

# Preface

*Financial Accounting in an Economic Context* is a trendsetting textbook in the area of introductory financial reporting and analysis. Since the publication of the first edition in 1989, this text has become an important part of the curriculum at a large and impressive group of forward-thinking schools. The eighth edition continues to build on the strengths of previous editions, while it introduces new ideas and refinements that better communicate the book's economic decision-making theme.

## CONTINUING TO CHANGE THE WAY STUDENTS LEARN

The eighth edition contains new elements designed to improve and sharpen the text's economic decision-making theme, and the real-world references have been updated. For the most part, however, this eighth edition maintains the same style and content of the seventh edition, which was very well received by a wide variety of universities, colleges, and other institutions.

## New to this Edition

In response to the changing financial reporting environment, thoughtful suggestions from reviewers, and the needs of today's students and tomorrow's business leaders, we have reengineered the text in the following ways.



### **GLOBALIZATION OF BUSINESS AND FINANCIAL REPORTING STANDARDS.**

Business is becoming more global with each passing day, and International Financial Reporting Standards (IFRS) are used throughout the world, including in the United States. While the eighth edition still is based on U.S. GAAP, IFRS standards and concepts are woven throughout the entire text. Starting with Chapter 1, IFRS is included in our definition of generally accepted accounting principles, and the ongoing process of converging toward a single global system is described and discussed. Chapter 2 features a complete set of IFRS-based financial statements, published by Unilever, a Dutch-based consumer-goods company, and discusses the conceptual differences between U.S. GAAP and IFRS. Throughout the remainder of the text, conceptual and mechanical differences between U.S. GAAP and IFRS are highlighted via international boxed-in

items that do not interrupt the flow of the text, but allow interested readers to see where differences between the two systems reside. In addition, many end-of-chapter exercises, problems, and issues for discussion deal directly with IFRS-based financial statements, and in a number of places complete IFRS-based financial statements are illustrated and discussed. Note as well that IFRS is not the only evidence of globalization featured in this edition. Differences in business practices and cultures, differences in financial disclosure and format practices, and environmental differences across national borders are all highlighted. Indeed, we live in a global business world, and the eighth edition reflects what future business leaders need to know to operate effectively within it.



**STATEMENT OF CASH FLOWS.** Prior editions illustrated and discussed the statement of cash flows from the very first chapter, and demonstrated how to prepare the statement directly from the activity in the cash T-account in Chapter 4. Mechanical differences between accruals and cash flows were introduced and illustrated in Appendix 4A through the process of reverse T-account analysis, but the actual preparation of the statement of cash flows, using the indirect form of presentation, did not occur until Chapter 14.

In the eighth edition we have expanded Appendix 4A to include not only reverse T-account analysis but also the preparation of a relatively simple statement of cash flows under both the direct and indirect forms of presentation. Throughout the remaining chapters we have worked in special boxed-in items, where appropriate, that invite the reader to consider differences between accruals and cash flows, normally in terms of the adjustments to net income in the operating section of the statement of cash flows prepared under the indirect method. This feature constantly reminds the reader of the reconciliation between net income and net cash from operations, a very important part of understanding financial statements, and it better prepares the students for Chapter 14, which covers the statement as a whole. Readers who understand Appendix 4A and make note of the boxed-in items will find that Chapter 14 is no more than a helpful review.

**FAIR MARKET VALUE ACCOUNTING.** Students in today's business environment should understand the basics of fair market value accounting, and how it differs from the traditional matching model. U.S. GAAP is showing signs of moving toward a fair market value-based system (e.g., the fair value option for financial instruments), and IFRS relies more heavily on fair values than does U.S. GAAP. To address this development, fair market value accounting is weaved throughout the eighth edition. In addition to frequent references to market and firm valuation, the text also discusses recent difficulties in the financial markets and security valuation issues related to the collapse of major financial institutions. Appendix A covers valuation and the time value of money. Other prominent examples appear in:

Chapter 2—Differences between U.S. GAAP and IFRS in their reliance on fair market value accounting.

Chapter 3—Measurement fundamentals of financial reporting, including a discussion of asset valuation in terms of fair market value vs. historical cost.

Chapter 5—Discussion of financial statement analysis and firm valuation.

Chapter 8—Illustrations and discussions of fair market value applications to asset valuation and the fair value option for financial instruments under U.S. GAAP. This chapter also introduces acquisitions and the valuation of goodwill.

Chapter 9—Special section dealing with accounting for long-lived assets using the matching model vs. the fair market value option available under IFRS.

Chapter 11—Discussion of the fair market value of long-term debt vs. long-term debt accounting under the effective interest method.

Chapter 12—Discussion of market value vs. book value of common stock.

**MORE COMPLETE FINANCIAL STATEMENT ANALYSIS PACKAGE.** In earlier editions, Chapter 5 has been devoted to financial statement analysis, and Appendix 5A has covered shareholder value creation, how it relates to the return on equity model, and cash flow analysis. The eighth edition enhances this package in two important ways. First, the chapter now includes a section devoted to business segment analysis, which introduces real-world disclosures and links these disclosures to overall financial statement analysis. Second, Appendix 5A has been expanded to include a section on the mechanics of projecting financial statements. Both of these improvements help to complete the coverage of financial statement analysis in Chapter 5, and end-of-chapter items are devoted to both business segment analysis and projection of financial statements.

## CONTINUING THE APPROACH

The eighth edition has retained and improved upon many of the popular features used in previous editions, such as ethics cases, Internet exercises, brief end-of-chapter real-world exercises and issues for discussion, and a set of interesting and challenging “quality of earnings” cases. This edition also includes an updated glossary considered by many to be the very best of its kind. But perhaps most important, this edition has maintained and improved upon its most distinctive feature—the economic decision-making approach and the balanced coverage of three important themes: economic factors, measurement issues, and mechanics.

### Economic Factors

Financial accounting is meaningless without an understanding of the economic environment in which it exists. Each chapter in the eighth edition, therefore, includes frequent references to actual events and companies; quotes from well-known business publications and corporate annual reports—information about industry practices, debt covenants, compensation arrangements, and debt and equity markets; and in-depth discussions of legal liability, ethical issues, and management’s incentives and influence on financial reports. The annual report of NIKE, which is the subject of short case questions at the end of each chapter, is also provided at the end of the text. Furthermore, ratio analysis and international issues are introduced early and integrated throughout the text, and the coverage still reflects a strong user orientation with a distinct “quality and persistence of earnings” flavor. The important role of the economic environment in this text makes it more than simply a study of financial accounting. It is a study of modern business management as seen through the financial accounting process.

### Measurement Issues

As future managers and users, students must understand the measurement issues underlying the financial statements before they can interpret and meaningfully use them. The eighth edition devotes considerable attention to the conceptual and theoretical foundation of financial accounting measurement, with special emphasis on how the financial statements provide useful measures of solvency and earning power. Cash and accrual statements are treated as equally important, with the statement of cash flows being covered from the very beginning. Chapter 3 provides a framework for accounting measurement that is used throughout the remainder of the text.

## Mechanics

Using financial statements without understanding the underlying mechanics is like trying to interpret a foreign language without knowing the vocabulary. Consequently, the eighth edition provides a strong mechanical foundation and stresses mechanics early and throughout the text. Journal entries and T-accounts play an important role, but they are never treated as a goal. Rather, they are characterized as an efficient way to communicate how economic events are reflected on the financial statements. A special coding is used throughout the text to link the form of each entry to the basic accounting equation and financial statements. Thorough mechanical coverage is especially important in a text that takes a user orientation because effective users must be able to infer transactions from the financial statements. This mechanical skill, referred to as *reverse T-account analysis*, is covered several times in the text, and many exercises and problems are designed to test it.

## Decision-Making Perspective

This text presents financial accounting in a way that helps managers make decisions—a decision-making perspective. At a fundamental level, managers make two kinds of decisions: attracting capital and investing capital. Simply put, managers must attract capital from debt and equity investors and then invest it in operations, producing assets, and investment securities. Successful management is defined by generating a return from these investments that exceeds the cost of capital. As depicted in Figure P-1, these two kinds of decisions can be matched with the three themes discussed above (mechanics, measurement issues, and economic factors) to produce six basic questions that must be answered by managers who use financial accounting information when making decisions.

FIGURE P-1

			Management Decisions	
			Attract Capital	Invest Capital
Mechanics	1	How do the transactions affect the financial statements?	4	How are financial ratios computed, and how can transactions be inferred from the financial statements?
Measurement Theory	2	How do these financial statement effects influence outside perceptions of the company's earning power and solvency?	5	How do the financial statements and ratios indicate a firm's solvency and earning power?
Economics	3	How do these financial statement effects influence decisions of outsiders as well as debt and compensation contracts?	6	What action should be taken (e.g., invest, extend credit, adjust loan terms)?

In their effort to attract capital, managers must address three questions when considering whether to enter into certain transactions: How do the transactions affect the financial statements? (cell 1); how do these financial statement effects influence outside perceptions of the company's earning power and solvency? (cell 2); and how do these financial statement effects influence the decisions of outsiders as well as debt and compensation contracts? (cell 3). These questions must be answered if management is to understand the economic consequences of the transactions under consideration.

In their effort to invest capital, managers must address three different questions: How are financial ratios computed, and how can transactions be inferred from the financial statements? (cell 4); how do the financial statements and ratios indicate a firm's solvency and earning power? (cell 5); and what action should be taken (e.g., invest, extend credit, adjust loan terms)? (cell 6). These questions must be answered if management is to understand how to use financial accounting information properly.

The decision-making perspective simply means that all six questions are addressed in this text. These are the areas where management decision making intersects with financial accounting information, or, in other words, this is what managers need to know about financial reporting and analysis. It is this perspective that makes *Financial Accounting in an Economic Context* different from all other texts.

## SUCCESSFUL FEATURES RETAINED FROM PREVIOUS EDITIONS

With few exceptions, the text retains the main features of previous editions. Below is a brief description of the most important ones.

**FLEXIBLE MODULES.** Chapter 3 (The Measurement Fundamentals of Financial Accounting), Chapter 4 (The Mechanics of Financial Accounting), and Chapter 5 (Using Financial Statement Information) have been written so that they can be covered in any order. This modular structure adds an important dimension of flexibility to the text.

**REAL WORLD REVIEW.** Throughout each chapter real world applications of chapter topics are highlighted and boxed. In the eighth edition, these boxed items also include real-world insights on general international issues, IFRS, and the reconciliation of net income with net cash from operations on the statement of cash flows.

**REVERSE T-ACCOUNT ANALYSIS.** An important user-oriented, analytical skill, called *reverse T-account analysis*, is covered in detail in Appendix 4A. This material shows students how to derive transactions from the financial statements, and many exercises and problems throughout the text require students to use it.

**ETHICS VIGNETTES.** Each chapter closes with a short business scenario that introduces an ethical issue related to the material covered in the chapter. Several questions that follow each scenario are designed to encourage meaningful class discussion.

**INTERNATIONAL COVERAGE.** At the end of each chapter, we discuss timely, relevant, and important international issues. These sections encourage students to think more broadly about global business issues and how they relate to accounting.

**INDUSTRY DATA.** Many of the chapters contain tables that compare accounting practices and show students the importance of accounting numbers and ratios across different industries and well-known companies. Updated in the eighth edition, these tables illustrate that the financial accounting issues faced by retailers, manufacturers, service enterprises, and financial institutions are quite different. A brief explanation of

the operations of companies in different industries and how these operations give rise to different financial accounting concerns follows each table.

**EXCERPTS FROM BUSINESS PUBLICATIONS AND PROFESSIONAL JOURNALS.**

Over 10,000 references from various business publications (*Wall Street Journal*, *Forbes*, and other professional and academic journals) are integrated throughout the text. Updated to reflect the most recent developments, these references document and clarify important chapter concepts and introduce students to information sources that will be useful to them in their business careers.

**NIKE CONSOLIDATED FINANCIAL STATEMENTS.** The financial statements of NIKE appear in Appendix C at the end of the text. In addition to being referenced periodically throughout the text, each chapter contains an end-of-chapter case that requires students to relate the financial statements to accounting issues covered in the chapter.

## STUDENT LEARNING AIDS

**STUDY GUIDE.** Designed to have a conceptual flavor that complements the textbook, this invaluable study aid includes for each chapter: (1) a review of key concepts and (2) a set of practice questions and exercises to enhance learning. This approach highlights important concepts and relations introduced in the textbook.

## SUPPLEMENTS FOR THE INSTRUCTOR

**INSTRUCTOR'S MANUAL.** This instructor's resource includes a synopsis that highlights general chapter topics, a text/lecture outline that summarizes the chapter in detail, lecture tips for areas in which students commonly have difficulty, answers to chapter questions, and an assignment classification table.

**TEST BANK.** More than 1,700 questions are included in both the printed and microcomputer versions of the Test Bank. Learning outcomes are provided for each question.

**SOLUTIONS MANUAL.** This supplement provides complete solutions to all exercises and problems in the text.

**POWERPOINT PRESENTATION SLIDES.** Lecture slides highlight the major concepts of each chapter. The slides may be printed out for use on an overhead projector.

**FINANCIAL ACCOUNTING WEB SITE** (<http://www.wiley.com/college/pratt>). This password-protected instructor resource provides the Solutions Manual, Instructor's Manual, Test Bank, and PowerPoint Presentation Slides in an easily downloadable format.

For more information on these or other supplemental materials, please contact your local Wiley sales representative or visit us on the Web at [www.wiley.com/college/pratt](http://www.wiley.com/college/pratt).