

**FUNDAMENTALS OF**



# **ACCOUNTING**

**Fourth Edition**

# **FUNDAMENTALS OF ACCOUNTING**

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## **Fourth Edition**

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# PREFACE

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THIS TEXTBOOK IS DESIGNED for use in the first course in accounting. It is relatively thorough in its exploration of the logic or theory which underlies accounting, and it is not intended for use where the major emphasis is upon procedural aspects of accounting. Major stress is placed instead upon developing an ability to analyze and report economic events as they relate to a business enterprise. An attempt has been made to present the problems of accounting in their modern setting as to record-keeping forms and procedures, terminology, and recent developments in professional standards and practices.

Since many of the readers of this book will choose careers other than accounting, stress is placed on the uses of accounting data by those who receive them in the form of reports as well as on the compilation of the data. The emphasis upon accounting as a control device and a major tool of management is reflected in the addition of new chapters on internal control and managerial uses of cost data.

The organization of the material in this fourth edition is similar to that of the first three editions. Production situations are used frequently in the demonstrations and problems throughout the text. The principal change in organization has been the addition of new chapters on internal control and managerial uses of cost data. The former material on accounting for cash has been integrated in the new chapter on internal control. The chapters on income determination and income distribution have been combined, and this material has been moved back to Chapter 12.

Cost accounting and cost analysis are again given considerable attention. In Chapter 4 the distinction is drawn between manufacturing operations and selling activities. Chapter 17 contains an over-all review of manufacturing operations and statements. Chapters 18 and 19 constitute a comprehensive but elementary treatment of modern cost accounting, including the essential features of standard costs. The new Chapter 20 illustrates the use of cost accounting data in treating specific problems of management.

There is little isolation of partnership and corporation accounting problems. The sole proprietorship, the partnership, and the corporation are used throughout the book. Certain unusual problems, such as partnership dissolution, have been omitted as being more appropriate for advanced courses.

The analysis and interpretation of financial statements is treated thoroughly. All of the illustrative material has been brought up to date. The book seeks to assist in the development of an understanding of the uses and limitations of financial reports by describing the methods of accumulating, classifying, and recording accounting data, the alternative procedures which might be developed, and the various bases of valuation, and by presenting a critical analysis and interpretation of financial reports.

Two sets of problems have been provided for each chapter. One group, called "Questions and Problems," is designed for use in class discussion or outside work. The other set, "Laboratory Problems," consists of longer problems which are suitable for use in laboratory periods and can also be assigned for outside work. These are placed in a separate section following the text. Problems used in the third edition have been revised and many new problems have been added.

The authors gratefully acknowledge the many helpful comments which they have received from their colleagues and other instructors who have used the earlier editions.

P. M.  
S. D.  
J. S. S.

April 15, 1959

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# INTRODUCTION

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## **The Function of Accounting**

**ACCOUNTING** is the language in which most business events are expressed. Its major function is to record and interpret those events in such a way that the orderly and intelligent operation of the economic system is facilitated. In the fast-moving, interdependent economic world of to-day, it is difficult to make rational decisions without relying on quantitative data. Accounting is performing its job well if it presents these quantitative data in a way which leads to sound and realistic economic decisions.

## **Definition of Accounting**

Definitions are apt to have limited meaning at an early stage of study of a subject. Yet if they are considered carefully rather than being blindly committed to memory, they may contribute to an understanding of what the subject does or does not encompass. The Committee on Terminology of the American Institute of Certified Public Accountants has offered the following definition:

Accounting is the art of recording, classifying and summarizing in a significant manner, and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.<sup>1</sup>

A few comments on the definition may make it more useful. The first part of the definition states that accounting involves the recording of trans-

<sup>1</sup> *Accounting Terminology Bulletin*, No. 1, 1953, p. 9.

actions and events. In order that the recorded facts may be useful to management and others, a well-designed system of records, forms, and procedures must be used. Each event must be analyzed carefully as to its effect on the business, and then recorded in a systematic, orderly fashion. The recorded amounts become more useful when they are classified or arranged according to a predetermined plan. The information which has been carefully recorded and classified then must be summarized and presented in the form of reports to management and others who need the information thus presented in making decisions and in carrying out their activities. Interpretation deals with the general problem of making the reports more meaningful—of bringing out relationships and trends which make the reported data more significant to the user.

The statement that accounting is concerned with “transactions and events which are, in part at least, of a financial character” and that it deals with them “in terms of money” emphasizes the quantitative nature of accounting. It is the accountant’s task to express the vast complex of business events in dollar terms, so that the position and operations of a business may be compared with some desirable standard, with some other business, or with the same business at some earlier date.

### **Scope of Accounting**

One way to indicate the nature and scope of accounting is to list some of the questions to which accounting provides at least partial answers:

**1. What are the results of the operation of a business?**

**a.** Did the business enterprise make a profit or suffer a loss during a given period of time, such as a month, quarter, or year? The principal report which the accountant prepares in order to determine this is called the “income statement.” Other titles sometimes used for this report are “statement of earnings” or “profit and loss statement.” The income statement shows the items which resulted in the profit or loss—the revenue earned and the various expenses incurred. This report is probably the most important one prepared by the accountant. From it the management of a business and investors make some of their most important decisions.

**b.** What is the taxable income for the year? How much of the income must be paid out as taxes to the state and federal governments? Probably no single factor has been more important in the development of adequate accounting records than the necessity of filing annual federal and state income tax returns.

**c.** What did it cost to make each of the products of a manufacturing plant? This is the most common “cost accounting” problem. Lack

of sufficient information relating to costs of production has been one of the most important reasons for business failures.

**d.** What has it cost to sell or distribute the products manufactured, the goods purchased for sale, or the services furnished to customers? This is another “cost accounting” problem.

**e.** What has it cost to operate the various departments or divisions of a business enterprise? The manager of a department store, for example, will want to know how profitable each department has been. If an oil company operates ten filling stations, it will be important for the owners to know the costs of operation and the profits earned by each of them.

**2.** What is the financial position of a business at some given date? The report which answers this question is commonly known as the “balance sheet.” This statement shows, for the given date, the property or “assets” that the business owns, the debts or “liabilities” owed by the business to its creditors, and the present status of the investment of its owners or stockholders.

**3.** Are the results of operations and the financial position in accord with the plans that were made by management? An efficiently managed business enterprise, as well as a governmental unit, must plan its operations and must be able to check the progress of its plan or budget. Accounting records are essential both to make a budget and to check its operation.

**4.** Are payroll records properly kept? One of the most expensive and time-consuming operations in accounting work is the keeping of payroll records. Not only is it necessary to calculate the amount earned by each employee and see that his pay check is prepared correctly, but numerous deductions must be computed and paid to the proper agencies. These deductions include such things as federal and state payroll taxes (for example, old-age benefits and unemployment insurance), federal income tax withheld, retirement or pension-fund contributions, hospital insurance, and bond purchases. For federal and state tax purposes it is also necessary to keep a record of the amount each employee earned, the various amounts deducted from his wages, and the net amount he was paid for each payroll period as well as for the year. Each business subject to the various tax laws must prepare and file the required periodic reports with the proper governmental bodies.

**5.** Is information available for other reports to local, state, and federal governmental agencies? A great variety of reports are required by various divisions of the government for purposes of statistical information as well as tax collection. In addition to income tax returns, they include

such items as city and county property tax returns, sales tax returns, census reports, and the annual reports of corporations.

### **Users of Accounting Information**

The information which results from the accounting process is of interest to various groups concerned with a business. The managers of a business constantly rely upon accounting data in reaching decisions designed to promote efficient management at all stages of operations. Investors use the information in accounting statements to a great extent in arriving at their decisions. Most employees feel that they have a definite stake in the general well-being of the enterprise which they serve, and in recent times, especially in larger enterprises, accounting reports have been used to keep them informed. In recent years accounting data have also been used in connection with the collective bargaining between labor unions and employers. Banks and other credit agencies rely heavily upon accounting information in connection with the making of loans or extending of credit to business firms. Various governmental agencies, as has been indicated, are also interested in accounting reports as a basis for tax collections and for the provision of statistical information concerning business operations.

Thus far we have considered accounting as being useful primarily in a private business enterprise organized to seek profits and we shall devote primary attention to such firms. It is worth noting, however, that accounting is also valuable in many other enterprises. Cooperatives and non-profit agencies such as religious, charitable, and scientific organizations usually find accounting records indispensable in the administration of their affairs. Governmental units at all levels and institutions such as hospitals and universities are other important examples of organizations outside the field of private business enterprise that require accounting records. Such groups may handle large amounts of cash, own large investment portfolios and considerable amounts of fixed property, and have both short-term and long-term obligations outstanding. Highly developed systems of accounting have been devised to meet their needs.

A word of caution about the usefulness of accounting should be offered. Accounting should never be considered an end in itself. It should, instead, be viewed as a facilitating function, as a means of providing information that will aid in the reaching of wiser economic decisions. The maintenance of accounting records is a costly process, and in considering its extension the utility of the additional information provided must be weighed against the cost of providing it.

### **Bookkeeping and Accounting**

Practically all modern accounting systems make use of what has long been called "double-entry bookkeeping." This method of keeping records had its origin in the Middle Ages or before. The first published explanation of the process was printed in Italy in 1494 as a part of a book on mathematics. The author was a monk, Luca Paciolo (or Pacioli). The section on bookkeeping was merely a description of practices that had been followed for many years by Italian merchants.

If it is necessary to make a distinction between bookkeeping and accounting, it may be said that accounting includes bookkeeping but is a broader and more analytical subject. The accountant designs the system of records which the bookkeeper uses. The accountant takes the results of the bookkeeper's work—the figures which he has accumulated—checks them, and studies and organizes them so that management, investors, the government, and anyone else interested can get the information which they desire with a minimum of difficulty.

There is, however, no sharp line of distinction between the bookkeeper and the accountant. The accountant must understand and be able to direct the work of the bookkeeper although he may not be able to perform all of the routine tasks with a high degree of skill; for example, the accountant might not be able to operate a bookkeeping machine as well as the bookkeeper. A bookkeeper must be accurate and skillful in the routine technique of keeping records. A good bookkeeper will also have a useful understanding of the accounting system as a whole, will be able to exercise intelligent judgment in handling the transactions which occur, and will have some ability in organizing and presenting the results of his work.

### **Forms of Business Organization**

Primary attention in this text will be centered on the accounting for private business enterprises which are engaged in profit-seeking activities. There are three principal forms of organization of such enterprises—the sole proprietorship, the partnership, and the corporation. Most accounting problems and their methods of solution are identical for all three forms of organization; there are, however, a few special problems which may arise in connection with each form. It will be helpful, therefore, to discuss these forms of business organization briefly at this time as a background for the later treatment of certain accounting situations.

### **The Sole Proprietorship**

The sole proprietorship is a business owned by one individual. It is the most common form of organization and is especially common in the fields of retailing, service enterprises, and farming. In this form of organization the funds necessary for operation are supplied largely by the owner, although he may borrow a substantial portion from banks or other financial institutions. As a rule the proprietor is the active manager of his business, although it is conceivable that he might hire a manager and take part only in the more important matters of general policy.

There are few legal barriers to the creation of a business enterprise in this form. Special permission or a license must sometimes be obtained, as in the case of barbers, pharmacists, morticians, and liquor-store proprietors. There may be zoning ordinances prohibiting the establishment of some enterprises within certain areas. Both of these limitations, however, are directed against the type of business rather than the form of organization; in general, the sole proprietorship can be started without formal permission of any governmental agency.

The sole proprietorship is not recognized as a separate unit or entity for legal purposes. Business property is subject to the claims of the proprietor's personal debts, and personal resources entirely outside of a particular business venture are subject to the claims of business creditors. In case of bankruptcy, no distinction is made between personal and business obligations. Despite this legal merging, it is important that the financial affairs of the sole proprietorship be kept entirely separate from the other business and personal affairs of the proprietor.

### **The Partnership**

When two or more individuals combine their resources and efforts to carry on a business enterprise as joint owners, the form of organization is known as a partnership. There are no special restrictions in the use of the partnership form; it can be used with the same freedom as the sole proprietorship. It is employed for many types of businesses such as retailing, wholesaling, service enterprises, manufacturing, and contracting, and for professional groups such as legal and accounting firms.

A partnership is created by an agreement among the partners, no other legal formalities being necessary. This agreement is very important and it should be prepared in written form with a great deal of care. Such matters as the character of the business, the amount and form of the contribution of each partner, withdrawals of funds for personal use, division



of net income, and the procedures to be followed at the time of dissolution or death of one of the partners, should be given special attention. Unless these items are definitely agreed upon at the time the partnership is formed, they may be the cause of a great deal of misunderstanding and trouble later on.

Although under modern law the partnership has been given a limited degree of separate existence apart from the personal affairs of the individual partners, it is still basically not a separate legal entity. As a result, each partner ordinarily is fully responsible for all the debts of the firm, although should he have to pay more than his share as defined in the partnership agreement, he has the right to bring action against the other partners to recover this excess.

### **The Corporation**

Although sole proprietorships and partnerships are far more numerous than corporations, the corporation is the most important form of business organization from the standpoint of the volume of business. In manufacturing and mining, in transportation and public utilities, and in insurance and banking the corporation is the predominant form of enterprise. Most large-scale enterprises use this form, although there are many small-size corporations.

The corporation is also an association of individuals or groups who have pooled their capital in an enterprise. In the eyes of the law, however, the corporation is usually a separate legal entity—entirely distinct from the stockholders who make it up. The corporation itself, not the stockholders, holds title to property, makes contracts, and otherwise enjoys almost all of the legal rights of a natural person. Since the corporation is a separate legal being, it comes into existence only when formal authority for its creation has been granted by the state in which it is formed. Individuals wishing to form a corporation must file “articles of incorporation” with the secretary of state or some other designated state official, and when they have been approved, the legal existence of the corporation begins. Approval of the articles of incorporation is automatic in most cases.

The requirements as to what must be included in the articles of incorporation differ among the various states, but the articles usually contain at least the following items:

1. *Name of the corporation.* This must not conflict with names of other corporations registered in the state, and it may have to be in a certain prescribed form.