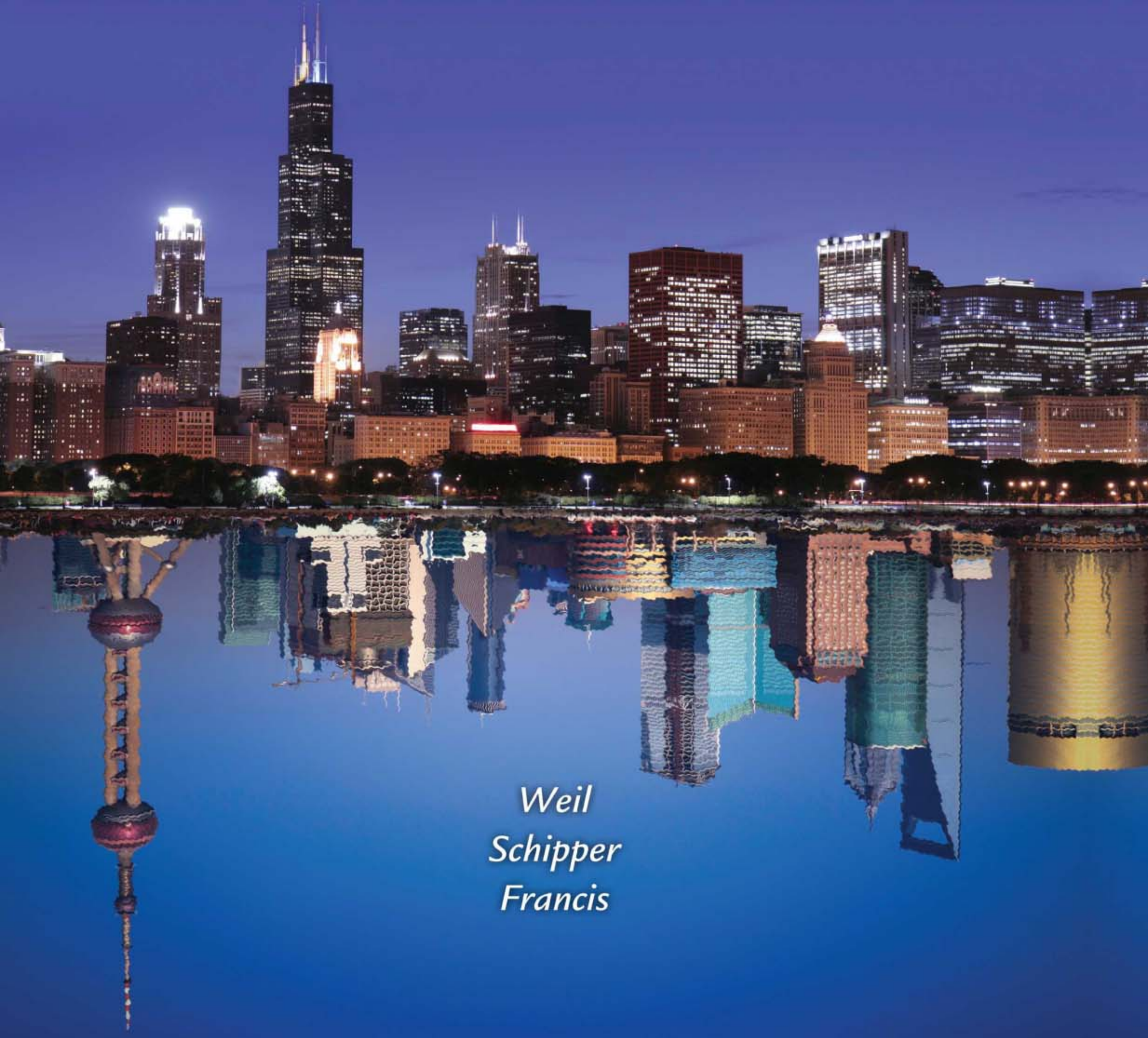
FINANCIAL ACCOUNTING

14e

AN INTRODUCTION TO CONCEPTS, METHODS, AND USES



Weil
Schipper
Francis

Differences Between U.S. GAAP and IFRS

(Exhibit 17.1, p. 670)

Chapter	Reporting Topic	U.S. GAAP	IFRS
8	Revenue recognition	Must have delivered a product or service in return for net assets capable of sufficiently reliable measurement. Over 200 documents provide industry-specific and transaction-specific guidance.	One general standard and a few documents with industry-specific guidance. For long-term contracts, use percentage-of-completion method if amounts are estimable. Otherwise, use cost-recovery method. Completed contract method not permitted.
9	Inventories and cost of goods sold: lower of cost or market	Measurement of market value uses a combination of replacement cost and net realizable values.	Measurement of market value uses net realizable value.
9	Inventories: cost flow	Specific identification, FIFO, weighted-average, and LIFO cost-flow assumptions permitted.	Specific identification, FIFO, and weighted-average cost-flow assumptions permitted. LIFO not permitted.
10	Property, plant, and equipment: revaluations above acquisition cost	Not permitted.	Permitted under certain conditions.
10	Research and development cost	Recognize as an expense in the period incurred, except for certain software development costs.	Recognize research costs as an expense in the period incurred. Capitalize certain development costs and amortize them over the expected period of benefit.
10	Property, plant, and equipment: impairment loss	If carrying value exceeds undiscounted cash flows value, recognize an impairment loss equal to the excess of carrying value over fair value.	Recognize an impairment loss for the excess of carrying value over recoverable amount. Recoverable amount is larger of the fair value less cost to sell and the value in use. Can subsequently reverse the impairment loss but not above acquisition cost.
10	Intangible assets with finite lives: impairment loss	If undiscounted cash flows exceed carrying value, recognize an impairment loss equal to the excess of carrying value over fair value.	Recognize an impairment loss for the excess of carrying value over recoverable amount. Recoverable amount is the larger of the fair value less cost to sell and the value in use. Can subsequently reverse the impairment loss but not above acquisition cost.
10	Intangible assets, other than goodwill, with indefinite lives: impairment loss	Recognize an impairment loss for the excess of carrying value over fair value.	Recognize an impairment loss for the excess of carrying value over recoverable amount. Recoverable amount is the larger of the fair value less cost to sell and the value in use. Test these assets annually for impairment losses and recoveries of impairment losses.
10	Goodwill: impairment loss	Step 1: Compare the carrying value to the fair value of a reporting unit. If the carrying value exceeds the fair value, proceed to Step 2. Step 2: Allocate the fair value of the reporting unit to assets and liabilities based on their fair values and any excess to goodwill. Recognize an impairment loss on the goodwill if the carrying value exceeds the allocated fair value. Step 3: Test goodwill annually for impairment loss or whenever a goodwill impairment loss is probable. Firms may also apply a qualitative impairment test.	Step 1: Compare the carrying value to the recoverable amount for a cash-generating unit. Step 2: Recognize an impairment loss for any excess of carrying value over recoverable amount of the cash-generating unit. First write down goodwill and then allocate any remaining loss to other assets based on their relative recoverable amounts. Step 3: Test goodwill annually for impairment losses.
12	Contingent obligations (U.S. GAAP) and provisions (IFRS)	Recognize as liabilities if payment is probable (probability usually exceeds 80%). Measure at the most likely amount or at the low end of range if no one estimate is better than any other.	Recognize as liabilities if payment is more likely than not (probability exceeds 50%). Measure at the best estimate of the amount to settle the obligation.
11	Leases	A lease is a capital lease if it satisfies one of four conditions; otherwise, it is an operating lease.	Judgment required based on several indicators to identify the entity that enjoys the benefits and bears the risks of leasing.
15	Convertible bonds	Unless the conversion option can be settled in cash, allocate issue price entirely to bonds and none to conversion option.	Allocate issue price between the bonds and the conversion option.

Summary of Financial Statement Ratios

(Exhibit 7.11, p. 244)

Ratio	Numerator	Denominator
Profitability Ratios		
Return on Equity (ROE)	Net Income	Average Shareholders' Equity During the Period
Return on Assets (ROA)	Net Income	Average Total Assets During the Period
Return on Assets, adjusted for financing	Net Income + Interest Expense (net of tax effects)	Average Total Assets During the Period
Profit Margin	Net Income	Sales
Various Expense Ratios	Various Expenses	Sales
Asset Ratio Turnover	Sales	Average Total Assets During the Period
Accounts Receivable Turnover Ratio	Sales	Average Accounts Receivable During the Period
Inventory Turnover Ratio	Cost of Goods Sold	Average Inventory During the Period
Fixed-Asset Turnover Ratio	Sales	Average Fixed Assets During the Period
Financial Leverage Ratio	Average Total Assets During the Period	Average Shareholders' Equity During the Period
Short-Term Liquidity Risk Ratios		
Current Ratio	Current Assets	Current Liabilities
Quick or Acid Test Ratio	Highly Liquid Assets (cash, marketable securities, and accounts receivable)[a]	Current Liabilities
Cash Flow from Operations to Current Liabilities Ratio	Cash Flow from Operations	Average Current Liabilities During the Period
Accounts Payable Turnover Ratio	Purchases[b]	Average Accounts Payable During the Period
Days Accounts Receivable Outstanding	365 days	Accounts Receivable Turnover Ratio
Days Inventories Held	365 days	Inventory Turnover Ratio
Days Accounts Payable Outstanding	365 days	Accounts Payable Turnover Ratio
Long-Term Liquidity Ratios		
Liabilities to Assets Ratio	Liabilities	Assets
Long-Term Debt Ratio	Long-Term Debt	Assets
Debt–Equity Ratio	Long-Term Debt	Shareholders' Equity
Cash Flow from Operations to Total Liabilities Ratio	Cash Flow from Operations	Average Total Liabilities During the Period
Interest Coverage Ratio	Income Before Interest and Income Taxes	Interest Expense

[a]The calculation could exclude receivables for some firms and include inventories for others.

[b]Purchases = Cost of Goods Sold + Ending Inventories − Beginning Inventories.

FINANCIAL ACCOUNTING

14e

AN INTRODUCTION TO CONCEPTS, METHODS, AND USES

Roman L. Weil
University of Chicago
University of California, San Diego

Katherine Schipper
Duke University

Jennifer Francis
Duke University

SOUTH-WESTERN
CENGAGE Learning®

Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

SOUTH-WESTERN
CENGAGE Learning®

Financial Accounting: An Introduction to Concepts, Methods, and Uses, 14e
Roman L. Weil, Katherine Schipper, Jennifer Francis

Senior Vice President, LRS/Acquisitions & Solutions Planning: Jack W. Calhoun

Editorial Director, Business & Economics: Erin Joyner

Editor-in-Chief: Rob Dewey

Senior Acquisitions Editor: Matthew Filimonov

Senior Developmental Editor: Craig Avery

Editorial Assistant: Ann Loch

Marketing Manager: Heather Mooney

Senior Content Project Manager: Tim Bailey

Media Editor: Jessica Robbe

Manufacturing Planner: Doug Wilke

Senior Marketing Communications Manager: Libby Shipp

Production Service: Lachina Publishing Services, Inc.

Senior Art Director: Stacy Jenkins Shirley

Cover and Internal Designer: Joe Devine, Red Hangar Design

Cover Images: ©Shutterstock

Rights Acquisition Director: Audrey Pettengill

For product information and technology assistance, contact us at
Cengage Learning Customer & Sales Support, 1-800-354-9706
For permission to use material from this text or product,
submit all requests online at **www.cengage.com/permissions**
Further permissions questions can be emailed to
permissionrequest@cengage.com

Exam*View*® is a registered trademark of eInstruction Corp. Windows is a registered trademark of the Microsoft Corporation used herein under license.

The financial statements are included for illustrative and education purposes only. Nothing herein should be construed as financial advice.

Library of Congress Control Number: 2012942884

ISBN-13: 978-1-111-82345-0
ISBN-10: 1-111-82345-6

South-Western
5191 Natorp Boulevard
Mason, OH 45040
USA

Cengage Learning products are represented in Canada by Nelson Education, Ltd.

For your course and learning solutions, visit **www.cengage.com**

Purchase any of our products at your local college store or at our preferred online store **www.cengagebrain.com**

Printed in the United States of America
1 2 3 4 5 6 7 16 15 14 13 12

For Our Students

Whatever be the detail with which you cram your students, the chance of their meeting in after-life exactly that detail is infinitesimal; and if they do meet it, they will probably have forgotten what you taught them about it. The really useful training yields a comprehension of a few general principles with a thorough grounding in the way they apply to a variety of concrete details. In subsequent practice the students will have forgotten your particular details; but they will remember by an unconscious common sense how to apply principles to immediate circumstances.

Alfred North Whitehead
The Aims of Education and Other Essays

WARNING: Study of this book is known to cause thinking, occasionally deep thinking. Typical side effects include mild temporary anxiety followed by profound long-term understanding and satisfaction.

Preface

Over the years, we have come to refer to our book's title by the acronym FACMU—*Financial Accounting: An Introduction to Concepts, Methods, and Uses*. We take *concepts, methods,* and *uses* to be the central elements in learning and teaching about financial accounting.

The 14th Edition of *FACMU* has the same objectives as the previous editions:

- To help students develop a sufficient understanding of the basic concepts underlying financial reports so that they can apply the concepts to new and different situations.
- To train students in accounting terminology and methods so that they can interpret, analyze, and evaluate financial statements and notes currently published in corporate annual reports.

Most introductory financial accounting textbooks state these, or similar, objectives. Textbooks differ in their relative emphases on concepts, methods, and uses.

1. **Concepts** This book emphasizes the rationale for, and implications of, accounting concepts. To learn accounting, students must develop the ability to conceptualize the transactions that accounting summarizes and the process of summarization. *Without such concepts, students will have difficulty focusing on the relevant issues in new and different situations*.

   Accordingly, each chapter identifies important accounting concepts and includes numerical examples illustrating their application. The end-of-chapter material includes numerous short exercises and longer problems to check students' ability to apply the concepts to different situations.

2. **Methods** We place enough emphasis on accounting procedures to enable students to interpret, analyze, and evaluate published financial statements. The text does not emphasize procedures to such an extent that students bog down in detail. All writers of accounting textbooks must decide just how much accounting procedure to include. We believe students learn most effectively by working exercises and problems. Too much emphasis on accounting procedures, however, lulls students into the security of thinking they understand accounting concepts when they do not. We have for many years used the mixture of concepts and procedures in this book and have found it effective in the classroom.

   Understanding the accounting implications of an event requires that students construct the journal entry for that event. Throughout this book we use journal entries in describing the nature of accounting events. Moreover, most chapters contain exercises and problems that require the analysis of transactions with debits and credits. *Do not conclude by a glance at this text, however, that it is primarily procedural. We want students to learn concepts; the procedures enhance the learning of concepts*.

3. **Uses** *This book attempts to bridge the gap between the preparation of financial reports and their use in various decision situations*. The chapters consider the effects of alternative accounting principles on the measurement of earnings and financial position and the appropriate interpretations of them. Numerous problems based on financial statement data of actual companies appear at the end of most chapters.

OVERVIEW OF THE 14TH EDITION

What's New in FACMU 14e

Most important, but easily visible, we have simplified the book. The text pulls back a bit from discussion of advanced accounting topics and simplifies the treatments remaining.

The major visible changes occur at the beginning and end of the book:

- **NEW:** We have split the former **Chapter 2**, which treated record-keeping procedures, into two chapters, now **Chapters 2** and **3**. **Chapter 2** treats balance sheet basics, and **Chapter 3** treats income statement basics.
- **NEW: Chapter 17** now treats issues of organizing and presenting elements of income in a single place. We discuss the following in sequence, with emphasis on why these matter: recurring versus nonrecurring income, operating versus peripheral income, earnings versus other comprehensive income, and errors and accounting changes.

Other important features of the 14th Edition are as follows. These features affect multiple chapters of the text.

- **Integration of International Financial Reporting Standards (IFRS)** We continue to integrate IFRS into the text. We start from the premise that U.S. GAAP and IFRS use the same concepts but sometimes require or permit different methods. At the FACMU level, for MBA students and upperclass undergraduates, the methods are often identical or similar; where they are not, we describe and illustrate the differences. You can easily see the scope of the U.S. GAAP/IFRS details in this book by examining the chart inside the front cover. That chart shows the chapters and topics where the discussion includes both IFRS and U.S. GAAP.
- **Fair values and components of other comprehensive income** As U.S. GAAP and IFRS incorporate more required or permitted fair value measurements, we have broadened our coverage. The fair value option in U.S. GAAP affects accounting for some debt securities and some investments. We discuss these in **Chapters 11, 13, 14, 15,** and **17**, both concepts and methods. Insofar as changes in fair values affect other comprehensive income, we've expanded that discussion as well.
- **Actual financial statements** We have continued the use of actual financial statement excerpts in the chapters and in end-of-chapter assignment materials. We often change the names and dates in the financial statements. You will see that Chapter 1, for example, shows the financial statements for Great Deal and Thames, which are based on the financial statements of Best Buy and Thales, respectively.

The following features affect individual chapters.

- **Treatment of record-keeping cycle in early chapters** Given the success the Duke University authors have had with the record-keeping material they give to their MBA students before the financial accounting class begins, we have reorganized the balance sheet and income statement record-keeping material into *a pair of chapters* that precede most of the conceptual discussions. **Chapter 2** introduces assets, liabilities, shareholders' equity, journal entries, and T-accounts. **Chapter 3** introduces the recording of operating transactions, elementary adjusting entries, closing entries, and preparation of financial statements.

  Chapters 2 and **3** accomplish this without overwhelming the student with advanced accounting and economic concepts. The problem material for **Chapter 3** includes the "working backward" problems that have distinguished this text from many of its competitors. The basic record-keeping cycle gives students transactions and then asks them to produce recording entries and adjusting entries, prepare the income statement, supply the closing entries, and finally provide the ending balance sheet and statement of cash flows. In the working backward problems, we give students some of the later items and ask them to derive earlier items. We say one doesn't understand accounting until one can work through the record-keeping cycle backward as well as forward. The typical accounting problem gives facts and asks the students to derive the financial statements. The working backward problems start with some subset of the financial statements and ask the students to derive the underlying transactions.
- **Focus on balance sheet and income statement measurements, formats, and conventions** **Chapter 4** (balance sheet) introduces the asset and liability recognition criteria and measurement bases, including fair value measurement. **Chapter 5** (income statement) continues by describing basic revenue and expense recognition criteria and measurement and timing issues. **Chapter 8** contains a more detailed discussion of revenue recognition. All three chapters highlight classification and display differences that exist across firms, as well as between firms that follow U.S. GAAP and IFRS.

- **Emphasis on the direct method of computing cash flow from operations** Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have expressed a preference for the direct method of computing cash flow from operations. Students are likely to increasingly encounter the direct method during their professional careers. Thus, we continue our emphasis on the direct method in the 14th Edition. Our students encounter difficulty with the indirect method of computing cash flow from operations when they first study the statement of cash flows. We have found that introducing the direct method early, as we do in **Chapter 1**, helps students to understand the adjustments required to convert net income to cash flow from operations under the indirect method. **Chapter 6** therefore emphasizes the direct method, without deleting material on the indirect method commonly found in practice. **Chapter 16** revisits the statement of cash flows, integrating material on more advanced topics into discussions of both the direct and indirect methods for presenting cash flow from operations. For example, we include transactions for, and income tax effects of, stock option compensation expense, impairment loss, and, employees' exercise of their stock options.
- **Organization of topics involving revenue recognition and working capital** **Chapter 8** treats revenue recognition, receivables, and advances from customers. **Chapter 9** treats other current assets and current liabilities, including inventories, payables, and restructuring liabilities. The decision to bring all the working capital account issues together results from our view that *the accounting for current liabilities has more in common with the accounting for current assets than with the accounting for noncurrent assets*. Consider, for example, the parallels between the allowance method applied to uncollectibles and to warranty costs.
- **IFRS differences from U.S. GAAP for noncurrent assets** **Chapter 10** contrasts the U.S. GAAP and IFRS treatments of noncurrent assets. At the elementary level of this book, the major differences between U.S. GAAP and IFRS in the accounting for noncurrent assets occur in the accounting for development costs and impairments.
- **Organization of noncurrent liability topics** **Chapter 11** treats mortgages, bonds, installment notes, and lease liabilities. Leases are so common in business that we treat them as a basic, not an advanced, topic in liabilities. As this book goes to press, the standard setters have proposed to change the accounting for leases. We have introduced the topics in such a way that the students learn both the existing and proposed accounting treatments. **Chapter 12** treats income taxes, off–balance sheet financing, and defined benefit pension arrangements, each in separate sections allowing the instructor to select one or two of these topics, without doing all three. For example, you can skip the pension material and assign the material on income taxes. We don't expect students to master all this material during their first term in accounting, but many will not take more accounting and find later in their careers that they need to understand the basics of accounting for these more advanced topics. We have included this material, in the FACMU style of concepts, methods, and uses, so that this book can serve as a reference on these topics for our alumni.
- **Separation of investments in marketable securities and derivatives from treatment of the equity method and consolidated statements** **Chapter 13** simplifies our coverage of accounting for derivatives, while **Chapter 14** continues to present material on joint ventures and variable interest entities (U.S. GAAP) and special purpose entities (IFRS). We have expanded this material into two chapters so that we can provide more coverage on derivatives without having a single enormous chapter. As in **Chapter 12**, we have provided some advanced materials to support instructor choice as to which advanced topics to cover and to ensure that our alumni will have this material at the ready when they encounter these issues on the job or in more advanced courses in the MBA curriculum.
- **Summary of the FASB's and IASB's joint projects on the conceptual framework** **Chapter 17** discusses the conceptual frameworks of both the FASB and IASB and the changes under consideration in their joint conceptual framework project.
- **Reporting on transactions of a company, other than with owners that affect owners' equity.** New in this edition, **Chapter 17** brings together into a unified discussion the reporting and disclosure of income statement information, including the nature and reporting of transactions, accounting errors and adjustments, earnings per share, and segment reporting.
- **More complex topics appear on the Web site** We have placed complex material on deferred taxes, foreign currency translation, and general price level adjusted accounting on the text's Web site.

Organization

This book comprises four major parts:

- **Part 1:** "Overview of Financial Statements," consisting of **Chapters 1** through **3**.
- **Part 2:** "Accounting Concepts and Methods," **Chapters 4** through **7**.
- **Part 3:** "Measuring and Reporting Assets and Equities," **Chapters 8** through **15**.
- **Part 4:** "Synthesis," **Chapters 16** and **17**.

In our view, the four parts are tiers, or steps, in the learning process. **Part 1** presents a general overview of the principal financial statements and basic transactions recording and financial statement preparation. **Part 2** discusses the basic accounting model accountants use to generate the principal financial statements. **Part 3** considers the specific accounting principles or methods used in preparing the financial statements. **Part 4** summarizes and integrates the material from the first three parts. **This organization reflects our view that learning takes place most effectively when students begin with a broad picture, then break up that broad picture into smaller pieces until achieving the desired depth, and finally synthesizing so that the relation between the parts and the whole retains its perspective.**

Chapter 1 presents a brief description of the principal activities of a business firm (goal setting and strategy formulation, investing, financing, and operating) and shows how the principal financial statements—the balance sheet, the income statement, and the statement of cash flows—report the results of these activities. We use the business activities and the financial statements of Best Buy and Thales, renamed Great Deal and Thames, to illustrate the important concepts. **Chapter 1** also provides an overview of the financial reporting environment. Many students feel deluged with the multitude of new terms and concepts after reading **Chapter 1**. Later, many students admit that the broad overview helped piece material together as they later explored individual topics at greater length and in greater depth. **Chapters 2** (balance sheet) and **3** (income statement) focus on record-keeping vocabulary and processes. **Chapter 3**, unlike treatments in other texts, integrates the accounting entries for transactions during a period with the related adjusting entries at the end of the period. When textbooks discuss these two types of entries in separate chapters, students often lose sight of the fact that measuring net income and reporting financial position requires both kinds of entries.

Chapters 4 and **5** present the basic accounting model that generates the financial statements. They discuss the elements of financial statements: assets, liabilities, equity, revenue, and expenses. The conceptual frameworks of the FASB and the IASB provide the basis for these discussions, which include fair value measurements for assets and liabilities.

Chapter 6 discusses cash flows. We continue to put coverage of the statement of cash flows early in the text. This placement serves two purposes. First, it elevates the statement to its rightful place among the principal financial statements. Students can thereby integrate the concepts of profitability and cash flow more effectively and begin to understand that one does not necessarily accompany the other. Covering this statement at the end of the course can lead students to think the cash flow statement less important. Placing this chapter early in the book forces the student to cement understanding of the basic accounting model from **Chapters 2, 3**, **4**, and **5**. Preparing the statement of cash flows requires the student to work backward from the balance sheet and income statement to reconstruct the transactions that took place. We present the direct method of computing cash flow from operations, without detracting from the importance of understanding the indirect method. The FASB, for more than a decade, and the IASB have expressed a preference for the direct method. Few U.S. companies currently use it, but we think this will change during the careers of students.

Chapters 2 through **6** use the Balance Sheet Equation or changes in the Balance Sheet Equation to motivate understanding of the topics discussed. Each of these chapters includes one or more simple problems that students can work using the balance sheet approach to prepare the principal financial statements. Although these chapters emphasize debit/credit procedures, instructors can use the Balance Sheet Equation approach to communicate the basics of statement preparation.

Chapters 3 through **6** each contain a section on analyzing and interpreting the financial statement introduced in the chapter. This presages the integrated analysis of profitability and risk in **Chapter 7**.

Chapter 7 describes and illustrates tools for analyzing the financial statements. The discussion structures the various financial statement ratios in a multi-level format that, students have found, reduces the students' need to memorize formulas. Instructors who incorporate annual reports of actual companies throughout their course, as we do with Great Deal and Thames, will find that analysis of the financial statements of such companies provides an effective synthesis at this point. An **appendix** to **Chapter 7** illustrates procedures for preparing pro forma financial statements. This topic helps cement understanding of the relation among the principal financial statements.

Chapters 8 through **15** discuss the guidance in U.S. GAAP and IFRS for generating the financial statements. Each chapter not only describes and illustrates the application of the guidance but also considers how accounting principles affect the financial statements. This approach reflects the view that students should be able to interpret and analyze published financial statements and to understand the effect of alternative accounting methods on such assessments.

Chapter 16 deepens the exploration of the statement of cash flows by presenting a comprehensive illustration using the transactions in **Chapters 8** to **14**. **Chapter 17** reviews the accounting principles discussed in **Chapters 8** to **15** and discusses reporting issues that standard-setting bodies are currently addressing, particularly those where U.S. GAAP and IFRS diverge.

An **appendix** to the book describes compound interest and present value computations for students not previously exposed to this topic.

The end of the book includes a comprehensive **glossary** of accounting terms. It serves as a reference tool for accounting and other business terms and provides additional descriptions of a few topics, such as *accounting changes* and *inventory profit*, considered only briefly in the text. The companion website for the book includes expanded discussion of certain topics in the text, including income taxes, foreign currency translation, and general price-level account. Go to http://login.cengage.com.

Related Materials Accompanying the Textbook

The following supplementary materials augment the textbook:

NEW online homework For the 14th Edition we have added **CengageNOW**.

CengageNOW is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes.

Where True Learning Takes Place

CengageNOW has the following advantages:

- "Smart Entry" ensures students do not guess their way through an assignment by unthinkingly clicking on an option in a drop-down menu. Instead, in selected assignments, students must use free response to type in the account title, meaning that students must understand the accounting to get the answer right. It will also help you prepare for tests and quizzes.
- Designed as teaching problems, **Blueprint problems** bring concepts full circle, focusing on a single topic and emulating the experience of a teacher working through an accounting problem with a student in their office.
- **Blueprint Connections** are shorter, scenario-based activities, built as an extension of the Blueprint Problem. These items focus on making sure that students understand the interrelationship of the concepts introduced in various Blueprint Problems.
- A variety of study tools helps students review concepts. Students can check out the multimedia resources such as games, Spotlight videos, animated review problems, and more.
- The publisher designed the Personalized Study Plan in CengageNOW to improve students' performance. They can master key concepts and prepare for exams with the Personalized Study Plan—a diagnostic tool plus study plan—that contains an Integrated eBook to make learning more engaging. 1. Students can take the Pre-Test to find out what they know prior to the class lecture. 2. Next, the Personalized Study Plan automatically generates a plan, pointing each student to the right section of the text that will help him or her focus on the areas of greatest need. 3. Finally, each time the student takes the Post-Test, the Personalized Study Plan revises the plan to help the student continue to focus on remaining areas of need.

For more information, go to **www.CengageBrain.com**.

Instructor's Resource CD (ISBN 978-1-133-62940-5) The Instructor's Resource CD includes the following supplements:

- **Solutions Manual** The Solutions Manual, written by the authors, provides full solutions for all end-of-chapter assignment items, including questions, exercises, and problems. We give computations, allowing the instructor to show how to reach a particular answer. The Solutions Manual also appears as a printed item.
- **Solutions Transparency Masters** Transparency masters, available to adopting instructors, accompany all numerical end-of-chapter exercises and problems.
- **Test Bank** The test bank includes multiple-choice items, matching questions, short essay questions, and problems.
- **ExamView computerized testing software** All items in the Test Bank are available in ExamView computerized testing software format. This supplement allows instructors to add or edit questions, instructions, and answers by previewing them onscreen. They can also create and administer quizzes online—whether over the internet, a local area network (LAN), or wide area network (WAN).
- **Lecture presentations in PowerPoint** These sample lectures aid in class preparation by those using this text. The PowerPoint slides are also available by download to instructors on the book's Web site.

Printed Solutions Manual (ISBN 978-1-133-37249-3) The Solutions Manual, written by the authors, provides full solutions for all end-of-chapter assignment items, including questions, exercises, and problems. We give computations, allowing the instructor to show how to reach a particular answer.

Bundle for Text Plus Solutions Manual (ISBN: 978-1-285-47797-8)

Spreadsheet template software To reduce tedium in solving problems and increase student awareness of basic software applications, at least three problems per chapter have a corresponding template where basic problem data appear on a Microsoft Excel® spreadsheet. Additional spreadsheet templates are a pedagogical tool in learning selected topics such as for the statement of cash flows. The templates, both student and instructor versions, are available by download on the book's Web site.

Student Solutions Manual (ISBN 978-1-133-59102-3) The Student Solutions Manual, written by the authors, provides full solutions for the odd end-of-chapter assignment items, including questions, exercises, and problems. We give computations, allowing the student to see how to reach a particular answer.

Bundle for Text Plus Student Solutions Manual (ISBN: 978-1-285-48198-2)

Web resources Many helpful Web resources, including free Study Guide components, topical discussions, advanced topics, regulatory updates, editorial and marketing contacts, and more are available for students to access. These items help reinforce and shed light on text topics. We invite you to discover this wealth of student and instructor resources by logging into the text Web site. **www.CengageBrain.com**, or, for instructors, **http://login.cengage.com**.

We encourage instructors to contact their South-Western Cengage Learning sales representative for information and samples of these items.

Instructors may also contact the publisher directly with questions, comments, or concerns:

Matt Filimonov, Senior Acquisitions Editor – matt.filimonov@cengage.com
Craig Avery, Senior Developmental Editor – craig.avery@cengage.com

ACKNOWLEDGMENTS

The following individuals provided invaluable and insightful comments during the development of the 14th Edition:

Laura Beal University of Nebraska at Omaha
Peggy De Prophetis University of Pennsylvania
Judith S. Flaxman Temple University
Joe Hatch Lewis University
Alison Iavarone Fordham University
Shirin Jahanian Philadelphia Community College
Adam Myers Texas A&M University
John R. Page Tulane University
Wilson Seda New York University
Greg Sommers Southern Methodist University
James Taibleson New York University
Xiao-Jun Zhang University of California, Berkeley
Stephen A. Zeff Rice University

The above-mentioned Steve Zeff has given us so many helpful comments and materials over the years that we have lost count, including half a dozen definitions about international accounting standard setting for the **glossary**. Most of these appear in the **glossary** at *International Accounting*. He deserves and gets our special thanks.

Thomas Horton and Daughters, Inc., permits us to reproduce material from *Accounting: The Language of Business*. Problems 42, 43, and 44 in **Chapter 2** derive from ones prepared by George H. Sorter. These problems involve working backward from one financial statement to another, and we have found them useful in cementing understanding.

We thank Katherine Xenophon-Rybowiak for helping us to prepare the manuscript for this edition and Lachina Publishing Services for preparing the index.

We thank the following at Cengage Learning: Matt Filimonov and Craig Avery for providing general guidance for the direction and scope of the revision and coordinating the revision process, and Tim Bailey for coordinating the production.

We are grateful to Jim Emig and Catherine Lumbattis for their careful reading of and helpful suggestions for chapters in the text and solutions manual.

We thank the employees of Lachina Publishing Services, Inc., for their copyediting and compositing expertise and for their excellent work on page makeup. Bonnie Briggle gets special thanks for coordinating the efforts.

Thanks to Michael Behnke for inspiring the WARNING on the dedication page.

We don't forget Sidney Davidson. What can we say? He taught us and guided us and wrote with us. We're all the intellectual descendants of William Paton. Thank you.

Finally, Clyde Stickney, who led FACMU efforts for over 35 years, since its inception in 1974. Even in this edition, where his name does not appear as author, he did yeoman work on the entire book. Clyde's special skills involve making sure that we who are inclined to give a "full-core dump," as the computer scientists called it, omit details that MBA students do not need to know, but making sure that we cover thoroughly the things they do. And after 35 years of reading endless manuscript and publisher proof, he has developed a skilled eye at spotting errors. We shall miss him.

RLW
KS
JF

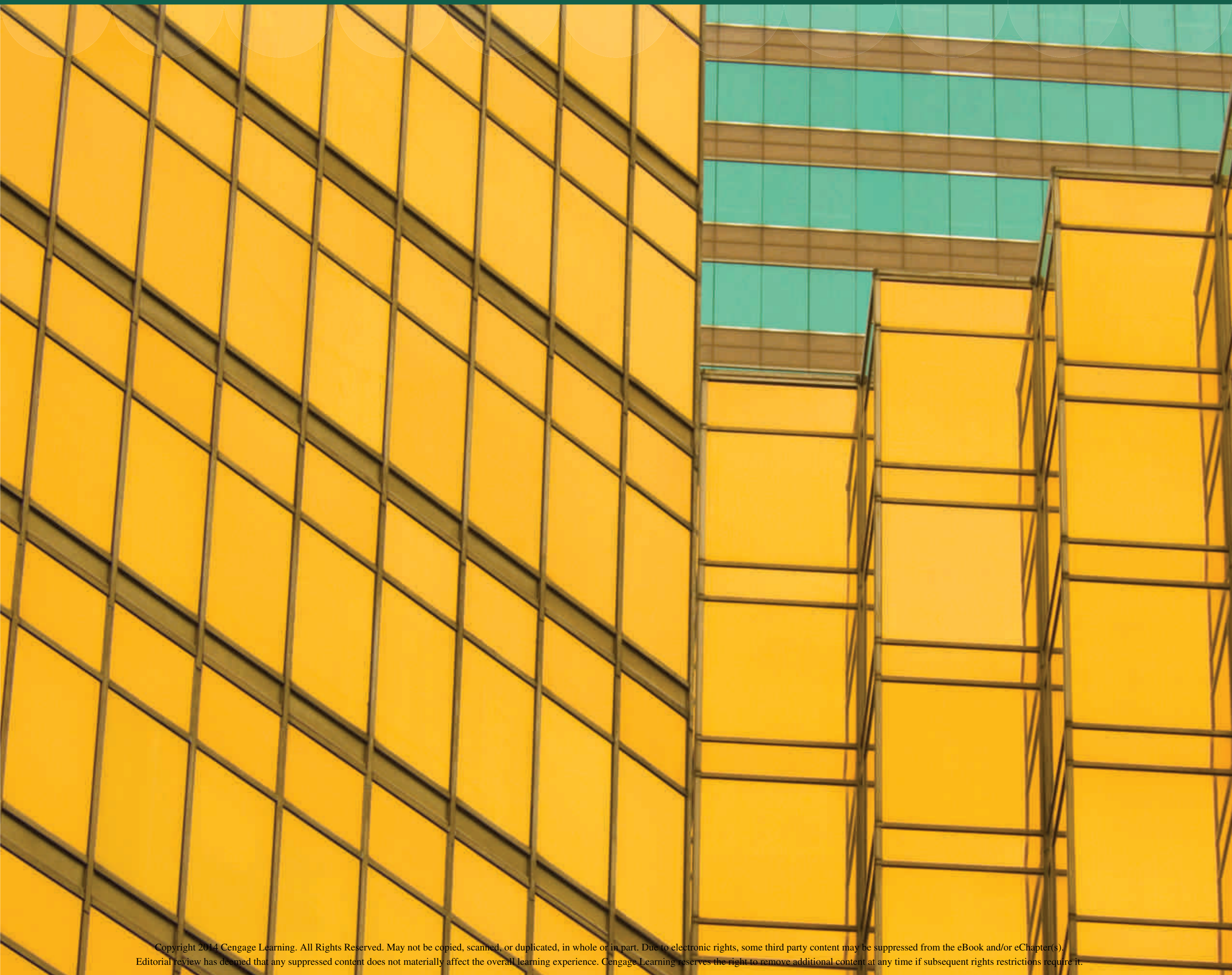
Brief Contents

Contents

Part 4 Synthesis 611

Overview of Financial Statements

Part 1



Chapter

1

Introduction to Business Activities and Overview of Financial Statements and the Reporting Process

LEARNING OBJECTIVES

1. Understand four key activities of business entities: (a) establish goals and strategies, (b) obtain financing, (c) make investments, and (d) conduct operations.
2. Understand the purpose and content of the financial statements: (a) balance sheet, (b) income statement, (c) statement of cash flows, and (d) statement of shareholders' equity.
3. Understand the roles of participants in the financial reporting process, including managers and governing boards, accounting standard setters and regulators, independent external auditors, and financial statement users.
4. Gain an awareness of financial reporting as part of a global system for providing information for resource allocation decisions, including two financial reporting systems (U.S. GAAP and International Financial Reporting Standards).
5. Understand the difference between the cash basis and the accrual basis of accounting, and why the latter provides a better measure of performance.

In making resource allocation decisions, investors and creditors depend on reliable and relevant information about financial position, profitability, and risk. Financial reports are a key source of this information. The process of preparing those reports is *financial accounting*, or, more broadly, *financial reporting*. Understanding the basics of the financial reporting process is fundamental to understanding how to use financial reports for resource allocation decisions, such as making investments.

You are about to embark on the study of financial accounting. You will learn the concepts underlying the accounting principles firms use to measure the results of their business activities, the accounting principles themselves, some of the judgments and estimates managers must make to apply accounting principles, and tools for analyzing financial statements. You will learn about two similar—but not identical—financial accounting systems: U.S. GAAP[1] and International Financial Reporting Standards (IFRS). Accounting systems specify the financial accounting principles that firms must use, and the kinds of estimates and judgments that managers must make in applying those principles. We introduce these two systems in this chapter, illustrate them with a firm that uses U.S. GAAP (Great Deal, Inc., hereafter Great Deal) and a firm that uses IFRS (Thames Limited, hereafter Thames), and continue to present both systems throughout the book.[2]

Our goal is to help you understand the concepts, methods, and uses of financial accounting to enable you to use financial accounting information effectively. As a financial statement user, you will encounter financial reports with a variety of formats and presentations. We show a few of those variations, understanding that you will encounter many more.

As the chapter title suggests, this chapter introduces the concepts, methods, and uses that later chapters discuss in detail. We begin with a description of Great Deal's and Thames's business activities. We next see how firms measure the results of their business activities and report those

[1]GAAP refers to generally accepted accounting principles. U.S. GAAP is the authoritative guidance for financial accounting in the United States. We discuss U.S. GAAP and IFRS in more detail throughout the book.

[2]Financial information presented for Great Deal and Thames Limited is derived from the financial reports of two actual firms that report using U.S. GAAP and IFRS, respectively. That information has been modified for inclusion in this book.

results in their financial statements. Finally, we describe several components of the financial reporting process and introduce U.S. GAAP and IFRS.

OVERVIEW OF BUSINESS ACTIVITIES

The managers of a business[3] prepare financial reports to present information about that business's activities to external users. External users include owners of the business, lenders, regulators, and employees. Understanding those financial reports requires an understanding of the activities of the business:

1. Establishing goals and strategies.
2. Obtaining financing.
3. Making investments.
4. Conducting operations.

We illustrate these four business activities using two firms, Great Deal and Thames.

Example 1 Great Deal, based in the United States, operates more than 3,500 retail stores in the United States and around the world. The United States is its largest market. It prepares financial statements using U.S. GAAP. Its retail stores sell consumer electronics, home office products, entertainment software, appliances, and related services.

Example 2 Thames, based in France, is an electronics company that provides information systems and related services to the aerospace, defense, and security sectors. Thames prepares its financial statements using IFRS. It operates around the world. Europe is its largest market.

Although Great Deal and Thames differ in terms of business model, size, and geographical scope, their managers must carry out similar kinds of business activities. Differences in the two firms' business models affect the content of each of the activities.

Establish Corporate Goals and Strategies

Goals are the end results toward which the firm directs its energies, and **strategies** are the means for achieving those results. Examples of corporate goals include maximizing the return to the firm's owners, providing a good working environment for employees, and improving the environmental performance of the firm's products and manufacturing processes. Management, under the oversight of the firm's governing board (or boards),[4] sets the firm's strategies—for example, determining the firm's lines of business and its geographic locations and the strategies for each business unit. Factors that would affect a firm's goals and strategies include the following:

1. Goals and strategies of competitors.
2. Barriers to entry of the industry, such as patents or large investments in buildings.
3. Nature of the demand for the firm's products and services. For example, demand might be increasing, such as for certain pharmaceutical products, or demand might be relatively stable, such as for groceries.
4. Existence and nature of government regulation.

Firms provide extensive information about their corporate goals and strategies. For example, a recent Great Deal financial report indicates that store development, including entering new markets, opening new stores in existing markets, and remodeling/expanding existing stores, plays a role in Great Deal's growth. The report provides quantitative information about store openings and store closings in the past year as well as plans for the coming year. Similarly,

[3] We use the terms *managers* and *management* to refer to employees who make operating, investing, and financing decisions and apply accounting standards to prepare financial statements. We also use the term *firms* to refer to these same decision makers.

[4] By law, some countries require firms to have two governing boards; other countries require one.

Thames's recent financial report announced a plan to address the difficult business outlook in its main markets by undertaking cost-cutting efforts.

Establishing corporate goals and strategies does not directly affect the firm's cash flows. The other three business activities—carrying out operations, making investments, and obtaining financing—either generate cash or use cash. The statement of cash flows, introduced later in the chapter, describes these cash flows in more detail.

Obtain Financing

To carry out their plans, firms require **financing**, that is, funds from owners and creditors. Owners provide funds to a firm and in return receive ownership interests. For a corporation, the ownership interests are shares of common stock and the owners are **shareholders** or **stockholders**.[5] In some cases the common shares trade in active markets such as the New York Stock Exchange and the London Stock Exchange. Firms whose shares trade in active markets are **publicly traded** and subject to special regulations. When the firm raises funds from owners, it has no obligation to repay these funds. Sometimes, a firm's governing board may decide to distribute **dividends** to that firm's shareholders. Dividends are a distribution of assets, often cash, to owners.

Creditors provide funds that the firm must repay in specific amounts at specific dates. *Long-term* creditors require repayment from the borrower over a period of time that exceeds one year. *Short-term* creditors require payment over the next year. One common form of long-term financing is *bonds*. A bond agreement specifies the amount borrowed and the terms of repayment, including the timing and amounts of cash the borrower agrees to pay to the creditors. Another common form of long-term borrowing is bank loans. Banks usually lend for periods between several months and several years. Finally, suppliers of raw materials or merchandise that do not require payment immediately also provide funds—the firm gets raw materials or merchandise now but does not pay cash until later.

Each firm makes financing decisions about the proportion of funds to obtain from owners, long-term creditors, and short-term creditors. Corporate finance courses cover the techniques that firms use to make financing decisions.

Make Investments

A firm makes investments to obtain the productive capacity to carry out its business activities. **Investing activities** involve acquiring the following:

1. **Land, buildings, and equipment.** These investments provide the capacity to manufacture and sell products and to create and sell services. They are usually long term, in the sense that they provide productive capacity for a number of years.
2. **Patents, licenses, and other contractual rights.** These investments provide rights to use ideas and processes. They are intangible, in the sense that they do not have a physical existence.
3. **Common shares or bonds of other firms.** These investments make a firm an owner or creditor of another firm. Short-term investments in equity shares typically involve partial ownership, while long-term investments in equity interests involve partial or complete ownership of another business.
4. **Inventories.** Firms maintain an inventory of products to sell to customers. For example, Great Deal maintains inventories of consumer electronics, home office products, entertainment software and appliances.
5. **Accounts receivable from customers.** In many businesses, customers do not pay for goods and services immediately. *Accounts receivable* describes the amounts owed to a firm by its customers for short periods, such as 30 days. In extending credit to customers, the firm does not collect cash right away. If the firm did not extend the credit, however, it might not make the sale in the first place.
6. **Cash.** Most firms maintain cash balances (like a corporate checking account) to pay their current bills.

[5] If the business is organized as a partnership, the owners are partners. If the business is organized as a proprietorship, the owner is the proprietor. This book considers corporations, in which the owners are shareholders or stockholders.

Managerial accounting courses and corporate finance courses cover the techniques that firms use to make investment decisions.

Carry Out Operations

Management operates the productive capacity of the firm to generate earnings. **Operating activities** include the following:

1. *Purchasing.* The purchasing department of a retailer, such as Great Deal, acquires items to sell to customers. The purchasing department of a firm with manufacturing operations, such as Thames, acquires raw materials needed for production.
2. *Production.* The production department in a manufacturing firm combines raw materials, labor services, and other manufacturing inputs to produce goods for sale. A service firm combines labor inputs and other inputs to provide services to customers.
3. *Marketing.* The marketing department oversees selling and distributing products and services to customers.
4. *Administration.* Administrative activities include data processing, human resource management, legal services, and other support services.
5. *Research and development.* A firm undertakes research and development with the objective of discovering new knowledge that it can use to create new products, new processes, or new services.

Managerial accounting, marketing, and operations management courses cover the techniques that firms use to make operating decisions.

PRINCIPAL FINANCIAL STATEMENTS

Firms communicate the results of their business activities in the **annual report to shareholders**.[6] The annual report may contain letters from the firm's management describing the firm's goals, strategies, and accomplishments, as well as descriptions and pictures of the firm's products, facilities, and employees. If the firm's shares trade publicly, it will also file an annual report with a regulator, typically a government agency.[7] The applicable laws and regulations of the country where the shares trade specify the form and content of the annual report. In the United States, regulatory requirements applicable to publicly traded firms require the inclusion of a **Management's Discussion and Analysis (MD&A)**, in which management discusses operating results, liquidity (sources and uses of cash), capital resources, and reasons for changes in profitability and risk during the past year.

We focus on the four principal financial statements and the supplementary information that firms report, including the following:

1. *Balance sheet or statement of financial position* at a specified time.
2. *Income statement or statement of profit and loss* for a specified time period.
3. *Statement of cash flows*.
4. *Statement of shareholders' equity or statement of changes in shareholders' equity*.
5. *Notes* to the financial statements, including various supporting schedules.

[6]Many firms provide these annual reports on their Web sites, often in the investor relations section. Some securities regulators' Web sites also provide required filings, including annual reports.

[7]The regulator may also require *interim reports*, for example, on a quarterly basis. In the United States, firms whose shares trade publicly file quarterly reports that contain a subset of the information in the annual report. Those quarterly reports appear on the regulator's Web site (www.sec.gov). The U.S. regulator is the Securities and Exchange Commission (SEC).

The following sections of this chapter briefly discuss each of these five items. In describing these items, we refer to the financial statements of Great Deal and Thames. Great Deal's financial statements appear in **Exhibits 1.1–1.4**, and Thames's financial statements appear in **Exhibits 1.5–1.8**. We begin with several observations about conventions and concepts that apply to financial statements in general.

Financial Reporting Conventions

In this section we describe some conventions used in financial statement preparation. These conventions govern the length of time covered by the financial statements (the accounting period), the number of reporting periods included in the financial reports, the monetary amounts, and the terminology and level of detail in the financial statements.

Length of Reporting (Accounting) Period Financial statement presentations can span intervals of any length. The most common accounting period for external reporting is one year, called the **fiscal year**. While many firms use the calendar year as their fiscal year (that is, the fiscal year ends on December 31), some firms select other fiscal year-ends. When the fiscal year ends in June–December of calendar year T, convention describes the financial reports as pertaining to fiscal year T. For example, Thames's financial report for the year ended December 31, 2013, reports Thames's performance for fiscal 2013. When the fiscal year ends in January–May of year T, convention describes the financial reports as pertaining to fiscal year $T - 1$. For example, Great Deal's financial report for the year ended February 27, 2013, reports Great Deal's performance for fiscal 2012.[8]

Number of Reporting Periods To assist in making comparisons over time, both U.S. GAAP and IFRS require firms to include results for multiple reporting periods in each report. Firms must include two balance sheets describing the beginning and ending balances of the accounts for the current fiscal year and the prior fiscal year. Refer to **Exhibit 1.1**, which shows that Great Deal's fiscal 2012 annual report includes a balance sheet as of February 27, 2013 (the end of fiscal 2012), and a balance sheet as of February 28, 2012 (the end of fiscal 2011). For the income statement, statement of cash flows, and statement of shareholders' equity, SEC rules require statements for the current year and the two prior years; IFRS requires statements for the current year and the prior year.

Monetary Amounts The financial statements report a numerical amount, the **monetary amount**, for each listed item. The financial statements indicate the measuring units, both the numerical expression such as in thousands or in millions, and the currency, such as dollars ($) or euros (€). A firm typically reports in the currency of the country where it is headquartered or where it conducts most of its business. For example, a firm with headquarters and most of its business activities in England would report its results in pounds sterling (£).

Terminology and Level of Detail U.S. GAAP and IFRS contain broad guidance on what the financial statements must contain, but neither completely specifies the level of detail or the names of accounts. IFRS contains relatively more guidance. For example, IFRS describes the line items that the balance sheet must display and described items that the firm must separately disclose.[9] U.S. GAAP contains no analog to this IFRS guidance.[10] *You should therefore expect to encounter variation in the ways financial statements display information and variation in the level of detail provided*. In addition, the rules do not always require firms to use specific names for accounts and line items on the financial statements. While practice tends to converge on certain names, such as cash, accounts receivable, and inventories, *you should expect to encounter variation in account titles as well as variation in format and display*.

With these conventions in mind, we turn to a discussion of the financial statements.

---

[8] Not all firms follow this convention, so use caution in comparing results across firms.

[9] International Accounting Standards Board (IASB), *International Accounting Standard 1*, "Presentation of Financial Statements," revised 2003.

[10] As of late 2011, a long-running project underway to improve and converge the U.S. GAAP and IFRS guidance for financial statement presentation was incomplete.

EXHIBIT 1.1

Great Deal, Inc.
Consolidated Balance Sheets
(amounts in millions of US$)

	February 27, 2013	February 28, 2012
Assets		
Current Assets		
Cash and cash equivalents	$ 1,826	$ 498
Short-term investments	90	11
Receivables	2,020	1,868
Merchandise inventories	5,486	4,753
Other current assets	1,144	1,062
Total current assets	10,566	8,192
Property and Equipment		
Land and buildings	757	755
Leasehold improvements	2,154	2,013
Fixtures and equipment	4,447	4,060
Property under capital lease	95	112
	7,453	6,940
Less: Accumulated depreciation	(3,383)	(2,766)
Net property and equipment	4,070	4,174
Goodwill	2,452	2,203
Tradenames	159	173
Customer relationships	279	322
Equity and other investments	324	395
Other assets	452	367
Total assets	$18,302	$15,826
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable	$ 5,276	$ 4,997
Unredeemed gift card liabilities	463	479
Accrued compensation and related expenses	544	459
Accrued liabilities	1,681	1,382
Accrued income taxes	316	281
Short-term debt	663	783
Current portion of long-term debt	35	54
Total current liabilities	8,978	8,435
Long-term liabilities	1,256	1,109
Long-term debt	1,104	1,126
Total liabilities	11,338	10,670
Commitments and contingencies	—	—
Shareholders' Equity		
Preferred stock	—	—
Common stock	42	41
Additional paid-in capital	441	205
Retained Earnings	5,797	4,714
Accumulated other comprehensive income	40	(317)
Total Great Deal shareholders' equity	6,320	4,643
Noncontrolling interests	644	513
Total shareholders' equity	6,964	5,156
Total Liabilities and Shareholders' Equity	$18,302	$15,826

Balance Sheet

The **balance sheet**, also called the **statement of financial position**, provides information, at a point in time, on the firm's productive resources and the financing used to pay for those resources. **Exhibit 1.1** presents Great Deal's balance sheet as of February 27, 2013, and February 28, 2012. **Exhibit 1.5** presents Thames's balance sheet as of December 31, 2013, and December 31, 2012. These balance sheets present information at the end of each firm's fiscal year. Great Deal's annual report states that its fiscal year ends on February 27 or February 28 of each year; Thames states that its fiscal year ends on December 31. The financial position of

EXHIBIT 1.2

Great Deal, Inc.
Consolidated Statements of Earnings
(amounts in millions of US$)

	February 27, 2013	February 28, 2012	February 27, 2011
Revenue	$49,694	$45,015	$40,023
Cost of goods sold	37,534	34,017	30,477
Gross profit	12,160	10,998	9,546
Selling, general, and administrative expenses	9,873	8,984	7,385
Restructuring charges	52	78	0
Goodwill and trade name impairment	0	66	0
Operating income	2,235	1,870	2,161
Other income (expense)			
Investment income and other	54	35	129
Investment impairment	0	(111)	0
Interest expense	(94)	(94)	(62)
Earnings before income tax expense and equity in income (loss) of affiliates	2,195	1,700	2,228
Income tax expense	802	674	815
Equity in income (loss) of affiliates	1	7	(3)
Net earnings including noncontrolling interests	1,394	1,033	1,410
Net earnings attributable to noncontrolling interests	(77)	(30)	(3)
Net earnings attributable to Great Deal, Inc.	$ 1,317	$ 1,003	$ 1,407
Earnings per share attributable to Great Deal, Inc.			
Basic	$3.16	$2.43	$3.20
Diluted	$3.10	$2.39	$3.12
Weighted-average common shares outstanding (in millions)			
Basic	416.8	412.5	439.2
Diluted	427.5	422.9	452.9

the firm at other times during the year can differ substantially from that depicted on the end-of-year balance sheet.

Concepts of Assets, Liabilities, and Shareholders' Equity The balance sheet lists the firm's assets, liabilities, and shareholders' equity and provides totals and subtotals. Each line item on the balance sheet has a title that indicates the nature of the item and a numerical amount, in units of currency. For example, the first item on Great Deal's balance sheet is Cash and Cash Equivalents of $1,826 million. The heading of the balance sheet indicates the measuring unit is millions of U.S. dollars. The first item on Thames's balance sheet is Goodwill, net, measured in millions of euros (€); the amount is €2,986.9 million.

Assets are economic resources with the potential to provide future economic benefits to a firm. The firm's investments in items to provide productive capacity are examples of assets. For example, both Great Deal and Thames list property and equipment (Thames calls these "tangible assets, net") among the assets on their balance sheets.[11]

Liabilities are creditors' claims. Creditors have provided funds, or goods and services, and the firm has an obligation to pay creditors for those goods and services. We describe two examples of liabilities that result from a firm's having previously received benefits (inventories, labor services):

- Both Great Deal and Thames have made purchases but have not yet paid the entire amount owed. Great Deal includes the amount owed to its suppliers in the liability account labeled "Accounts payable." Thames includes the amount in the account "Accounts, notes and other current payables."

[11] The order in which the assets appear differs between Great Deal's and Thames's balance sheets. We discuss this ordering later in this chapter.