Brief Contents

Part 1	An Overview of Financial Accounting 1 1 Financial Accounting and Its Economic Context 2 2 The Financial Statements 33
Part 2	Measurement, Mechanics, and Use of Financial Statements The Measurement Fundamentals of Financial Accounting The Mechanics of Financial Accounting Using Financial Statement Information 176
Part 3	Assets: A Closer Look 241 6 The Current Asset Classification, Cash, and Accounts Receivable 242 7 Merchandise Inventory 290 8 Investments in Equity Securities 332 9 Long-Lived Assets 384
Part 4	Liabilities and Shareholders' Equity: A Closer Look 435 10 Introduction to Liabilities: Economic Consequences, Current Liabilities, and Contingencies 436 11 Long-Term Liabilities: Notes, Bonds, and Leases 484 12 Shareholders' Equity 539
Part 5	Income and Cash Flows 595 13 The Complete Income Statement 596 14 The Statement of Cash Flows 639
Appendices	A The Time Value of Money 696 B Quality of Earnings Cases: A Comprehensive Review 721 C NIKE-SEC Form 10-K Selected Pages 754 Glossary 784 Subject Index 812 Company Index 824

Contents

PART 1: AN OVERVIEW OF FINANCIAL ACCOUNTING 1

1 FINANCIAL ACCOUNTING AND ITS ECONOMIC CONTEXT 2

Financial Reporting and Investment Decisions 3

Economic Consequences 4 User Orientation 4

The Demand for Financial Information: A User's Orientation 5

Consumption and Investment 5 Where to Invest? 5 The Demand for Documentation 6 The Demand for an Independent Audit 6 Martin and the CPA: Different Incentives 6 The Auditor's Report, the Management Letter, and the Financial Statements 7 Descriptions of Financial Statements 11 Analysis of Financial Statements 12 What Form of Investment: Debt or Equity? 12 A Decision Is Made, but Important Questions Still Remain 14

The Economic Environment in which Financial Reports Are Prepared and Used 14 Reporting Entities and Industries 16

Corporate Governance 17

Financial Information Users and Capital Markets 17 Contracts: Debt Covenants and Management Compensation 19 Financial Reporting Regulations and Standards 19 Generally Accepted Accounting Principles 20 Independent Auditors 22 Board of Directors and Audit Committee 22 Sarbanes—Oxley Act 24 Legal Liability 24 Professional Reputation and Ethics 24

International Perspective: Movement Toward a Global Financial Reporting System 25

Appendix 1A 26 Summary of Key Points 28 Key Terms 29 Internet Research Exercise 30 Issues for Discussion 30

2 THE FINANCIAL STATEMENTS 33

Capital Flows and Operating, Investing, and Financial Activities 34

The Classified Balance Sheet 36

A Photograph of Financial Condition 36 Balance Sheet Classifications 36 Assets 38 Liabilities 42 Shareholders' Equity 43

Contents v

The Income Statement 45

Operating Revenues 46 Operating Expenses 46 Other Revenues and Expenses 47

The Statement of Shareholders' Equity 48

The Statement of Cash Flows 49

Cash Flows from Operating Activities 50 Cash Flows from Investing Activities 51 Cash Flows from Financing Activities 51

Relationships among the Financial Statements 52

International Perspective: An Example of International Financial Reporting Standards 52

Review Problem 57
Summary of Key Points 62
Key Terms 63
Internet Research Exercise 64
Brief Exercises 64
Exercises 65

Problems 68
Issues for Discussion 73

PART 2: MEASUREMENT, MECHANICS, AND USE OF FINANCIAL STATEMENTS 77

3 THE MEASUREMENT FUNDAMENTALS OF FINANCIAL ACCOUNTING 77

Assumptions of Financial Accounting 79

Economic Entity Assumption 79 Fiscal Period Assumption 80 Going Concern Assumption 81 Stable Dollar Assumption 81 Summary of Basic Assumptions 83

Valuations on the Balance Sheet 84

Four Valuation Bases 84 Valuation Bases Used on the Balance Sheet 85

The Principles of Financial Accounting Measurement 87

The Principle of Objectivity 88 The Principles of Matching and Revenue Recognition 90 The Principle of Consistency 92

Two Exceptions to the Basic Principles: Materiality and Conservatism 93Materiality 93 Conservatism 95

International Perspective: Measurement Fundamentals and International

Reporting Standards 95

Summary of Key Points 96
Key Terms 98
Internet Research Exercise 98
Brief Exercises 98
Exercises 99
Problems 102

Issues for Discussion 108

vi Contents

4 THE MECHANICS OF FINANCIAL ACCOUNTING 112

Economic Events 113

Relevant Events 113 Objectivity 114

The Fundamental Accounting Equation 114

Assets 114 Liabilities 115 Shareholders' Equity 115

Business Transactions, the Accounting Equation, and the Financial Statements 116

Transactions and the Accounting Equation 116 The Accounting Equation and the Financial Statements 117

The Journal Entry 121

Recognizing Gains and Losses 128

Periodic Adjustments 129

Accruals 130 Deferrals 132 Revaluation Adjustments 139

Reporting Difficulties Faced by Multinational Companies 140

Appendix 4A

T-Account Analysis and Preparing the Statement of Cash Flows 141

Operating Items 141

Review Problem 147

Summary of Key Points 152

Key Terms 153

Internet Research Exercise 154

Brief Exercises 154

Exercises 155

Problems 162

Issues for Discussion 172

5 USING FINANCIAL STATEMENT INFORMATION 176

Control and Prediction 177

Financial Accounting Numbers and Management Control 177 Financial Accounting Numbers as Prediction Aids 178

Framework for Using Financial Statements to Predict Future

Earnings and Cash Flows 179

Business Environment 179 Unrecorded Events 180 anagement Bias 180

Elements of Financial Statement Analysis 181

Assessing the Business Environment 181

Reading and Studying the Financial Statements and Footnotes 182

The Audit Report 182 Significant Transactions 183 Financial Statements and Footnotes 184

Assessing Earnings Quality 185

Overstating Operating Performance 185 Taking a Bath 185 Creating Hidden Reserves 186 Employing Off-Balance-Sheet Financing 186 Earnings Quality and Unrecorded Events 187

Analyzing the Financial Statements 188

Comparisons across Time 188 Comparison within the Industry 188 Comparisons within the Financial Statements: Common-Size Statements and Ratio Analysis 189

Contents

Predict Future Earnings and/or Cash Flow 197

Annual Report Information and Predicting Stock Prices 198

International Perspective: Financial Statement Analysis in an International Setting 198

Appendix 5A

Shareholder Value, ROE, and Cash Flow Analyses 200

Determinants of Value Creation: Analyzing Return on Equity 201

Shareholder Value Creation and the ROE Model: JCPenney vs. Kohl's 202

Cash Flow Analysis 206

Cash Flow Profiles 207

Projecting Future Financial Statements 208

Review Problem 209

Summary of Key Points 212

Key Terms 213

Internet Research Exercise 214

Brief Exercises 214

Exercises 215

Problems 222

Issues for Discussion 231

PART 3: ASSETS: A CLOSER LOOK 241

6 THE CURRENT ASSET CLASSIFICATION, CASH, AND ACCOUNTS RECEIVABLE 242

The Current Asset Classification 243

The Relative Size of Current Assets across Industries 244 Measures Using Current Assets: Working Capital, Current Ratio, and Quick Ratio 245 The Economic Consequences of Working Capital, the Current Ratio, and the Quick Ratio 246 Limitations of the Current Asset Classification 247

Cash 248

Restrictions on the Use of Cash 249 Proper Management of Cash 250 Control of Cash 251

Accounts Receivable 251

Importance of Accounts Receivable 253 Net Realizable Value: The Valuation Base for Accounts Receivable 254 Cash Discounts 254 The Allowance Method of Accounting for Bad Debts (Uncollectibles) 256 Inaccurate Bad Debt Estimates 261 Accounting for Sales Returns 263

Accounts Receivable from a User's Perspective 264

When Should a Receivable Be Recorded? 264 Balance Sheet Valuation of Receivables 266

International Perspective: Receivables, Foreign Currency, and Hedging 269

ROE Exercise: Management of Working Capital and Receivables and Return on Equity 270

Current and Quick Ratios 270 Accounts Receivable Turnover 271 ROE Analysis 271

viii Contents

Review Problem 271

Summary of Key Points 272

Key Terms 274

Internet Research Exercise 274

Brief Exercises 275

Exercises 275

Problems 278

Issues for Discussion 285

7 MERCHANDISE INVENTORY 290

The Relative Size of Inventories 292

Accounting for Inventory: Four Important Issues 292

Acquiring Inventory: What Costs to Capitalize? 293

What Items or Units to Include? 293 What Costs to Attach? 295

Carrying Inventory: Perpetual Method 297

Selling Inventory: Which Cost Flow Assumption? 301

Specific Identification 301 Three Inventory Cost Flow Assumptions: Average, FIFO, and LIFO 302 Inventory Cost Flow Assumptions: Effects on the Financial Statements 304 Inventory Cost Flow Assumptions: Effects on Federal Income Taxes 305 Choosing an Inventory Cost Flow Assumption: Trade-Offs 306

Ending Inventory: Applying the Lower-of-Cost-or-Market Rule 310

The Lower-of-Cost-or-Market Rule and Hidden Reserves 311

International Perspective: Japanese Business and Inventory Accounting 312

ROE Exercise: Management of Inventory and Return on Equity 313

Inventory Turnover 313

ROE Analysis 314

Review Problem 314

Summary of Key Points 316

Key Terms 317

Internet Research Exercise 318

Brief Exercises 318

Exercises 319

Problems 323

Issues for Discussion 328

8 INVESTMENTS IN EQUITY SECURITIES 332

Equity Securities Classified as Current 333

The Existence of a Ready Market 334

The Intention to Convert: Another Area of Subjectivity 335

Trading and Available-for-Sale Securities 335

Purchasing Trading and Available-for-Sale Securities 336 Declaration and Receipt of Cash Dividends 336 Sale of Securities 337 Price Changes of Securities at the End of the Accounting Period 337 Reclassifications and Permanent Market Value Declines 340 Mark-to-Market Accounting and Comprehensive Income 340

Long-Term Equity Investments 341

Accounting for Long-Term Equity Investments 342 The Cost Method 343 The Equity Method 343 Some Cautions to Financial Statement Users about the Equity Method 346 Business Acquisitions, Mergers, and Consolidated Financial Statements 348 Goodwill 350 The Equity Method or Consolidated Statements? 351 Special Purpose Entities (SPEs) 353 Accounting for Equity Investments: A Summary 354 Preparing Consolidated Financial Statements for Multinationals 355

ROE Exercise: Managing Investments in Equity Securities and Return on Equity 356

ROE Analysis 356

Appendix 8A

Consolidated Financial Statements 356

Accounting for Business Acquisitions and Mergers: The Acquisition Method 357 Other Issues Concerning Consolidated Financial Statements 361

Review Problem I 361
Review Problem II 363
Summary of Key Points 364
Key Terms 366
Internet Research Exercise 366
Brief Exercises 366
Exercises 368
Problems 373
Issues for Discussion 379

9 LONG-LIVED ASSETS 384

The Relative Size of Long-Lived Assets 385

Long-Lived Asset Accounting: General Issues and Financial Statement Effects 386

An Overview of Long-Lived Asset Accounting 389

Acquisition: What Costs to Capitalize? 390

The Acquisition of Land 391 Lump-Sum Purchases 391 Construction of Long-Lived Assets 393

Postacquisition Expenditures: Betterments or Maintenance? 393

Cost Allocation: Amortizing Capitalized Costs 395

Estimating the Useful Life and Salvage Value 395 Revising the Useful-Life Estimate 396 Cost Allocation (Depreciation) Methods 398 Cost Allocation Methods and the Matching Principle 402 How Does Management Choose an Acceptable Cost Allocation Method? 403 Depreciation Methods for Income Tax Purposes 404

Disposal: Retirements, Impairments, Sales, and Trade-Ins 406

Retirement and Impairment of Long-Lived Assets 406 Sale of Long-Lived Assets 408 Trade-Ins of Long-Lived Assets 409

Intangible Assets 410

Copyrights, Patents, and Trademarks 411

The Costs of Developing Computer Software 411

Goodwill 412

Organizational Costs 412

x Content

Research and Development Costs 412

IFRS vs. GAAP: Revaluations to Fair Market Value 413

ROE Exercise: Managing Long-Lived Assets and Return on Equity 414

ROE Analysis 415

Review Problem 415

Summary of Key Points 416

Key Terms 418

Internet Research Exercise 418

Brief Exercises 419

Exercises 420

Problems 426

Issues for Discussion 430

PART 4: LIABILITIES AND SHAREHOLDERS' EQUITY: A CLOSER LOOK 435

10 INTRODUCTION TO LIABILITIES: ECONOMIC CONSEQUENCES, CURRENT LIABILITIES, AND CONTINGENCIES 436

What Is a Liability? 437

The Relative Size of Liabilities on the Balance Sheet 438

Reporting Liabilities on the Balance Sheet: Economic Consequences 439 Shareholders and Investors 439 Creditors 439 Management 440 Auditors 441

Current Liabilities 441

The Relative Size of Current Liabilities on the Balance Sheet 442 Valuing Current Liabilities on the Balance Sheet 443 Reporting Current Liabilities: An Economic Consequence 443

Determinable Current Liabilities 444

Accounts Payable 444 Short-Term Debts 445 Dividends Payable 446 Unearned Revenues 446 Third-Party Collections 447 Income Tax Liability 448 Incentive Compensation 448

Contingencies and Contingent Liabilities 450

Contingent Liabilities: A Scenario 451 Accounting for Contingencies 453

Provisions vs. Contingent Liabilities: The "Devil is in the Details" 456

ROE Exercise: Managing Current Liabilities 457

ROE Analysis 457

Appendix 10A

Retirement Costs: Pensions and Postretirement Healthcare and Insurance 457

Pensions 457

Defined Contribution Plan 458 Defined Benefit Plan 458

Postretirement Healthcare and Insurance Costs 460

Appendix 10B

Deferred Income Taxes 461

The Concept of Deferred Income Taxes 462

Accounting Entries for Deferred Income Taxes 462

Deferred Income Taxes: Additional Issues 463

The Conservatism Ratio 464

Review Problem 466

Summary of Key Points 468

Key Terms 469

Contents

Internet Research Exercise 469

Brief Exercises 470

Exercises 471

Problems 474

Issues for Discussion 478

11 LONG-TERM LIABILITIES: NOTES, BONDS, AND LEASES 484

The Relative Size of Long-Term Liabilities 486

The Economic Consequences of Reporting Long-Term Liabilities 487

Basic Definitions and Different Contractual Forms 488

Effective Interest Rate 490

Installment and Non-Interest-Bearing Obligations 490 Interest-Bearing Obligations 491

Accounting for Long-Term Obligations: The Effective Interest Method 492

Accounting for Long-Term Notes Payable 492

Bonds Payable 494

Bond Terminology 495 The Price of a Bond 497 The Effective Rate and the Stated Rate 497 Accounting for Bonds Payable 498 The Effective Interest Method and Changing Interest Rates 503

Financial Instruments, Fair Market Values, and Off-Balance-Sheet Risks 504

Bond Redemptions 504

Leases 506

Operating Leases 506 Capital Leases 507 Operating Leases, Capital Leases, and Off-Balance-Sheet Financing 508

International Perspective: The Importance of Debt Financing in Other Countries 510

ROE Exercise: Managing Long-Term Debt 511

ROE Analysis 512

Appendix 11A

The Determination of Bond Prices 512

Determine the Effective (Actual) Rate of Return 512 Determine the Required Rate of Return 512 Determine the Risk-Free Return 513 Determine the Risk Premium 513 Compare the Effective Rate to the Required Rate 513 Factors Determining Bond Prices 514

Appendix 11B

Investing in Bonds 514

Appendix 11C

Interest Rate Swaps and Hedging 516

xii Contents

Review Problem 516

Cash Flow Calculations 518

Journal Entry Calculations 518

Discount Balance and Balance Sheet Value of Bonds Payable 518

Summary of Key Points 520

Key Terms 520

Internet Research Exercise 521

Brief Exercises 521

Exercises 521

Problems 527

Issues for Discussion 534

12 SHAREHOLDERS' EQUITY 539

The Relative Importance of Liabilities, Contributed Capital, and Earned Capital 541

Debt and Equity Distinguished 542

Characteristics of Debt 542 Characteristics of Equity 542 Why Is It Important to Distinguish Debt from Equity? 543

The Economic Consequences Associated with Accounting for Shareholders' Equity 546

Accounting for Shareholders' Equity 547

Preferred Stock 548 Common Stock 552 Market Value 552 Book Value 552 Market-to-Book Ratio 553 Par Value 553

Accounting for Common and Preferred Stock Issuances 553

Treasury Stock 554 Stock Options 559 Retained Earnings 560

The Statement of Shareholders' Equity 567

International Perspective: The Rise of International Equity Markets 567

ROE Exercise: Return on Equity and Value Creation 569

ROE Analysis 570

Review Problem 570

Summary of Key Points 572

Key Terms 575

Internet Research Exercise 576

Brief Exercises 576

Exercises 577

Problems 582

Issues for Discussion 588

PART 5: INCOME AND CASH FLOWS 595

13 THE COMPLETE INCOME STATEMENT 596

The Economic Consequences Associated with Income Measurement and Disclosure 597

The Measurement of Income: Different Measure for Different Objectives 598

The Different Concepts of Income: Matching and Fair Market Value 601 Financing, Investing, and Operating Transactions: A Framework 602 Classifying Operating Transactions 604

A Complete Income Statement: Disclosure and Presentation 605

(1) Operating Revenues and Expenses: Usual and Frequent 607 (2) Other Revenues and Expenses: Unusual or Infrequent 607 (3) Disposal of a Business Segment 608 (4) Extraordinary Items: Unusual and Infrequent 609 (5) Mandatory Changes in Accounting Principles 610

Intraperiod Tax Allocation 612

Earnings-per-Share Disclosure 613

Income Statement Categories: Useful for Decisions but Subjective 613

International Perspective: Investments and Income Statement Disclosures 616

ROE Exercise: Using the Right Earnings Number 617

ROE Analysis 617

Review Problem 617

Summary of Key Points 620

Key Terms 621

Internet Research Exercise 622

Brief Exercises 622

Exercises 622

Problems 629

Issues for Discussion 635

14 THE STATEMENT OF CASH FLOWS 639

Contents

The Definition of Cash 641

A General Description of the Statement of Cash Flows 641

Cash Provided (Used) by Operating Activities 642 Cash Provided by Investing Activities 644 Cash Provided (Used) by Financing Activities 644

How the Statement of Cash Flows Can Be Used 646

Analyzing the Statement of Cash Flows 646 The Importance of Cash from Operating Activities 647 The Importance of Significant Noncash Transactions 648

The Statement of Cash Flows: Economic Consequences 648

Deriving Cash Flow from Accrual Financial Statements 650

Cash Provided (Used) by Operating Activities 652 Cash Provided (Used) by Investing Activities 656 Cash Provided (Used) by Financing Activities 657

The Complete Statement of Cash Flows 659

The Direct Method 659 The Indirect Method 660

Analyzing the Statement of Cash Flows: An Application 662

Summarizing the Cash Effects of Operating Transactions 662 Summarizing the Cash Effect of Investing and Financing Transactions 663 Two Additional Observations 664

International Perspective: The Statement of Cash Flows 664

Review Problem 665
Summary of Key Points 668
Key Terms 669
Internet Research Exercise 669
Brief Exercises 670
Exercises 671

Contents

xiv

Problems 680

Issues for Discussion 691

Appendix A The Time Value of Money 696

Interest: The Price of Money 696

Time Value 697

Size Time of Value 697 Inflation 697

Time Value Computations 698

Future Value 698 Present Value 702 An Illustration 703

Computing Implicit Rates of Return and Interest Rates 707

Present Value and Financial Accounting 709

Exercises 710
Problems 713

APPENDIX B QUALITY OF EARNINGS CASES: A COMPREHENSIVE REVIEW 721

Case 1: Liberty Manufacturing 721

Company Description 721 Note from Your Supervisor 721 Financial Statements 722

Case 2: Microline Corporation 725

Case 3: Technic Enterprises and Sonar-Sun Inc. 728

Technic Enterprises 728 Sonar-Sun Inc. 732

Case 4: Avery Corporation 734

Letter from the Chief Executive Officer 735 Footnotes to the Financial Statements 736

Case 5: Zenith Creations 739

Footnotes to the Financial Statements (Dollar Amounts, Except Per Share, in Thousands) 741

Case 6: Pierce and Snowden 744

Footnotes to the Financial Statements of Wellington Mart (Dollar Values, Except Per-Share Amounts, Are in Thousands) 745 Footnotes to the Financial Statements of Wagner Stores 750

APPENDIX C 2009 NIKE SEC FORM 10-K SELECTED PAGES 754

GLOSSARY 784

SUBJECT INDEX 812

COMPANY INDEX 824