

Paul D. Kimmel PhD, CPA

University of Wisconsin---Milwaukee Milwaukee, Wisconsin

Jerry J. Weygandt PhD, CPA

University of Wisconsin—Madison Madison, Wisconsin

Donald E. Kieso PhD, CPA

Northern Illinois University DeKalb, Illinois

WILEY

Contents

Chapter 1

Introduction to Financial Statements 2

Knowing the Numbers 3 Forms of Business Organization 4 Users and Uses of Financial Information 6 Internal Users 6 External Users 6 Ethics in Financial Reporting 8 **Business Activities 9** Financing Activities 9 Investing Activities 10 **Operating Activities** 10 Communicating with Users 11 Income Statement 12 **Retained Earnings Statement 13 Balance Sheet 14** Statement of Cash Flows 15 Interrelationships of Statements 16 Other Elements of an Annual Report 19 A Look at IFRS 43

Chapter 2

A Further Look at Financial Statements 46

Just Fooling Around? 47 The Classified Balance Sheet 48 Current Assets 49 Long-Term Investments 50 Property, Plant, and Equipment 51 Intangible Assets 51 Current Liabilities 52 Long-Term Liabilities 53 Stockholders' Equity 53 Using the Financial Statements 54 Ratio Analysis 54 Using the Income Statement 54 Using the Statement of Stockholders' Equity 56 Using a Classified Balance Sheet 57 Keeping an Eye on Cash 61

Financial Reporting Concepts 63

The Standard-Setting Environment 63 Qualities of Useful Information 64 Assumptions in Financial Reporting 65 Principles in Financial Reporting 66 Cost Constraint 66

A Look at IFRS 95

Chapter 3

The Accounting Information System 100

Accidents Happen 101 The Accounting Information System 102 Accounting Transactions 102 Analyzing Transactions 103 Summary of Transactions 109 The Account 111 Debits and Credits 111 Debit and Credit Procedures 112 Stockholders' Equity Relationships 115 Summary of Debit/Credit Rules 116 Steps in the Recording Process 116 The Journal 117 The Ledger 119 Chart of Accounts 120 Posting 120 The Recording Process Illustrated 121 Summary Illustration of Journalizing and Posting 127 The Trial Balance 129 Limitations of a Trial Balance 129 Keeping an Eye on Cash 130 A Look at IFRS 159

Chapter 4

Accrual Accounting Concepts 162

Keeping Track of Groupons 163 Timing Issues 164 The Revenue Recognition Principle 164 The Expense Recognition Principle 165 Accrual versus Cash Basis of Accounting 166 The Basics of Adjusting Entries 167 Types of Adjusting Entries 168 Adjusting Entries for Deferrals 169 Adjusting Entries for Accruals 175 Summary of Basic Relationships 181 The Adjusted Trial Balance and Financial Statements 183 Preparing the Adjusted Trial Balance 183 Preparing Financial Statements 184 Quality of Earnings 185 **Closing the Books 188** Preparing Closing Entries 188 Preparing a Post-Closing Trial Balance 189 Summary of the Accounting Cycle 191

Keeping an Eye on Cash 191 APPENDIX 4A: Adjusting Entries in an Automated World–Using a Worksheet 195 A Look at IFRS 225

Chapter 5

Merchandising Operations and the Multiple-Step Income Statement 228

Buy Now, Vote Later 229 Merchandising Operations 230 Operating Cycles 231 Flow of Costs 231

Recording Purchases of Merchandise 233 Freight Costs 234 Purchase Returns and Allowances 235 Purchase Discounts 236 Summary of Purchasing Transactions 237 Recording Sales of Merchandise 238

Sales Returns and Allowances 239 Sales Discounts 240

Income Statement Presentation 241 Sales Revenues 243 Gross Profit 243 Operating Expenses 243 Nonoperating Activities 244 Determining Cost of Goods Sold Under a Periodic System 246

Evaluating Profitability 247 Gross Profit Rate 247 Profit Margin 249

Keeping an Eye on Cash 251

APPENDIX 5A: **Periodic Inventory System 253** Recording Merchandise Transactions 253 Recording Purchases of Merchandise 254 Freight Costs 254 Recording Sales of Merchandise 254 Comparison of Entries—Perpetual vs. Periodic 255 A Look at IFRS 279

Chapter 6

Reporting and Analyzing Inventory 282

"Where Is That Spare Bulldozer Blade?" 283 Classifying and Determining Inventory 284 Classifying Inventory 284 Determining Inventory Quantities 286 Inventory Costing 288 Specific Identification 288 Cost Flow Assumptions 289 Financial Statement and Tax Effects of Cost Flow Methods 294

Keeping an Eye on Cash 296 Using Inventory Cost Flow Methods Consistently 297 Lower-of-Cost-or-Market 298 Analysis of Inventory 299 Inventory Turnover 299 Analysts' Adjustments for LIFO Reserve 301 APPENDIX 6A: Inventory Cost Flow Methods in Perpetual Inventory Systems 305 First-In, First-Out (FIFO) 306 Last-In, First-Out (LIFO) 306 Average-Cost 307 APPENDIX 6B: Inventory Errors 308 Income Statement Effects 308 Balance Sheet Effects 309 A Look at IFRS 331 Chapter 7 Fraud, Internal Control, and Cash 334 Minding the Money in Moose Jaw 335 Fraud and Internal Control 336 Fraud 336 The Sarbanes-Oxley Act 337 Internal Control 337 Principles of Internal Control Activities 338 Limitations of Internal Control 345 Cash Controls 347 Cash Receipts Controls 347 Cash Disbursements Controls 350 Control Features: Use of a Bank 352 Bank Statements 352 Reconciling the Bank Account 353 **Reporting Cash 358** Cash Equivalents 359 Restricted Cash 359 Managing and Monitoring Cash 360 Basic Principles of Cash Management 361 Keeping an Eye on Cash 362 APPENDIX 7A: Operation of the Petty Cash Fund 367 Establishing the Petty Cash Fund 367 Making Payments from Petty Cash 367 Replenishing the Petty Cash Fund 368 A Look at IFRS 393

Chapter 8

Reporting and Analyzing Receivables 396

What's Cooking? 397 **Types of Receivables 398 Accounts Receivable 399** Recognizing Accounts Receivable 399 Valuing Accounts Receivable 400

Notes Receivable 407

- Determining the Maturity Date 408 Computing Interest 408
- Recognizing Notes Receivable 409 Valuing Notes Receivable 409 Disposing of Notes Receivable 410
- Financial Statement Presentation of Receivables 411

Managing Receivables 412

Extending Credit 412 Establishing a Payment Period 413 Monitoring Collections 413 Evaluating Liquidity of Receivables 415 Accelerating Cash Receipts 417 Keeping an Eye on Cash 420 A Look at IFRS 444

Chapter 9

Reporting and Analyzing Long-Lived Assets 446

A Tale of Two Airlines 447 Plant Assets 448

Determining the Cost of Plant Assets 449 To Buy or Lease? 452

Accounting for Plant Assets 453

Depreciation 453 Factors in Computing Depreciation 454 Depreciation Methods 454 Revising Periodic Depreciation 459 Expenditures During Useful Life 460 Impairments 461 Plant Asset Disposals 461

Analyzing Plant Assets 464

Return on Assets 464 Asset Turnover 465 Profit Margin Revisited 466

Intangible Assets 467

Accounting for Intangible Assets 468 Types of Intangible Assets 469

Financial Statement Presentation of Long-Lived Assets 472

Keeping an Eye on Cash 473

APPENDIX 9A: Calculation of Depreciation Using Other Methods 476 Declining-Balance 476 Units-of-Activity 477 A Look at IFRS 500

Chapter 10

Reporting and Analyzing Liabilities 504

And Then There Were Two 505

Current Liabilities 506 What Is a Current Liability? 506 Notes Payable 507 Sales Taxes Payable 507 Unearned Revenues 508 Current Maturities of Long-Term Debt 509 Payroll and Payroll Taxes Payable 510 Bonds: Long-Term Liabilities 512 Types of Bonds 512 Issuing Procedures 513 Determining the Market Price of Bonds 513 Accounting for Bond Issues 515 Issuing Bonds at Face Value 516 Discount or Premium on Bonds 516 Issuing Bonds at a Discount 517 Issuing Bonds at a Premium 519 Accounting for Bond Redemptions 520 Redeeming Bonds at Maturity 520 Redeeming Bonds before Maturity 521 **Financial Statement Presentation** and Analysis 521 **Balance Sheet Presentation 521** Keeping an Eye on Cash 522 Analysis 523 Off-Balance-Sheet Financing 525 APPENDIX 10A: Straight-Line Amortization 530 Amortizing Bond Discount 530 Amortizing Bond Premium 531 APPENDIX 10B: Effective-Interest Amortization 532 Amortizing Bond Discount 533 Amortizing Bond Premium 535 APPENDIX 10C: Accounting for Long-Term Notes Payable 536 A Look at IFRS 564

Chapter 11

Reporting and Analyzing Stockholders' Equity 568

Oh Well, I Guess I'll Get Rich 569 The Corporate Form of Organization 570 Characteristics of a Corporation 571 Forming a Corporation 574 Stockholder Rights 574 Stock Issue Considerations 575 Authorized Stock 576 Issuance of Stock 576 Par and No-Par Value Stocks 577 Accounting for Issues of Common Stock 577 Accounting for Treasury Stock 579 Purchase of Treasury Stock 580 Preferred Stock 581

Dividend Preferences 582 Liquidation Preference 583 Dividends 584 Cash Dividends 584 Stock Dividends 586 Stock Splits 588 Retained Earnings 590 **Retained Earnings Restrictions 590 Financial Statement Presentation of** Stockholders' Equity 591 **Balance Sheet Presentation 591** Keeping an Eye on Cash 592 Measuring Corporate Performance 593 Dividend Record 593 Earnings Performance 594 Debt versus Equity Decision 595 APPENDIX 11A: Entries for Stock Dividends 599 A Look at IFRS 621

Chapter 12

Statement of Cash Flows 624

Got Cash? 625 The Statement of Cash Flows: Usefulness and Format 626 Usefulness of the Statement of Cash Flows 626 Classification of Cash Flows 627 Significant Noncash Activities 628 Format of the Statement of Cash Flows 629 The Corporate Life Cycle 630 Preparing the Statement of Cash Flows 632 Indirect and Direct Methods 632 Preparation of the Statement of Cash

Flows-Indirect Method 633

Step 1: Operating Activities 635
Summary of Conversion to Net Cash Provided by Operating Activities–Indirect Methods 638
Step 2: Investing and Financing Activities 640
Step 3: Net Change in Cash 641

Using Cash Flows to Evaluate a Company 642 Free Cash Flow 642

Keeping an Eye on Cash 644 Assessing Liquidity and Solvency Using Cash Flows 645

APPENDIX 12A: Statement of Cash Flows–Direct Method 649

Step 1: Operating Activities 651 Step 2: Investing and Financing Activities 655 Step 3: Net Change in Cash 656 APPENDIX 12B: **Statement of Cash Flows—T-Account Approach 656**

A Look at IFRS 685

Chapter 13

Financial Analysis: The Big Picture 688

It Pays to Be Patient 689 ` Sustainable Income 690 Irregular Items 691

Changes in Accounting Principle 694 Comprehensive Income 695 Concluding Remarks 696 Comparative Analysis 697 Horizontal Analysis 698 Vertical Analysis 700 **Ratio Analysis 703** Liquidity Ratios 704 Solvency Ratios 704. Profitability Ratios 705 Quality of Earnings 706 Alternative Accounting Methods 706 Pro Forma Income 706 Improper Recognition 707 Price-Earnings Ratio 707 APPENDIX 13A: Comprehensive Illustration of Ratio Analysis 712 Liquidity Ratios 714 Solvency Ratios 716 Profitability Ratios 719 A Look at IFRS 748

Chapter 14

Managerial Accounting 752

Just Add Water . . . and Paddle 753 Managerial Accounting Basics 754 Comparing Managerial and Financial Accounting 755 Management Functions 755 Organizational Structure 757 **Business Ethics 758** Managerial Cost Concepts 759 Manufacturing Costs 760 Product versus Period Costs 761 Manufacturing Costs in Financial Statements 762 Income Statement 762 Cost of Goods Manufactured 763 Cost of Goods Manufactured Schedule 764 Balance Sheet 766 Cost Concepts—A Review 767 Product Costing for Service Industries 768 Managerial Accounting Today 769 Focus on the Value Chain 770 Balanced Scorecard 771 Corporate Social Responsibility 771

Chapter 15

Job Order Costing 798

She Succeeds Where Others Have Failed 799 Cost Accounting Systems 800 Job Order Cost System 800 Process Cost System 801 Job Order Cost Flow 802

Accumulating Manufacturing Costs 803

xxi

Assigning Manufacturing Costs to Work in Process 805 Manufacturing Overhead Costs 809

Assigning Costs to Finished Goods 813 Assigning Costs to Cost of Goods Sold 814 Summary of Job Order Cost Flows 815 Job Order Costing for Service Companies 816 Advantages and Disadvantages of Job Order Costing 818

Reporting Job Cost Data 819

Under- or Overapplied Manufacturing Overhead 820

Chapter 16

Process Costing 844

Ben & Jerry's Tracks Its Mix-Ups 845 The Nature of Process Cost Systems 846 Uses of Process Cost Systems 846 Process Costing for Service Companies 847 Similarities and Differences Between Job Order Cost and Process Cost Systems 847 Process Cost Flow 849 Assigning Manufacturing Costs—Journal Entries 850 Equivalent Units 853 Weighted-Average Method 853 Refinements on the Weighted-Average Method 854 **Production Cost Report 856** Compute the Physical Unit Flow (Step 1) 857 Compute the Equivalent Units of Production (Step 2) 858 Compute Unit Production Costs (Step 3) 858 Prepare a Cost Reconciliation Schedule (Step 4) 859 Preparing the Production Cost Report 860 Costing Systems—Final Comments 862 APPENDIX 16A: FIFO Method 866 Equivalent Units Under FIFO 866 Comprehensive Example 867 FIFO and Weighted-Average 871 Chapter 17

Activity-Based Costing 894

Precor Is on Your Side 895 Traditional Costing and Activity-Based Costing 896

Traditional Costing Systems 896 The Need for a New Approach 897

Activity-Based Costing 897

Example of ABC versus Traditional Costing 900 Identify and Classify Activities and Allocate Overhead to Cost Pools (Step 1) 900 Identify Cost Drivers (Step 2) 901

Compute Activity-Based Overhead Rates (Step 3) 901 Assign Overhead Costs to Products (Step 4) 901 Comparing Unit Costs 903 Activity-Based Costing: A Closer Look 905 Benefits of ABC 905 Limitations of ABC 906 When to Use ABC 907 Value-Added versus Non-Value-Added Activities 907 Classification of Activity Levels 909 Activity-Based Costing in Service Industries 911 Traditional Costing Example 912 Activity-Based Costing Example 912 APPENDIX 17A: Just-in-Time Processing 916

Objective of JIT Processing 917 Elements of JIT Processing 918 Benefits of JIT Processing 918

Chapter 18

Cost-Volume-Profit 944

Don't Worry—Just Get Big 945 Cost Behavior Analysis 946 Variable Costs 946 Fixed Costs 947 Relevant Range 948 Mixed Costs 950 Importance of Identifying Variable and Fixed Costs 953 Cost-Volume-Profit Analysis 954 Basic Components 954

Basic Components 954 CVP Income Statement 955 Break-Even Analysis 958 Target Net Income 962 Margin of Safety 963

Chapter 19

Cost-Volume-Profit Analysis: Additional Issues 984

Rapid Replay 985
Cost-Volume-Profit (CVP) Review 986

Basic Concepts 986
Basic Computations 988
CVP and Changes in the Business
Environment 989

Sales Mix 992

Break-Even Sales in Units 992
Break-Even Sales in Dollars 994
Determining Sales Mix with Limited
Resources 997

Cost Structure and Operating Leverage 1000

Effect on Contribution Margin Ratio 1001

Effect on Break-Even Point 1001 Effect on Margin of Safety Ratio 1001 Operating Leverage 1001

APPENDIX 19A: Absorption Costing versus Variable Costing 1005

Example Comparing Absorption Costing with Variable Costing 1005 An Extended Example 1008 Decision-Making Concerns 1012 Potential Advantages of Variable Costing 1014

Chapter 20

Incremental Analysis 1040

Make It or Buy It? 1041

Management's Decision-Making Process 1042 Incremental Analysis Approach 1043 How Incremental Analysis Works 1043 Types of Incremental Analysis 1045 Accept an Order at a Special Price 1045

Make or Buy 1046 Sell or Process Further 1049 Repair, Retain, or Replace Equipment 1052 Eliminate an Unprofitable Segment or Product 1054 Other Considerations in Decision-Making 1056

Chapter 21

Budgetary Planning 1080

The Next Amazon.com? Not Quite 1081 Budgeting Basics 1082 Budgeting and Accounting 1082 The Benefits of Budgeting 1083 Essentials of Effective Budgeting 1083 Length of the Budget Period 1083 The Budgeting Process 1084 Budgeting and Human Behavior 1084 Budgeting and Long-Range Planning 1085 The Master Budget 1086

Preparing the Operating Budgets 1087 Sales Budget 1087 Production Budget 1088

Direct Materials Budget 1090 Direct Labor Budget 1093 Manufacturing Overhead Budget 1094 Selling and Administrative Expense Budget 1095 Budgeted Income Statement 1095 **Preparing the Financial Budgets 1097** Cash Budget 1097

Budgeted Balance Sheet 1101

Budgeting in Nonmanufacturing Companies 1102 Merchandisers 1102 Service Companies 1103 Not-for-Profit Organizations 1104

Chapter 22

Budgetary Control and Responsibility Accounting 1132

Turning Trash Into Treasure 1133 **Budgetary Control 1134** Static Budget Reports 1135 Examples 1135 Uses and Limitations 1136 Flexible Budgets 1137 Why Flexible Budgets? 1137 Developing the Flexible Budget 1139 Flexible Budget-A Case Study 1140 Flexible Budget Reports 1143 **Responsibility Accounting 1145** Controllable versus Noncontrollable Revenues and Costs 1147 Principles of Performance Evaluation 1147 Responsibility Reporting System 1149 Types of Responsibility Centers 1152 Responsibility Accounting for Cost Centers 1153 Responsibility Accounting for Profit Centers 1153 Responsibility Accounting for Investment Centers 1156 APPENDIX 22A: Residual Income—Another Performance Méasurement 1163 Residual Income Compared to ROI 1164 Residual Income Weakness 1164

Chapter 23

Standard Costs and Balanced Scorecard 1192

80,000 Different Caffeinated Combinations 1193 The Need for Standards 1194 Distinguishing Between Standards and Budgets 1194 Why Standard Costs? 1195 Setting Standard Costs 1196 Ideal versus Normal Standards 1196 A Case Study 1196 Analyzing and Reporting Variances from Standards 1200 Direct Materials Variances 1201 Direct Labor Variances 1204 Manufacturing Overhead Variances 1207 Reporting Variances 1209 Statement Presentation of Variances 1210 **Balanced Scorecard 1210** APPENDIX 23A: Standard Cost Accounting System 1216

Journal Entries 1216 Ledger Accounts 1218

APPENDIX 23B: A Closer Look at Overhead Variances 1219 Overhead Controllable Variance 1219 Overhead Volume Variance 1220 Chapter 24

Planning for Capital Investments 1244 Floating Hotels 1245

The Capital Budgeting Evaluation Process 1246 Cash Flow Information 1246 Illustrative Data 1248 Cash Payback 1248

Net Present Value Method 1250 Equal Annual Cash Flows 1251 Unequal Annual Cash Flows 1251 Choosing a Discount Rate 1252 Simplifying Assumptions 1253 Comprehensive Example 1254

Additional Considerations 1255 Intangible Benefits 1255 Profitability Index for Mutually Exclusive Projects 1257 Risk Analysis 1258 Post-Audit of Investment Projects 1259

Other Capital Budgeting Techniques 1260 Internal Rate of Return Method 1260 Comparing Discounted Cash Flow Methods 1262 Annual Rate of Return Method 1263

Appendix A

Specimen Financial Statements: Tootsie Roll Industries, Inc. A-1

The Annual Report A-1 Letter to the Stockholders A-2 Financial Highlights A-3 Management Discussion and Analysis A-6 Financial Statements and Accompanying Notes A-14 Auditor's Report A-28

Appendix B

Specimen Financial Statements: The Hershey Company B-1

Appendix C

Specimen Financial Statements: Zetar plc C-1

Appendix D

Time Value of Money D-1

Nature of Interest D-1 Simple Interest D-1 Compound Interest D-2

Future Value Concepts D-2 Future Value of a Single Amount D-2 Future Value of an Annuity D-4

Present Value Concepts D-7 Present Value Variables D-7 Present Value of a Single Amount D-7 Present Value of an Annuity D-9 Time Periods and Discounting D-11 Computing the Present Value of a Long-Term Note or Bond D-11 Using Financial Calculators D-14

Present Value of a Single Sum D-14 Present Value of an Annuity D-15 Useful Applications of the Financial Calculator D-15

Appendix E

Reporting and Analyzing Investments E-1

Why Corporations Invest E-1
Accounting for Debt Investments E-2

Recording Acquisition of Bonds E-2
Recording Bond Interest E-3
Recording Sale of Bonds E-3

Accounting for Stock Investments E-4

Holdings of Less Than 20% E-4
Holdings Between 20% and 50% E-5
Holdings of More Than 50% E-7

Valuing and Reporting Investments E-7

Categories of Securities E-8
Balance Sheet Presentation E-10
Presentation of Realized and
Unrealized Gain or Loss E-12
Statement of Cash Flows Presentation E-12

Appendix F (available online at www.wiley.com/college/kimmel)

Payroll Accounting F-1

Accounting for Payroll F-1 Determining the Payroll F-1 Recording the Payroll F-5

Employer Payroll Taxes F-8 FICA Taxes F-8 (Federal Unemployment Taxes F-8 State Unemployment Taxes F-8 Recording Employer Payroll Taxes F-9 Filing and Remitting Payroll Taxes F-9

Internal Control of Payroll F-10

Appendix G (available online at www.wiley.com/college/kimmel)

Subsidiary Ledgers' and Special Journals G-1

Expanding the Ledger—Subsidiary Ledgers G-1 Subsidiary Ledger Example G-2

Advantages of Subsidiary Ledgers G-3

Expanding the Journal—Special

Journals G-3

Sales Journal G-4 Cash Receipts Journal G-6 Purchases Journal G-10 Cash Payments Journal G-12 Effects of Special Journals on General Journal G-14

Appendix H (available online at www.wiley.com/college/kimmel)

Accounting for Partnerships H-1

Partnership Form of Organization H-1

Characteristics of Partnerships H-1 Organizations with Partnership Characteristics H-3 Advantages and Disadvantages of Partnerships H-3 The Partnership Agreement H-4 **Basic Partnership Accounting H-4** Forming a Partnership H-4 Dividing Net Income or Net Loss H-6 Partnership Financial Statements H-9 Admission and Withdrawal of Partners H-9

Liquidation of a Partnership H-10 No Capital Deficiency H-10 Capital Deficiency H-12

Appendix I (available online at www.wiley.com/college/kimmel)

Accounting for Sole Proprietorships 1-1

Sole Proprietorship Accounting I-1 Owner's Equity in a Sole Proprietorship I-2 Recording Transactions of a Proprietorship I-2 Financial Statements for a Proprietorship I-3 Closing the Books of a Proprietorship I-4 Preparing a Post-Closing Trial Balance for a Proprietorship I-7

Appendix J (available online at www.wiley.com/college/kimmel)

Pricing J-1

Pricing Goods for External Sales J-1

Target Costing J-2
Cost-Plus Pricing J-2
Variable-Cost Pricing J-5

Pricing Services J-6

Transfer Pricing for Internal Sales J-8
Negotiated Transfer Prices J-9
Cost-Based Transfer Prices J-12
Market-Based Transfer Prices J-13
Effect of Outsourcing on Transfer Pricing J-14

Transfers Between Divisions in Different

Countries J-14

Other Cost Approaches to Pricing J-15

Absorption-Cost Pricing J-16
Variable-Cost Pricing J-17

Company Index I-1

Subject Index I-3