

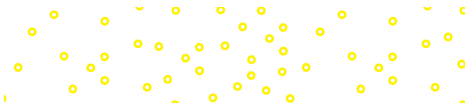


# FINANCIAL ACCOUNTING

Fifth Edition

J. David Spiceland | Wayne Thomas | Don Herrmann

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# Financial Accounting

FIFTH EDITION

**J. DAVID SPICELAND**

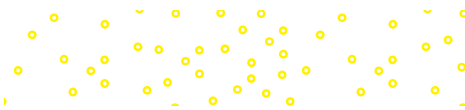
*University of Memphis*

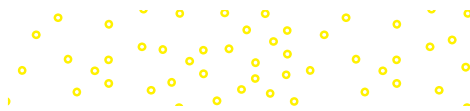
**WAYNE THOMAS**

*University of Oklahoma*

**DON HERRMANN**

*Oklahoma State University*





## Dedicated to

*David's wife Charlene, daughters Denise and Jessica, and three sons Mike, Michael, and David*

*Wayne's wife Julee, daughter Olivia, and three sons Jake, Eli, and Luke*

*Don's wife Mary, daughter Rachel, and three sons David, Nathan, and Micah*

*In addition, David and Wayne would like to dedicate the fifth edition of Financial Accounting to Don Herrmann, who lost his battle with brain cancer on May 8, 2018. Don was a true friend, and his lasting impact on us will never be forgotten.*



FINANCIAL ACCOUNTING, FIFTH EDITION

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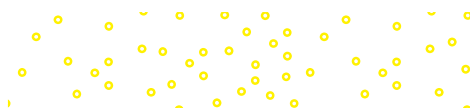
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# About the Authors

## DAVID SPICELAND



David Spiceland is Accounting Professor Emeritus at the University of Memphis. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*. David has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom. David is a co-author on McGraw-Hill's best-selling *Intermediate Accounting* text, with Mark Nelson and Wayne Thomas.

David enjoys playing basketball, is a former all-state line-backer, and is an avid fisherman. Cooking is a passion for David, who served as sous chef for Paula Deen at a Mid-South Fair cooking demonstration.

## WAYNE THOMAS



Wayne Thomas is the W. K. Newton Chair in Accounting at the University of Oklahoma, where he teaches introductory financial accounting and intermediate accounting. He received his bachelor's degree in accounting from Southwestern Oklahoma State University, and his master's and PhD

in accounting from Oklahoma State University.

Professor Thomas has won teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. Wayne is also a co-author on McGraw-Hill's best-selling *Intermediate Accounting*, with David Spiceland and Mark Nelson.

His primary research interests are in markets-based accounting research, financial disclosures, financial statement

analysis, and international accounting issues. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals including *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Review of Accounting Studies*, and *Contemporary Accounting Research*. He has won several research awards, including the American Accounting Association's Competitive Manuscript Award.

Wayne is married to Julee and they have four kids, Olivia, Jake, Eli, and Luke. He enjoys playing sports (basketball, tennis, golf, and ping pong), solving crossword puzzles, and spending time with his family.

## DON HERRMANN



Don Herrmann passed away on May 8, 2018, after a 14-month battle with brain cancer. He was the Deloitte Professor of Accounting at Oklahoma State University, where he had been on the faculty since 2005.

Don won several teaching awards and enjoyed teaching financial accounting, intermediate accounting, and doctoral students. He received his bachelor's degree in business from John Brown University, his master's degree in accounting from Kansas State University, and his PhD in accounting from Oklahoma State University. He was active in the AAA and served as president of the International Accounting Section.

Don was best known for his warm and welcoming personality. He enjoyed serving in his local community and church, as well as hosting families and students in his home. His outgoing nature wasn't the type that filled a room with his presence, but it was the type that filled a one-on-one conversation with purpose.

Above all else, family was first to Don. Some of his favorite family activities included camping, going to amusement parks, and coaching little league sports. He is survived by his wonderful wife Mary and four amazing children Rachel, David, Nathan, and Micah. As he battled through the different stages of cancer, he often reflected on his family. He was so proud of them and talked about them with a humble thankfulness.

Those of us who knew Don were fortunate to share our lives with him. He lived with a sense of purpose and a solid foundation. That foundation continues through his family and the people he's touched. He will be missed by many.

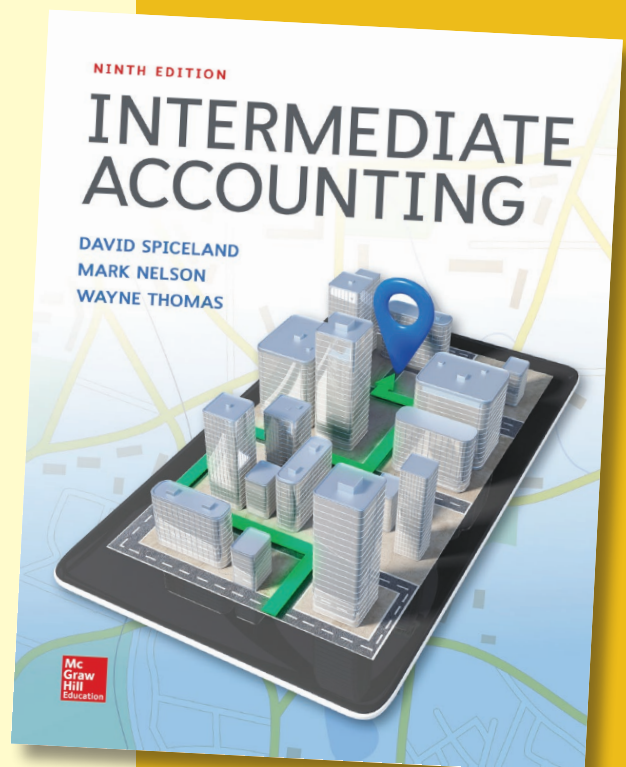
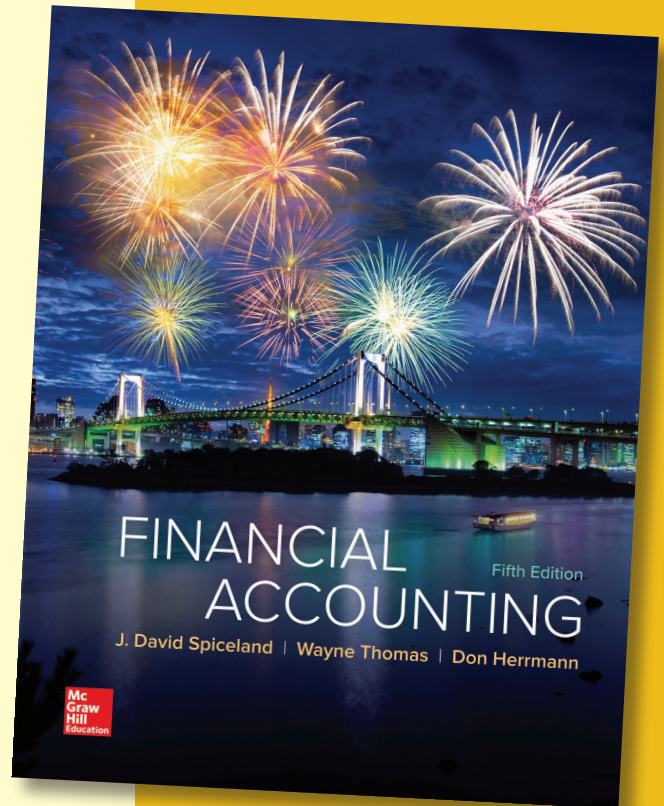


# CELEBRATING STUDENT SUCCESS

Don't you love those moments in your course when students are fully engaged? When the "Aha!" revelations are bursting like fireworks? David Spiceland, Wayne Thomas, and Don Herrmann have developed a unique set of materials based directly on their collective years in the classroom. They've brought together best practices like highlighting Common Mistakes, offering frequent Let's Review exercises, integrating the course with a running Continuing Problem, demonstrating the relevance of the course with real-world companies and decision analysis, and communicating it all in a student-friendly conversational writing style. After the proven success of the first four editions of *Financial Accounting*, we are confident that the fifth edition will not only motivate, engage, and challenge students—it will illuminate the financial accounting course like never before.

## Spiceland's Accounting Series

To allow *Financial Accounting* to be part of a complete learning system, authors David Spiceland and Wayne Thomas have teamed up with Mark Nelson to offer *Intermediate Accounting*. Now in its ninth edition, *Intermediate Accounting* uses the same approach that makes *Financial Accounting* a success—conversational writing style with a real-world focus, decision maker's perspective, innovative pedagogy, and author-prepared assignments and supplements. The Spiceland Accounting Series is fully integrated with McGraw-Hill's Connect, an educational platform that seamlessly joins Spiceland's superior content with enhanced digital tools to deliver precisely what a student needs, when and how they need it.



# EDUCATION IS CHANGING . . .

At McGraw-Hill, the Spiceland: *Financial Accounting* authors recognize that teaching is **part art and part science**.

**The Art:** The Spiceland team’s teaching experience in large lecture halls, flipped classrooms, and online courses, along with their interactions with thousands of faculty members, students, and business owners who have shared their insights, leads them to continually improve their content, incorporating successful teaching and learning strategies.

While financial accounting will always be important to successful business management, the ways in which students learn and are motivated continue to evolve.

**The Science:** The authors’ insight into the student experience are complemented by information gleaned from millions of student interactions in Connect. By analyzing consumption and heat map data from SmartBook and Connect, the authors are able to see where students are struggling, refine their content, and provide additional focus in these areas.

*By applying the science of what works and integrating the art of teaching, the Spiceland Financial Accounting authors continue to build on the text’s successful approach.*

The image shows a tablet displaying a lesson titled "Module 18 The Foundations of Memory" from McGraw-Hill Connect. The tablet screen shows text about memory processes, with a circular callout highlighting performance data: "PERCENTAGE CORRECT ANSWERS 58%", "AVERAGE RESPONSE TIME 0:51", and "NUMBER OF ANSWERS 63559". The text on the tablet includes "Memory specialists speak", "material is not stored adequately", "Memory also depends on", and "inability to retrieve". A small box at the bottom of the tablet screen says "Encoding (Initial recording of information)".

**Informed By Data**

- 1 Anonymous user data is collected through our adaptive platforms
- 2 Data is analyzed and performance patterns are identified
- 3 Content is informed and updated based on findings



# SO ARE WE.

## CREATING FUTURE BUSINESS LEADERS

From the first edition of *Financial Accounting*, the authors have been talking with standard setters, auditors, and business leaders across the country to ensure their materials are consistent with what's being practiced in the business world. For example, in the fifth edition, we now cover installment notes early in the chapter on long-term liabilities based on feedback that loans with monthly principle and interest payments are very common in the business world. Coverage of installment notes is also practical for students who may be considering a car loan or a home loan in the not so distant future.

The authors believe that the foundation students get in the first financial accounting course is paramount to their business success. In keeping with feedback from business leaders and instructors, the authors have focused their approach on four key areas:

- **Building Student Interest**
- **Helping Students Become Better Problem Solvers**
- **Fostering Decision-Making and Analysis Skills**
- **Using Technology to Enhance Learning**

The result? Better-prepared students who have greater potential to take on leadership roles when they graduate and enter the business world.

### **Building Student Interest**

The first step in student engagement is real-world relevance. The authors of *Financial Accounting* expose students to interesting, real-world examples that are applicable to their lives and future careers. They also ensure engagement through an accessible tone: crafting their narrative in an approachable, conversational style.

### **Helping Students Become Better Problem Solvers**

Students with a strong foundation in problem-solving skills are better equipped to interpret and analyze how financial information affects businesses. The authors have carefully organized a scaffolded set of problem-solving features, starting with the in-chapter **Let's Review** problems. These supported practice problems encourage students to check their understanding, prepare them to successfully complete the assigned end-of-chapter material, and are complemented by videos that help students review. The **Common Mistakes** feature is a student favorite, helping them avoid mistakes that regularly trip up both learners and professionals. Finally, **General Ledger Problems** allow students to see the big picture of how information flows through the accounting cycle—letting them problem solve as businesspeople would, by analyzing the effect of transactions on the financial statements.

### **Fostering Decision-Making and Analysis Skills**

Companies today cite decision-making and analysis skills as top desired skills among recent graduates. Students are given opportunities to explore real business decision-making practices in each chapter—**Decision Maker's Perspectives** and **Decision Points**—and employ decision making in their homework assignments using materials like the **Great Adventures** continuing case and the Analysis portion of most **General Ledger Problems**. New for the 5th edition, the Financial Analysis, Ethics, and Earnings Management cases are all auto-gradable in Connect—allowing students additional decision-making practice *and* ease of grading.

### **Using Technology to Enhance Learning**

Today's students live online and seek out videos to aid their learning—make sure they get quality material! Spiceland: *Financial Accounting* reinforces students' conceptual understanding with elements like SmartBook and videos such as **Let's Review**, **Interactive Illustrations**, **new Concept Overview Videos** and **new Applying Excel videos**. End-of-chapter exercises are supplemented with **Hints/Guided Example videos**.



# NEW IN THE FIFTH EDITION

We've incorporated an enormous amount of feedback from over 700 reviewers, focus group, and symposium participants. The list of changes and improvements on the next few pages is testament to the many hours that reviewers spent thinking about and analyzing our earlier editions, helping us to make *Financial Accounting* the **best book of its kind**.

## Overall Updates in the Fifth Edition

- **Updated content to reflect latest FASB pronouncements** including terminology related to changes in Revenue Recognition, Inventory, Goodwill, Investments, and Leases.
- **Feature stories, real-world examples, and ratio analyses** were updated to include the most recent year of company data available.
- **Financial Analysis Cases** for American Eagle and Buckle are assignable and gradable in Connect for each chapter.
- **Ethics Cases** are assignable and gradable in Connect for each chapter.
- **Earnings Management Cases** are assignable and gradable in Connect for each chapter.
- **Chapter Highlights** illustrations have been added to the end of chapters to give students a succinct overview of the chapter's primary topics.
- **Applying Excel** problems added to all 12 chapters.
- **Self-Study Questions** were revised to include 15 per chapter.
- **Continuing Problem** for Great Adventures adds content from each successive chapter to build a comprehensive set of financial statements.
- **Revised illustrations** in the new edition to continue to offer clear and visual learning tools for students.
- **Added content and new illustrations in Chapters 1–3** to build students' understanding of the framework of financial accounting and the accounting cycle activities during the year versus the end of the year.
- **Usage data** from SmartBook and Connect were used in developing changes to the 5th Edition.

## CHAPTER 1

- Expanded discussion of the definition and meaning of retained earnings.
- Added discussion of the statement of retained earnings.
- Updated **AP1–2**, **AP1–3**, and **AP1–4** for American Eagle and The Buckle's most recent financial information.

## CHAPTER 2

- Added brief discussion of the role of aggregation in calculating account balances to more efficiently communicate measurements to users of financial statements.
- Updated **AP2–2**, **AP2–3**, and **AP2–4** for American Eagle and The Buckle's most recent financial information.

## CHAPTER 3

- Streamlined the discussion of accrual-basis accounting versus cash-basis accounting.
- Added discussion of the asset/liability approach for revenue and expense recognition.
- Revised the discussion of the primary description of the four types of adjusting entries.
- Added **Illustrations 3–4A** and **3–4B**.
- Revised **Illustration 3–11** to illustrate the link between the adjusted trial balance and financial statements.

- Expanded discussion of the income statement and its components.
- Created new **P3–4A** and **P3–4B**.
- Updated **AP3–2**, **AP3–3**, and **AP3–4** for American Eagle and Buckle's most recent financial information.

## CHAPTER 4

- Added new **Illustration 4–5** to demonstrate separation of duties.
- Linked **Illustrations 4–8** and **4–9** to better demonstrate the need for a bank reconciliation.
- Added more illustrations comparing the bank statement to the company's cash records.
- Accounting for employee purchases are separated into credit card transactions and petty cash transactions.
- Revised Cash Analysis section to focus on the link between cash reporting in the balance sheet and statement of cash flows.
- Updated **AP4–2**, **AP4–3**, and **AP4–4** for American Eagle and Buckle's most recent financial information.

## CHAPTER 5

- Added basic journal entry for cash received on account in Part A.
- Revised example of transactions affecting net revenues.
- Added discussion and illustration of sales returns and the effect on net revenues.

- Eliminated the term net realizable value when referring to net accounts receivable.
- Revised discussion of the allowance method to first discuss establishing the allowance account.
- Moved the aging of accounts receivable method to follow writing off bad debts.
- Expanded discussion on the interpretation of the receivables turnover ratio.
- Added **Exercise 5–22** as additional General Ledger problem.
- Converted **AP5–1 Great Adventures** to be used as a General Ledger problem.
- Updated **AP5–2**, **AP5–3**, and **AP5–4** for American Eagle and Buckle's most recent financial information.

## CHAPTER 6

- Rearranged introduction to first talk about manufacturing companies and then merchandising companies.
- Revised LIFO discussion and illustration to make clear that in practice LIFO is calculated only as a year-end adjusting entry (periodic method).
- Added Kroger's balance sheet in **Illustration 6–11** to better demonstrate FIFO versus LIFO for a real-world company.
- Added discussion and illustration of the effects of inventory errors on net income and retained earnings.
- Converted **AP6–1 Great Adventures** to be used as a General Ledger problem.

- Updated **AP6-2**, **AP6-3**, and **AP6-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 7

- Added some discussion of the financial statement impact of incorrectly capitalizing rather than expensing a material expenditure.
- Revised discussion of estimates used in determining depreciation in each year.
- Clarified discussion of gain and loss on sale of assets.
- Added **Decision Maker's Perspective** on understanding gains and losses.
- Added discussion to the Analysis section of the impact on financial ratios of estimating residual values and service lives.
- Updated discussion of impairment for intangible assets with indefinite useful lives based on ASU No. 2017-04.
- Added five new **Brief Exercises**.
- Converted **AP7-1 Great Adventures** to be used as a General Ledger problem.
- Updated **AP7-2**, **AP7-3**, and **AP7-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 8

- Modified discussion and example of warranty liability.
- Added small discussion and assignment material for gift card breakage.
- Revised discussion of accounting for warranties.
- Add two **Brief Exercises** and two **Exercises**.

- Converted **AP8-1 Great Adventures** to be used as a General Ledger problem.
- Updated **AP8-2**, **AP8-3**, and **AP8-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 9

- Added discussion of reclassifying the current portion of a long-term installment note as a current liability.
- Revise discussion of leases to include advantages over installment notes.
- Revised discussion of leases for ASU 2016-02.
- Added journal entry to record a lease.
- Revised Part B and Part C so that instructors can easily choose whether to cover bonds with or without having to calculate the issue price.
- Added three new **Brief Exercises**, three new **Exercises**, and two new **Problems** for installment notes and leases.
- Converted **AP9-1 Great Adventures** to be used as a General Ledger problem.
- Updated **AP9-2**, **AP9-3**, and **AP9-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 10

- Added new **Feature Story**.
- Revised **Illustrations 10-3** and **10-6**.
- Revised discussion of preferred stock to clarify its distinguishing features.
- Converted **AP10-1 Great Adventures** to be used as a General Ledger problem.
- Updated **AP10-2**, **AP10-3**, and **AP10-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 11

- Separated investing activities and financing activities into separate Learning Objectives.
- Revised **Illustration 11-4** to show relationship between income statement and operating cash flows.
- Added **Illustration 11-27** to convert income statement items to their operating cash flows.
- Added five new **Brief Exercises** and five new **Exercises**.
- Updated **AP11-2**, **AP11-3**, and **AP11-4** for American Eagle and Buckle's most recent financial information.

#### CHAPTER 12

- Revised discussion of discontinued operations and other revenues and expenses.
- All ratios for Nike and Under Armour updated to include the most recent year of company data available.
- Updated **AP12-2**, **AP12-3**, and **AP12-4** for American Eagle and Buckle's most recent financial information.

#### APPENDIX D

- Updated for ASU 2016-01 which eliminates available-for-sale classification for equity investments.
- Revised discussion of equity securities to follow four critical events.
- Revised discussion of debt securities to follow four critical events.
- Added discussion to explain the effect of interest rate on the fair value of debt investments.

# BUILDING STUDENT INTEREST

With a wide variety of students enrolled in the financial accounting course, getting them interested in the content and making it enjoyable to learn can be challenging. Spiceland: *Financial Accounting* achieves this by using relevant examples and context that relate well to students, making the content both approachable and easy to digest.

Part of the unique art in how the authors of Spiceland: *Financial Accounting* approach the material is through their signature **Conversational Writing Style**. The authors took special care to write chapters that foster a friendly dialogue between the text and each individual student. The tone of the presentation is intentionally conversational—creating the impression of *speaking with the student*, as opposed to *teaching to the student*. This conversational writing style has been a proven success with Spiceland's *Intermediate Accounting* (now in its ninth edition), and that same approach has led to the success of Spiceland: *Financial Accounting*.

The **conversational writing style** is of tremendous benefit. . . addressing students directly is engaging.

—Bruce Runyan, *University of North Texas*

Layered in with the conversational tone, the authors' infuse relevant examples from real companies throughout each chapter's content, resulting in compelling material that increases student engagement.

First talking about the theory then applying the theory to a company **helps students visualize and understand the concept**.

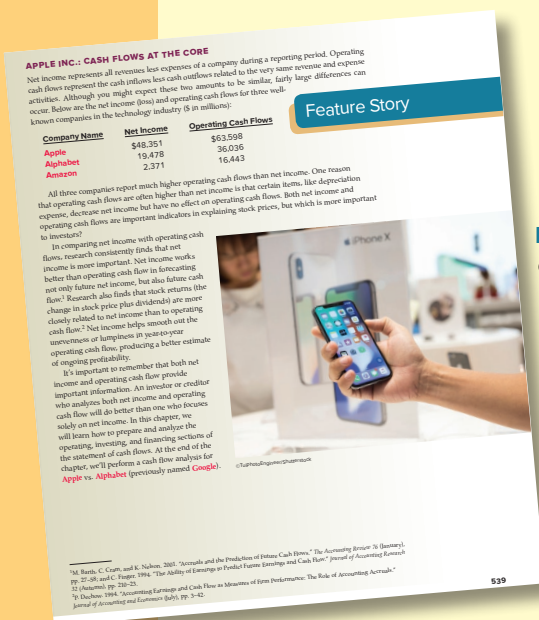
—Mindy Wolfe, *Arizona State University*

**Real-World Focus** Students retain more information when they see how concepts are applied in the real world. Each chapter begins with a **Feature Story** that involves real companies and offers business insights related to the material in the chapter. As the chapter's topics are being presented, references to the companies in the Feature Story and other related companies help keep topics relevant. The authors understand that students are engaged best when the discussion involves companies that students find interesting and whose products or services are familiar, such as **Apple, American Eagle Outfitters, Best Buy, Six Flags, Regal Entertainment, and Google**. In **Chapter 12**, full financial statement analysis is provided for **Nike versus Under Armour**.

The authors carry these real-world companies into the end-of-chapter material, asking students to analyze real-world situations.

Most importantly, it **offers opportunities for students to have insights into accounting careers** via Career Corners.

—Chuo-Hsuan Lee, *SUNY-Plattsburgh*



To help students be forward-thinking about their careers, discussions are included to bring the business world front and center. **Career Corner** boxes highlight how particular accounting topics relate to different business careers—allowing both accounting *nonmajors* and *majors* to see how accounting is relevant in their future career options.

# HELPING STUDENTS BECOME BETTER PROBLEM SOLVERS

**Building a Framework** In honing analytical skills and becoming good problem solvers, it's crucial that students have the right tools and build the right framework to help them along the way—especially when learning the accounting cycle. The **accounting cycle chapters** clearly distinguish activities During the Period (Chapter 2) versus End of the Period (Chapter 3). Chapters 4–10 cover specific topics in **balance sheet order**. Throughout the chapters, several features keep students on the right track as they learn the accounting process.

**New! Chapter Highlights** illustrations have been added to the end of chapters, providing students a flowchart visual through which they can see how the chapter's primary topics fit into the measurement/communication framework of financial accounting.

I like the Let's Review scenarios and use them as a learning tool. I also like the Let's Review videos as some **students are visual and this helps**. —Stephane Bacik,  
*Wake Technical Community College*

**Let's Review** sections within each chapter test students' comprehension of key concepts. These short review exercises, with solutions, are intended to reinforce understanding of specific chapter material and allow students to apply concepts and procedures learned in the chapter prior to attempting their homework assignment. Each Let's Review exercise also contains **Suggested Homework**, which enables instructors to easily assign corresponding homework. For the fifth edition, 22 **Let's Review Videos** show students how to solve the exercise and model that approach for related homework.

**Key Points** provide quick synopses of the critical pieces of information presented throughout each chapter.



#### KEY POINT

The revenue recognition principle states that revenue is recognized in the period in which goods and services are provided to customers, not necessarily in the period in which we receive cash.

**Common Mistakes** made by students and professionals are highlighted throughout each of the chapters. With greater awareness of the potential pitfalls, students can avoid making the same mistakes and gain a deeper understanding of the chapter material.



#### COMMON MISTAKE

Dividends represent the payment of cash but are not considered an expense in running the business. Students sometimes mistakenly include the amount of dividends as an expense in the income statement, rather than as a distribution of net income in the statement of stockholders' equity.

The **Flip Side** feature demonstrates how various transactions are viewed by each side. Including the “flip side” of a transaction—in context—enhances students' understanding of both the initial and the related transaction. Selected homework materials also include the Flip Side transactions, to reinforce student understanding.

The “Flip Side” and “Common Mistakes” sections are outstanding and are **likely to be among the favorite parts of the content** for students.

— Christian Wurst, *Temple University*

# FOSTERING DECISION-MAKING & ANALYSIS SKILLS

In today's environment, business graduates are to be equipped in analyzing data and making decisions. To address this need, each chapter includes **Decision Maker's Perspective** sections, which offer insights into how the information discussed in the chapters affects decisions made by investors, creditors, managers, and others. Each chapter also contains **Decision Points** highlighting specific decisions in the chapter that can be made using financial accounting information.

**Analysis** sections are offered at the end of topical chapters (4–11). These sections analyze the ratios of two real companies related to that chapter's theme. Students are able to see how companies' different business strategies affect their financial ratios. The **Financial Statement Analysis** chapter (12) allows students to take a deep dive into these concepts by analyzing the financial statements of Nike and Under Armour.

**General Ledger Problems** in Connect not only help students see how journal entries flow through to financial statements, but also ask students to demonstrate their understanding of Ratio Analysis. **NEW** for the 5th edition, General Ledger problems extend to chapters throughout the text.

The **Additional Perspectives** section of each chapter offers cases and activities that ask students to apply the knowledge and skills they've learned to real, realistic, or provocative situations. Students are placed in the role of decision maker, presented with a set of information, and asked to draw conclusions that test their understanding of the issues discussed in the chapters. Each chapter offers an engaging mix of activities and opportunities to perform real-world financial accounting analysis, conduct Internet research, understand earnings management, address ethical dilemmas, and practice written communication. **NEW** to the 5th edition, Ethics, Earnings Management, and Financial Analysis cases from the section are auto-gradable in Connect.

The **Great Adventures Continuing Problem** progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. These problems allow students to see how each chapter's topics can be integrated into the operations of a single company. Great Adventures problems are also available in McGraw-Hill Connect's General Ledger format.

**Financial Analysis: American Eagle Outfitters, Inc. & The Buckle, Inc.** ask students to gather information from the annual report of American Eagle in Appendix A and Buckle in Appendix B. **Comparative Analysis**—In addition to separately analyzing the financial information of American Eagle and Buckle, students are asked to compare financial information between the two companies. **NEW** for the 5th edition, these questions will be auto-gradable in Connect!

## Decision Maker's Perspective

### Investors Understand One-Time Gains

Investors typically take a close look at the components of a company's profits. For example, **Ford Motor Company** announced that it had earned a net income for the fourth quarter (the final three months of the year) of \$13.6 billion. Analysts had expected Ford to earn only \$1.7 to \$2.0 billion for that period. The day that Ford announced this earnings news, its stock price *fell* about 4.5%.

Why would Ford's stock price fall on a day when the company reported these seemingly high profits? A closer inspection of Ford's income statement shows that it included a one-time gain of \$12.4 billion for the fourth quarter. After subtracting this one-time gain, Ford actually earned only about \$1.2 billion from normal operations, easily missing analysts' expectations. This disappointing earnings performance is the reason the company's stock price fell.

**E3-21** On January 1, 2021, the general ledger of Dynamite Fireworks includes the following account balances:

Accounts	Debit	Credit
Cash	\$23,800	
Accounts Receivable	5,200	
Supplies	3,100	
Land	50,000	
Accounts Payable		\$ 3,200
Common Stock		65,000
Retained Earnings		13,900
Totals	<u>\$82,100</u>	<u>\$82,100</u>

During January 2021, the following transactions occur:

January 2	Purchase rental space for one year in advance, \$6,000 (\$500/month).
January 9	Purchase additional supplies on account, \$3,500
January 13	Provide services to customers on account, \$25,500.
January 17	Receive cash in advance from customers for services to be provided in the future.

Complete the accounting cycle LO3-3, 3-4, 3-5, 3-6



# USING TECHNOLOGY TO ENHANCE LEARNING

**Connect** and Spiceland's *Financial Accounting* are tightly integrated to continue honing students' conceptual understanding, problem-solving, decision-making & analysis skills.



All end-of-chapter items in the textbook that can be built into Connect have been included with feedback and explanations and many with **Hints/Guided Examples** to help students work through their homework in an effective manner.

This text is very well written and offers a set of end-of-chapter problems that **progressively challenges students** and directs them to **build problem-solving skills**. —Gregg S. Woodruff, *Western Illinois University*

## ASSESSMENT & PRACTICE: END-OF-CHAPTER AND TEST BANK

### Algorithmic Content & End-of-Chapter assignments

New algorithmic problems have been added, allowing students more practice and you more opportunities for students to demonstrate their understanding.

Extensive end-of-chapter assignments are available in the text and Connect:

- Brief Exercises
- Exercises (A & B set)
- Problems (A & B set)
- Great Adventures Continuing Problem
- Real-world financial analysis cases
- Ethics cases
- Earnings management cases

### TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. TestGen's random generator provides the option to display different text or calculated number values each time questions are used. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

### SmartBook

Available within Connect, **SmartBook** makes study time as productive and efficient as possible. SmartBook identifies and closes knowledge gaps through a continually adapting reading experience that provides personalized learning resources at the precise moment of need. This ensures that every minute spent with SmartBook is returned to the student as the most value-added minute possible. The result? More confidence, better grades, and greater success.

## NEW! CONNECT TOOLS

### Concept Overview Videos

New Concept Overview Videos provide engaging narratives of all chapter learning objectives in an assignable, interactive online format. These videos follow the structure of the text and match specific learning objectives within each chapter of *Financial Accounting*. Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice at their own pace. New assignable assessment questions paired with the videos help students test their knowledge, ensuring that they are retaining concepts.

### APPLYING EXCEL

New Applying Excel features in each chapter help build students' Excel skills, showing them how Excel can be used to make efficient calculations and analysis. Applying Excel video solutions housed in Connect complement the feature, allowing students to view the power of Excel to analyze business scenarios.

### SKILL-BUILDING TOOLS: CRITICAL THINKING AND BEYOND

#### General Ledger Problems

Expanded general ledger problems provide a much-improved student experience when working with accounting cycle questions with improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and are able to see how the numbers flow through the various financial statements. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

Account Title	Debit	Credit
Cash	223,000	5,100
Accounts receivable		
Allowance for uncollectible accounts	12,000	
Note receivable	4,200	
Interest receivable	155,000	
Inventory	19,500	
Land		300
Equipment		60,200
Accumulated depreciation		32,600
Accounts payable		9,000
Salaries payable		220,000
Income tax payable		50,000
Common stock		220,000
Retained earnings		50
Sales revenue	115,000	
Interest revenue	300	
Cost of goods sold	62,400	
Depreciation expense	16,500	
Salaries expense	5,000	
Utilities expense	9,000	
Bad debt expense		
Income tax expense		
Total	628,200	628,200

Enter your answer as a whole number (i.e. 5% should be entered as 5, not .05).

Dates: Dec 31 to: Jan 31

Analyze how well TNT Fireworks manages its assets.

(a) Calculate the return on assets ratio for the month of January. If the average return on assets for the industry in January is 2%, is the company more or less profitable than other companies in the same industry?

The return on assets ratio is:  %

The company is more profitable. (True or False)  True

(b) Calculate the profit margin for the month of January. If the industry average profit margin is 4%, is the company more or less efficient at converting sales to profit than other companies in the same industry?

The profit margin is:  %

The company is more efficient at converting sales to profit. (True or False)  True

(c) Calculate the asset turnover ratio for the month of January. If the industry average asset turnover is 0.5 times per month, is the company more or less efficient at producing revenues with its assets than other companies in the same industry?

The asset turnover ratio is:  times

The company is more efficient at producing revenues with its assets. (True or False)  True

#### Excel Simulations

Excel simulation questions, assignable within Connect, allow students to practice their Excel skills—such as basic formulas and formatting—within the context of financial accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled), as well as automatic feedback and grading.

### JUST-IN-TIME RESOURCES: VIDEOS AND MORE

#### Hints/Guided Examples

Hint/Guided Example videos are narrated, animated, and step-by-step walkthroughs of algorithmic versions of assigned exercises in Connect. Presented to the student as hints, Guided Examples provide just-in-time remediation—and help—students get immediate feedback, focused on the areas where they need the most guidance.

#### Interactive Illustrations

Interactive Illustrations provide video-based explanations of key illustrations in each chapter. These videos walk students step-by-step through the illustration, deepening students' understanding of the concepts or the calculations shown.

#### Let's Review Videos

Let's Review videos relate to the Let's Review sections in each chapter, showing students how to solve certain exercises. In walking students through a particular scenario or question, these videos model how students can approach problem solving.



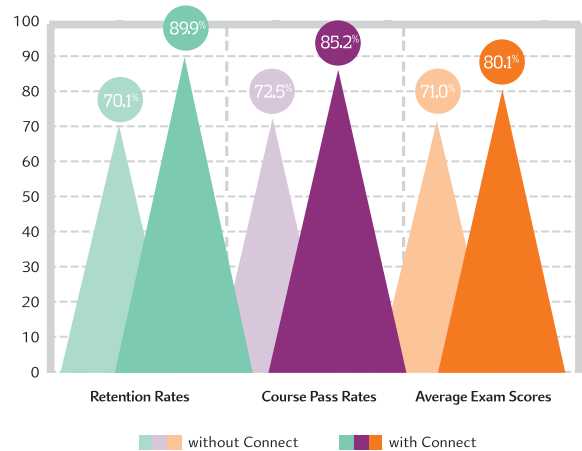
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McGraw-Hill Connect® is a highly reliable, easy-to-use homework and learning management solution that utilizes learning science and award-winning adaptive tools to improve student results.

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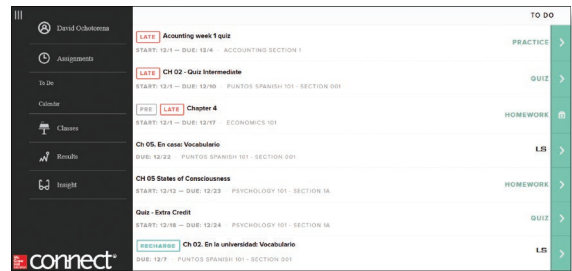


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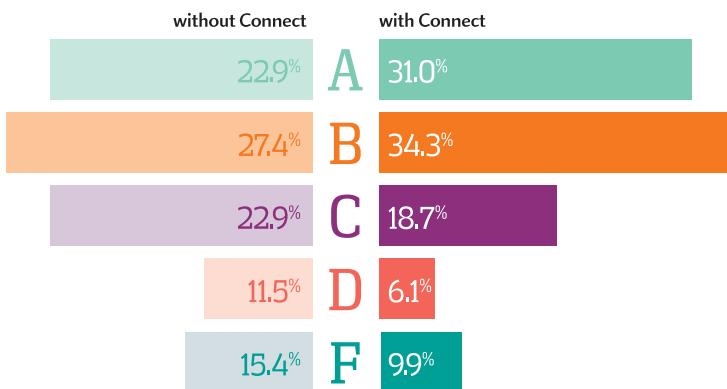
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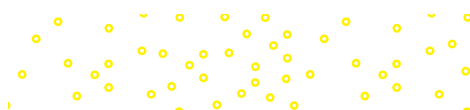


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# A HEARTFELT THANKS TO THE MANY VOICES . . .

The version of *Financial Accounting* you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and selective use of pedagogy. We are grateful to them for taking the time to read each chapter and offer their insights.

We also acknowledge those reviewers who helped in the genesis of this text with the first and second edition reviews—we appreciate your efforts to this day!

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## ... WHO SHAPED THIS BOOK

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### SUPPLEMENTS WITH THE SAME VOICE

Last but not least, we thank the authors of *Financial Accounting*, who write all of the major **supplements**, including the Solutions Manual, Instructor's Manual, all end-of-chapter material, additional online Exercises, and the Test Bank. The test bank includes over 3,000 questions, including more than 1,900 multiple-choice questions and more than 1,125 other types of questions and problems. The authors actively engage in the development of ALL technology-related supplements, such as SmartBook, end-of-chapter Questions, including our new General Ledger Problems, Interactive Illustrations, Let's Review Problems, Auto-Graded Excel Simulations and PowerPoints.



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# A Framework for Financial Accounting

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## Learning Objectives

### **PART A: ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS**

- **LO1-1** Describe the two primary functions of financial accounting.
- **LO1-2** Understand the business activities that financial accounting measures.
- **LO1-3** Determine how financial accounting information is communicated through financial statements.
- **LO1-4** Describe the role that financial accounting plays in the decision-making process.

### **PART B: FINANCIAL ACCOUNTING INFORMATION**

- **LO1-5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

### **PART C: CAREERS IN ACCOUNTING**

- **LO1-6** Identify career opportunities in accounting.

### **Appendix**

- **LO1-7** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

### **SELF-STUDY MATERIALS**

- Let's Review—Measuring business activities (p. 8).
- Let's Review—Communicating through financial statements (p. 17).
- Chapter Highlights (p. 31).
- Key Points by Learning Objective (p. 32).
- Glossary of Key Terms (p. 33).
- Self-Study Questions with answers available (p. 34).
- Applying Excel videos to demonstrate key topics (p. 35).
- Videos for Let's Review and certain illustrations.

## BERKSHIRE HATHAWAY: SPEAKING THE LANGUAGE OF BUSINESS

*“You have to understand accounting and you have to understand the nuances of accounting. It’s the language of business and it’s an imperfect language, but unless you are willing to put in the effort to learn accounting—how to read and interpret financial statements—you really shouldn’t select stocks yourself.” —Warren Buffett*

Warren Buffett is the chairman and CEO of **Berkshire Hathaway**, a holding company that invests billions of dollars in other companies. In 1965, Warren Buffett acquired control of Berkshire Hathaway, and the company’s stock has returned an amazing 1,972,595% over the 53-year period from 1965–2017. That means anyone investing \$1,000 in Berkshire Hathaway’s stock in 1965 would have watched their investment grow to nearly \$20,000,000 by the end of 2017. Buffett’s personal net worth has grown to more than \$74 billion, making him one of the richest people in the world according to *Forbes* magazine.

Some of Buffett’s more famous investments have included companies such as Coca-Cola, Dairy Queen, American Express, Gillette, GEICO, and Heinz. How did he decide which stocks to purchase? Over ten thousand company stocks are available in the United States and thousands more on stock exchanges around the world. How did he separate the successful companies from the unsuccessful ones?

Buffett explains that the key to identifying good stocks is to look for companies having a durable competitive advantage. In other words, look for companies that are expected to produce *profits* for a long time because they have achieved a sustainable advantage over their rivals. How do you do this? There are, of course, many factors to consider, but Buffett explains that the primary source of this information comes from analyzing companies’ financial accounting information—the subject of this book.

As you read through the chapters, you’ll begin to understand the purpose of financial accounting to measure the business transactions of a company and then to communicate those measurements to investors, like Warren Buffett, in formal accounting reports called *financial statements*. It is from these financial statements that investors base their decisions on buying and selling a company’s stock.

## Feature Story



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## PART A

## ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

Welcome to accounting. A common misconception about this course is that it is a math class, much like college algebra, calculus, or business statistics. You will soon see that this is *not* a math class. Don't say to yourself, "I'm not good at math so I probably won't be good at accounting." Though it's true that we use numbers heavily throughout each chapter, accounting is far more than adding, subtracting, and solving for unknown variables. So, what exactly is accounting? We'll take a close look at this next.

### Defining Accounting

#### LO1-1

Describe the two primary functions of financial accounting.

**Accounting is "the language of business."** It's the language companies use to tell their financial story. More precisely, **accounting** is a system of maintaining records of a company's operations and communicating that information to decision makers. The earliest use of such systematic recordkeeping dates back thousands of years to when records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.<sup>1</sup> In this book, you'll learn how to read, interpret, and communicate a company's financial story using the language of business.

Millions of people every day must make informed decisions about companies. Illustration 1-1 identifies some of those people and examples of decisions they make about the companies.

#### ILLUSTRATION 1-1

Decisions People Make About Companies



1. **Investors** decide whether to invest in stock.
2. **Creditors** decide whether to lend money.
3. **Customers** decide whether to purchase products.
4. **Suppliers** decide the customer's ability to pay for supplies.
5. **Managers** decide production and expansion.
6. **Employees** decide employment opportunities.
7. **Competitors** decide market share and profitability.
8. **Regulators** decide on social welfare.
9. **Tax authorities** decide on taxation policies.
10. **Local communities** decide on environmental issues.

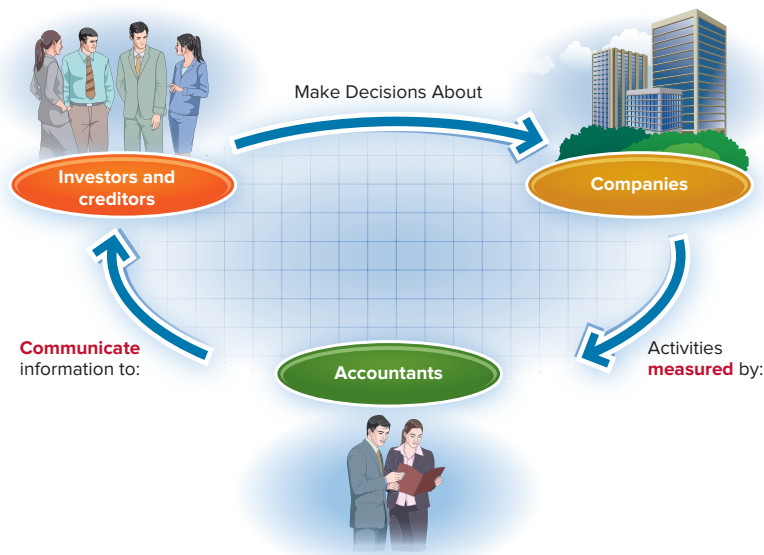
To make the decisions outlined in Illustration 1-1, these people need information. This is where accounting plays a key role. As Illustration 1-2 shows, accountants **measure the activities of the company and communicate those measurements to others**.

Accounting information that is provided for *internal* users (managers) is referred to as **managerial accounting**; that provided to *external* users is referred to as **financial accounting**. In this book, we focus on financial accounting. Formally defined, the two functions of **financial accounting** are to measure business activities of a company and then to communicate those measurements to *external* parties for decision-making purposes.

As you study the business activities discussed in this book, it is important for you to keep in mind this "framework" for financial accounting. For each activity, ask yourself

1. How is the business activity being measured?
2. How is the business activity being communicated?

<sup>1</sup>S. Basu and G. Waymire. 2006. Recordkeeping and Human Evolution. *Accounting Horizons* 20 (3): 201-229.



**ILLUSTRATION 1-2**  
Framework for  
Financial Accounting



[mhhe.com/4fa1](http://mhhe.com/4fa1)

These are the two functions of financial accounting. You'll better understand *why* this process exists by thinking about *how* the measurements being communicated help people make better decisions.

For example, **investors** want to make good decisions related to buying and selling their shares of the company's stock: Will the company's stock increase or decrease in value? The value of a stock is directly tied to the company's ability to make a profit, so what activities reflect the company's profitability? How should those activities be measured, and how should they be communicated in formal accounting reports?

As another example, **creditors** make decisions related to lending money to the company: Will the company be able to repay its debt and interest when they come due? How can debt activity be measured and how can it be communicated so that creditors better understand the ability of the company to have sufficient cash to repay debt and interest in the short term and the long term?



#### KEY POINT

The functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

*User's Guide* For learning objectives throughout this book, you will see boxed sections, like this one, titled *Key Point*. These boxed items will highlight the central focus of the learning objectives.

## Measuring Business Activities

Let's first look at the typical activities of a start-up business. We'll do this with a simple example. Suppose you want to start a soccer academy. The "goal" of the academy is to provide lessons to develop junior players for top university programs and perhaps even one day to play in a professional league. Let's look at some initial activities of your new company, which you've decided to name **Eagle Soccer Academy**.

Let's assume you need about \$35,000 to get the business up and running. You don't have that amount of money to start the business, so you begin by looking for investors. With their money, **investors** buy ownership in the company and have the right to share in the company's profits. Each share of ownership is typically referred to as a share of common stock. For your company, let's say you sell 1,000 shares of common stock for \$25 each, receiving cash of \$25,000 from investors. The 1,000 shares include 300 sold to your grandparents for

#### LO1-2

Understand the business activities that financial accounting measures.