |
| 2. Balance Sheet Concepts: Assets, Liabilities, and Equities | 22 |
| 3. Income Statement Concepts: Income, Revenues, and Expenses | 45 |
| 4. Statement of Cash Flows: Operating, Investing, and Financing Activities | 70 |
| 5. Using the Accounting Framework: America Online, Inc. | 97 |
| Part Two: Valuation Basics and Accounting Measures | 99 |
| 6. Economic Concepts: Behind the Accounting Numbers | 114 |
| 7. Financial Statement Analysis: Connecting Economic Concepts to Accounting Reports | 130 |
| Part Three: Topics in Financial Reporting | 155 |
| 8. Accounts Receivable | 156 |
| 9. Inventories | 173 |
| 10. Marketable Securities | 189 |
| 11. Long-Lived Assets | 205 |
| 12. Long-Term Liabilities | 223 |
| 13. Equities | 254 |
| 14. Income Taxes | 274 |
| 15. Active Investments in Corporations | 298 |
| 16. Financial Statement Analysis and the Valuation of Common Stock | 323 |

contents

Part One: Fundamentals of Accounting 1

1. Introduction to Financial Accounting 2

- 1.1 What Is Accounting? 3**
 - 1.1.1 Framework for Understanding Accounting Information 3
 - 1.1.2 Financial Histories: The Financial Statements 4
- 1.2 Why Study Accounting? 8**
 - 1.2.1 Decision Making 8
 - 1.2.2 Accounting Is More Than Just Numbers 9
- 1.3 Economic Concepts 12**
 - 1.3.1 Financial Value 12
 - 1.3.2 Wealth 13
 - 1.3.3 Economic Income 14
 - 1.3.4 Importance of Financial Value, Wealth, and Economic Income in Accounting 14
- 1.4 Accounting Conventions 16**
 - 1.4.1 Nature of Accounting Conventions 16
 - 1.4.2 Factors Affecting Accounting Conventions 17
- 1.5 Institutional Context 18**
- 1.6 Conclusion 20**

2. Balance Sheet Concepts: Assets, Liabilities and Equities 23

- 2.1 Basic Definitions, Theory, and Examples 23**
 - 2.1.1 The Entity Concept 23
 - 2.1.2 Assets: Definition 24
 - 2.1.3 Assets: Examples 24
 - 2.1.4 Assets: Valuation 28
 - 2.1.5 Liabilities: Definition 28
 - 2.1.6 Liabilities: Examples 28
 - 2.1.7 Liabilities: Valuation 31
 - 2.1.8 Equities: Definition 32
 - 2.1.9 Equities: Examples 32
 - 2.1.10 Examples: Concluding Remarks 33
- 2.2 Balance Sheet Construction: Using the Accounting Identity 34**
 - 2.2.1 An Example: Websell 34
- 2.3 T-accounts, Debits and Credits 38**
- 2.4 Analyses Using Balance Sheet Information 42**
- 2.5 Conclusion 43**
- 3. Income Statement Concepts: Income, Revenues and Expenses 45**
 - 3.1 Income (loss) 47**
 - 3.2 Revenues 52**
 - 3.3 Expenses 54**

| | | |
|------------|---|------------|
| 3.4 | Gains and Losses | 57 |
| 3.5 | Debits and Credits | 57 |
| 3.5.1 | A Word About Ledgers and Journals | 59 |
| 3.5.2 | An Example: Continuing Websell | 59 |
| 3.5.3 | The Processing of Adjusting | 62 |
| 3.6 | Conclusion | 69 |
| 4. | Cash Flow Statements | 70 |
| 4.1 | Cash | 71 |
| 4.2 | Cash Flows versus Net Income | 73 |
| 4.2.1 | An Example: Total Joy Company | 73 |
| 4.3 | The Cash Flow Statement | 80 |
| 4.3.1 | Investing Activities | 81 |
| 4.3.2 | Financing Activities | 81 |
| 4.3.3 | Operating Activities | 82 |
| 4.3.4 | Types of Cash Flows and Types of Accounts | 82 |
| 4.4 | Methods of Deriving Cash Flow Statements | 83 |
| 4.4.1 | Direct Method | 83 |
| 4.4.2 | Indirect Method | 85 |
| 4.5 | Conclusion | 94 |
| 5. | Using the Accounting Framework: America Online, Inc. | 97 |
| 5.1 | AOL: Business and Environment | 98 |
| 5.2 | AOL's Balance Sheet | 99 |
| 5.3 | AOL's Income Statement | 101 |
| 5.4 | Notes to AOL's Financial Statements | 102 |
| 5.5 | AOL's Cash Flow Statement | 105 |
| 5.6 | Using Articulation to Complete the Picture | 107 |

| | | |
|------------|--------------------------------|------------|
| 5.7 | Analysis and Discussion | 108 |
|------------|--------------------------------|------------|

| | | |
|------------|-------------------|------------|
| 5.8 | Conclusion | 112 |
|------------|-------------------|------------|

Part Two: Valuation Basics and Accounting Measures 99

| | | |
|-----------|---|------------|
| 6. | Economic Concepts: Behind the Accounting Numbers | 114 |
|-----------|---|------------|

| | | |
|------------|------------------------------|------------|
| 6.1 | Accounting Adjustment | 116 |
|------------|------------------------------|------------|

| | | |
|-------|-----------------------|-----|
| 6.1.1 | Websell's Adjustments | 116 |
|-------|-----------------------|-----|

| | | |
|------------|--|------------|
| 6.2 | Adjustment Approach 1: Estimate the Remaining Asset Value | 116 |
|------------|--|------------|

| | | |
|------------|---|------------|
| 6.3 | Adjustment Approach 2: Estimate the Amount of Expense for the Period | 118 |
|------------|---|------------|

| | | |
|-------|---------------------------|-----|
| 6.3.1 | Adjustments and Valuation | 119 |
|-------|---------------------------|-----|

| | | |
|------------|--------------------------------------|------------|
| 6.4 | Cash Flows and Economic Value | 120 |
|------------|--------------------------------------|------------|

| | | |
|------------|---|------------|
| 6.5 | Uncertain Cash Flows: Expected Value | 125 |
|------------|---|------------|

| | | |
|-------|----------------------------|-----|
| 6.5.1 | Relationship to Accounting | 126 |
|-------|----------------------------|-----|

| | | |
|-------------|--|------------|
| 6.6. | Time and Uncertainty: Combining Present and Expected Values | 127 |
|-------------|--|------------|

| | | |
|------------|-------------------|------------|
| 6.7 | Conclusion | 128 |
|------------|-------------------|------------|

| | | |
|-----------|---|------------|
| 7. | Financial Statement Analysis: Connecting Economic Concepts to Accounting Reports | 130 |
|-----------|---|------------|

| | | |
|------------|--|------------|
| 7.1 | Alternative Measures of Value: A Framework for Financial Statement Analysis | 132 |
|------------|--|------------|

| | | |
|-------|---|-----|
| 7.1.1 | The Value of a Firm in the Stock Market | 132 |
|-------|---|-----|

| | | |
|-------|----------------|-----|
| 7.1.2 | GAAP Valuation | 133 |
|-------|----------------|-----|

| | | |
|-------|------------------------------|-----|
| 7.1.3 | Financial Statement Analysis | 134 |
|-------|------------------------------|-----|

| | | |
|-------|---|-----|
| 7.1.4 | Conceptual Framework for Financial Statement Analysis | 134 |
|-------|---|-----|

| | | | | | |
|--|--|-----|----------------------------------|---|-----|
| 7.2 | Harrodsburg First Financial Bancorp, Inc. | 137 | 9.6 | Conclusion | 187 |
| 7.3 | Microsoft Corporation | 145 | 10. Marketable Securities | 189 | |
| 7.4 | Discussion | 152 | 10.1 | Nature of Marketable Securities | 190 |
| | | | 10.1.1 | An Example: Merrill Lynch | 190 |
| Part Three: Topics in Financial Reporting | 155 | | 10.2 | Economic Value of Marketable Securities | 193 |
| | | | 10.2.1 | An Example | 193 |
| 8. Accounts Receivable | 156 | | 10.3 | GAAP for Marketable Securities | 194 |
| 8.1 | Nature of Accounts Receivable | 157 | 10.3.1 | Trading Securities | 194 |
| 8.1.1 | An Example: LECG, Inc. | 157 | 10.3.2 | Available-for-Sale Securities | 196 |
| 8.2 | Economic Value of Accounts Receivable | 160 | 10.3.3 | Held-to-Maturity Securities | 199 |
| 8.3 | GAAP for Accounts Receivable | 162 | 10.4 | Comparison of GAAP and Economic Values | 200 |
| 8.3.1 | Determining Bad Debt Expense and the Allowance for Bad Debts | 166 | 10.5 | Financial Statement Analysis of Marketable Securities | 202 |
| 8.4 | Comparison of GAAP and Economic Value | 168 | 10.6 | Conclusion | 203 |
| 8.4.1 | Discussion | 170 | 11. Long-Lived Assets | 205 | |
| 8.5 | Financial Statement Analysis of Accounts Receivable | 171 | 11.1 | Nature of Long-Lived Assets | 206 |
| 8.6 | Conclusion | 172 | 11.1.1 | An Example: Quaker Oats | 206 |
| 9. Inventories | 173 | | 11.2 | Economic Value of Long-Lived Assets | 210 |
| 9.1 | Nature of Inventories | 174 | 11.3 | GAAP for Long-Lived Assets | 212 |
| 9.1.1 | An Example: Maytag | 175 | 11.3.1 | Capitalization vs. Expense | 212 |
| 9.2 | Economic Value of Inventories | 176 | 11.3.2 | Valuation | 213 |
| 9.3 | GAAP for Inventories | 179 | 11.3.3 | Depreciation | 213 |
| 9.3.1 | FIFO (First-in, First-out) | 180 | 11.4 | Comparison of GAAP and Economic Values | 216 |
| 9.3.2 | LIFO (Last-in, First-out) | 181 | 11.4.1 | Changing Expectations | 216 |
| 9.4 | Comparison of GAAP and Economic Values | 185 | 11.4.2 | Asset Impairment | 218 |
| 9.5 | Financial Statement Analysis of Inventory | 186 | 11.5 | Financial Statement Analysis | 220 |
| | | | 11.6 | Conclusion | 220 |

12. Long-Term Liabilities 223

- 12.1 Nature of Long-Term Liabilities 224**
 - 12.1.1 General Characteristics of Financial Instruments 224
 - 12.1.2 Classification of Long-Term Financing Instruments 227
 - 12.1.3 An Example: Northwest Airlines 227
 - 12.1.4 Conclusion 229
- 12.2 Economic Value of Long-Term Liabilities 230**
- 12.3 GAAP for Long-Term Liabilities 234**
 - 12.3.1 Operating and Capital Leases 235
 - 12.3.2 Retirement of Long-Term Liabilities 237
- 12.4 Comparison of GAAP and Economic Values 238**
- 12.5 Financial Statement Analysis of Long-Term Liabilities 241**
- 12.6 Conclusion 245**

13. Equities 254

- 13.1 The Nature of Equities 255**
 - 13.1.1 Ownership 255
 - 13.1.2 Equity, Debt, and Hybrid Financial Instruments 257
 - 13.1.3 An Example: 3M 258
- 13.2 Economic Value Equities 262**
- 13.3 GAAP for Equities 263**
 - 13.3.1 Issuance and Retirement 263
 - 13.3.2 Treasury Stock 263
 - 13.3.3 Conversion 266
 - 13.3.4 Distributions to Shareholders 266
 - 13.3.5 Stock Splits and Stock Dividends 267
 - 13.3.6 Conclusion 268
- 13.4 Financial Statement Analysis of Equities 269**
 - 13.4.1 Earnings per Share 269
 - 13.4.2 Employee Stock Options 271
 - 13.4.3 Conclusion 272

14. Income Taxes 274

- 14.1 Nature of Income Taxes 275**
 - 14.1.1 An Example: Northwest Airlines 276
 - 14.1.2 Example of TAP Financial Statements 283
- 14.2 Economic Value of Deferred Income Taxes 288**
 - 14.2.1 Example of Deferred Tax Liability Creation: Depreciation 288
 - 14.2.3 Example of Deferred Tax Asset Creation: Warranties 290
- 14.3 GAAP for Deferred Income Taxes 291**
- 14.4 GAAP vs. TAP Accounts for NetService and the GAAP Tax Adjustments 294**
- 14.5 Comparison of GAAP and Economic Values for Deferred Income Taxes 296**
- 14.6 Analysis of Deferred Income Taxes 296**
- 14.7 Conclusion 297**

15. Active Investments in Corporations 298

- 15.1 The Nature of Active Investments 300**
 - 15.1.1 An Example: Xerox Corporation 301
- 15.2 The Economics of Active Investments 305**
- 15.3 GAAP for Active Investments 306**
 - 15.3.1 The Equity Method 306
 - 15.3.2 Consolidation Method 308
 - 15.3.3 Purchase Method 309
 - 15.3.4 Pooling of Interests 310
- 15.4 Do GAAP Capture the Economics? 311**
- 15.5 Ratio Analysis of Consolidated Statements 311**
- 15.6 Conclusion 312**