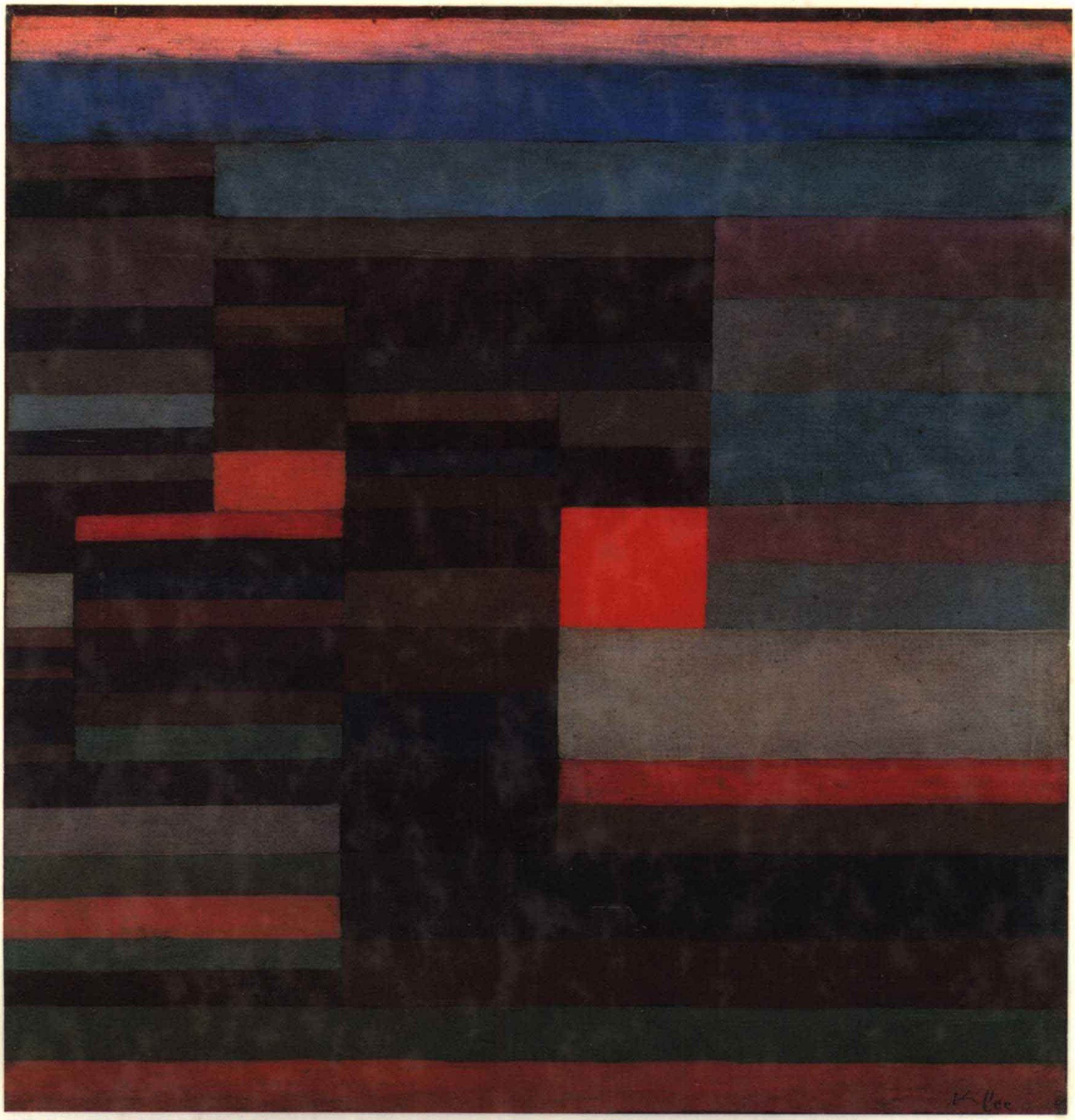
INTERMEDIATE ACCOUNTING

Standard Volume

Eighth Edition

Smith · Skousen



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PREFACE

The seventh edition of *Intermediate Accounting* was a significant revision of this widely accepted textbook. The response to the changes from both accounting educators and students has been very positive. Our objective of making this text the most teachable intermediate text on the market is still foremost in our minds in the revisions and refinements incorporated in the eighth edition. No major organizational changes were considered necessary to the many changes in the last edition. The 21 chapters are divided into four logically related parts. Each chapter contains three types of end-of-chapter materials: questions, exercises and problems. A brief description of the contents precedes each exercise and problem. Sufficient material is included for each chapter to permit varying assignments from class to class.

Since the publication of the seventh edition, the FASB has issued several new accounting standards. With few exceptions, these standards have dealt with specialized industry accounting issues. Because we have decided to be selective in our treatment of financial accounting topics, very few of these specialized areas are included in this edition. The few standards that have affected the text coverage have been interspersed throughout the text with the same conciseness and clarity used in previous editions. Appendix C provides a listing of all APB and FASB pronouncements to mid-1983 and the chapter references where the standard is discussed.

In addition to the issued standards, the FASB has been wrestling with many difficult conceptual and implementation issues that are still in various stages of investigation. These include the conceptual issues of current value and constant dollar information and its usefulness, income tax allocation, and reporting cash flows. We have added to this edition material related to these current study areas to provide students with an awareness of the complex issues still on the FASB agenda. These are long-term projects that have no quick and easy solutions. Differences of opinion among educators and practitioners are sincere and strong. We have tried to include these differing views in a way that should stimulate students' thinking and help them to realize the dynamic nature of the accounting profession.

In addition to work being done by the FASB, the Internal Revenue Service and the U.S. Congress have had some impact on topics in this text. New tax laws designed to stimulate the economy were passed in both 1981 and 1982. Some of the provisions in the new laws, such as the Investment Tax Credit (Chapter 15), directly affect the coverage of *Intermediate Accounting.* We have selectively updated material to describe the most current tax requirements.

Following is a brief description of the most significant changes in the eighth edition:

- Chapter 2—Changed illustration from manufacturing company to merchandising company.
- Chapter 3—Updated conceptual framework material; added Concepts Statement No. 3, "Elements of Financial Statements of Business Enterprises."
- Chapter 5—Expanded early discussion of funds statement with increased emphasis on cash flows.
- Chapter 11—Introduced and discussed implication of ACRS as substitute for accelerated depreciation on the tax return.
- Chapter 15—Updated for 1981 and 1982 income tax laws.
- Chapter 19—Introduced T-accounts in development of funds statement.

The annual newsletter is now arranged by chapters to permit instructors to update the text with new developments between editions. Each newsletter is indexed to permit an easy identification of changes that we feel should be made as the subject is taught.

The authors wish to thank the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the American Accounting Association for permission to quote from their various publications and pronouncements.

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ABOUT THE AUTHORS

Jay M. Smith, Jr., PhD, CPA, is Professor of Accounting at the School of Accountancy, Brigham Young University. He holds a bachelor's and a master's degree from BYU and a PhD from Stanford University. He has twenty-six years of teaching experience at BYU, Stanford University, the University of Minnesota where he served as department chairman for four years, and at the University of Hawaii. He has received several awards and recognitions in accounting, including fellowships from the Danforth and Sloan Foundations, the Distinguished Faculty Award from the BYU School of Management, and several teaching excellence awards. Professor Smith has written extensively in accounting journals and has been involved in several research projects, including work done on grants from the Ford Foundation, Peat, Marwick, Mitchell & Co., and Arthur Andersen & Co. He served as editor of the Education Research Department of the Accounting Review from 1976 to 1978, as secretary to the Auditing Section of the American Accounting Association, and as a member of the editorial board for the Auditing Section's journal. He is a member of the American Institute of CPAs, the Utah Association of CPAs, and the American Accounting Association and has served on numerous committees of these organizations.

K. Fred Skousen, PhD, CPA, is Professor of Accounting and Director of the School of Accountancy at Brigham Young University. He holds a bachelor's degree from BYU and the master's and PhD degrees from the University of Illinois. Professor Skousen has taught at the University of Illinois, the University of Minnesota, the University of California at Berkeley, and the University of Missouri. He received Distinguished Faculty Awards at the University of Minnesota and at BYU and was recognized as the National Beta Alpha Psi Academic Accountant of the Year in 1979. Professor Skousen is the author or co-author of numerous articles, research reports, and books. He served as Director of Research and a member of the Executive Committee of the American Accounting Association and is a member of the American Institute of CPAs, the Accounting Research Association, and the Utah Association of CPAs. He is currently serving on the Board of Directors of the UACPA and on Council for the AICPA. Dr. Skousen has also served as a consultant to the Controller General of the United States, the Federal Trade Commission, the California Society of CPAs, and several large companies. He was a Faculty Resident on the staff of the Securities and Exchange Commission and a Faculty Fellow with Price Waterhouse and Co.

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1 THE ACCOUNTING PROFESSION

CHAPTER OBJECTIVES

Describe the nature of accounting and the various opportunities available to students with an accounting background.

Identify the key historical events that have affected the growth and development of accounting.

Describe the public accounting profession and its entry requirements.

Identify and describe the organizations that exercise the greatest influence on the accounting profession.

Encourage students to prepare themselves for the many challenges facing accountants.

This text centers upon the accounting profession, one of society's youngest and most exciting professions. Traditionally, the term "professional" has been used to designate a doctor, dentist, or lawyer—members of old and established professions. Increasingly, however, students are discovering the challenges and opportunities of accounting. To help students understand more fully the profession of accounting, this introductory chapter will focus on (1) the different types of accountants and their attributes, (2) the historical development of the profession, and (3) the organizations that exercise significant influence on members of the accounting profession.

WHAT IS ACCOUNTING?

As indicated in the following quotation, the objective of accounting is to provide information that can be used in making economic decisions.

> Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions — in making reasoned choices among alternative courses of action.[1]

Several important concepts are included in this definition of accounting. Accounting is a **service activity**. It is intended to fulfill a **useful** function in our society by offering to provide service to various segments of the economic community involved directly or indirectly with business entities. It is primarily concerned with **quantitative financial information** describing the activities of a business, rather than qualitative, judgmental evaluations of those activities. The output of the accounting system is intended to serve as an aid to users who must make **economic decisions** among alternative actions available to them.

Economists and environmentalists remind us that we live in a world with limited resources. We must use our natural resources, our labor, and our financial wealth wisely so as to maximize their benefits to society. The better the accounting system that measures the cost of using these resources, the better the decisions that can be made for allocating them. To the extent that accounting information meets these needs, the accounting system is fulfilling its major purpose. As the needs of society and environmental conditions change, the techniques, concepts, and to some extent even the basic objectives of accounting must also change.

Management Accounting and Financial Accounting

A distinction is commonly made between management (or managerial) accounting and financial accounting. **Management accounting** is primarily concerned with information used for management decision making within the entity. Accurate and timely information is essential to management in making short-term operating decisions and long-term resource allocation decisions. Do we make this product or another one? Do we build a new production plant or expand existing facilities? Do we increase prices or cut costs?

The information required by management for making both short- and long-term decisions should be supplied by a well-integrated management information system. The type and amount of information generated by any particular system is determined by the needs and desires of management.

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[1] *Statements of the Accounting Principles Board, No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" (New York: American Institute of Certified Public Accountants, 1970), par. 40.

Although general guidelines exist for these management information systems, specific details vary widely among industries and among entities within the same industry.

More businesses have failed because of poor management decisions, often based on inadequate accounting information, than because of inferior technology or products. The critical need for trained management accountants is especially evident when economic conditions are unstable and demand a rapid analysis of the impact of external factors on a company's well-being.

The other area of accounting, and the one this text is primarily concerned with, is financial accounting. In contrast with management accounting, **financial accounting** focuses on the information needs of users outside the entity. The primary external users of financial information include creditors, investors, government agencies, and the general public. These groups are interested in the financial activities of an entity but are not directly involved in its operations. They must rely upon those managing the enterprise to provide a stewardship report of their activities in the form of financial statements. They are not in a position to obtain directly the information they desire.

Most external users are interested in more than one entity and need to compare the financial statements of two or more entities in order to evaluate their relative efficiencies. These users may wish to make choices among reporting entities. Examples of these choices include investing decisions by stockholders, lending decisions by banks and other credit institutions, and employment decisions by employees. Essentially, these are all resource allocation decisions. In order to permit comparisons of financial statements, a consistent and comparable pattern must be followed in summarizing and reporting information to external users. The development of principles and procedures to promote uniformity, consistency, and quality in financial reporting is the subject matter of financial accounting.

The Accounting Profession

The accounting profession may be subdivided into two major segments: public accounting and internal accounting. The **public accountant** functions as an independent expert and performs services for many clients. The **internal accountant** may have similar training and perform duties similar to those of a public accountant, but works for a single entity, generally in a staff position. The two major segments of the profession can be further subdivided as follows:

Public Accounting	Internal Accounting
External auditor	Financial or general accountant
Tax specialist	Cost accountant
Management consultant	Internal auditor
	Tax accountant
	Systems analyst

Public Accounting. The term "public accounting" is generally equated with the services provided by **certified public accountants (CPAs)**. Public accounting firms offer various services to clients, primarily auditing, tax, and management consulting services. In addition, these firms provide accounting services, such as preparation of financial statements, for some "small business" clients.

Auditing is the dominant activity in larger public accounting firms. The **external (independent) auditor** examines the financial statements of a client and expresses an opinion as to the fairness of the statements and their adherence to generally accepted accounting principles. The auditor must be knowledgeable in accounting and must also possess skills in evaluating evidence that supports the amounts reported in the financial statements prepared by the client. The financial statements of all publicly held companies must be examined by an external auditor. Many privately held companies also engage public accounting firms to audit their financial statements, since audited statements are frequently required to obtain credit and in some cases to provide assurance to stockholders who are not actively involved in management.

In contrast with lawyers, the auditor does not serve solely as an advocate for the client who pays for the services. An auditor has a professional obligation to protect the interests of society as an independent expert. External users of financial statements must rely on the auditor's opinion as to the fairness of management's representations in the financial statements. This relationship between the external auditor, the client, and society is unique to the accounting profession.

Tax specialists in public accounting firms prepare tax returns and assist clients in tax planning and in resolving tax problems. CPAs also function as **management consultants**, offering advice to clients in such areas as systems design, organization, personnel, finance, internal control, and employee benefits. These services are frequently referred to as **management advisory services (MAS)**.

CPAs in large public accounting firms typically specialize in auditing, tax, or MAS. The degree of specialization decreases as firm size decreases. The nature of public accounting firms and the requirements for becoming a CPA are discussed in detail later in the chapter.

Internal Accounting. A team of internal accountants is generally necessary to provide the data required for both internal and external reporting. The **financial or general accountant** is primarily concerned with the recording and summarizing of financial accounting information and the preparation of financial statements. **Cost accountants** are responsible for analyzing detailed cost information and preparing various reports for use by management.

Internal auditors review the work performed by accountants and others within the enterprise and report their findings to management. Although internal auditors are employees of the enterprise, they must be independent with respect to the employees whose work they review. Thus, internal auditors generally report to a high level of management. External auditors frequently rely to some extent on the work performed by internal auditors.

Internal **tax accountants** may be employed to prepare tax returns and advise management in matters relating to taxation. A company may also employ **systems analysts** who design and monitor information systems.

HISTORICAL DEVELOPMENT OF ACCOUNTING

Accounting has been called "the language of business." Its development has closely paralleled the needs arising from reporting increasingly complex business and economic transactions. Among the earliest accounting records were those kept as part of the feudal system during the early middle ages. Lords of the manors collected taxes from their subjects, and used the proceeds to further the work of the estate and to meet their personal needs. A report of stewardship was prepared by the more conscientious of the lords for review by their subjects. Another activity during this period that involved the accountant's skills was the maintaining of voyage records for those involved with trade between countries. These records were usually maintained for a single voyage, at the end of which the records were closed, and the profit or loss was calculated. Banking institutions, which arose in the 11th and 12th centuries in the Italian states, often lent money to finance such voyages. These various business activities required a record of income and outgo, especially when the spoils were divided at the end of the voyage.

Because many of these business ventures originated in the European countries bordering on the Mediterranean Sea, such as Spain, Portugal, Italy, and Greece, it is not surprising that one of the earliest treatises in accounting was written by an Italian monk, Luca Paciolo. He was really a mathematician who used his analytical skills to describe the system of double-entry accounting, which had been evolving for decades. The work was first published in 1494 and carried the title *Summa de Arithmetica Geometria Proportioni et Proportionalita.*

Accounting did not progress rapidly as a discipline until business began to grow in size, and until a need arose to distinguish more clearly between the ownership of the entity and its operation. The Industrial Revolution had its birth in England, and it was there that the increased need for accounting developed. In 1845, the first Companies Act was passed permitting a business to be organized as a company with the status of a legal entity. These companies could borrow money, issue stock, pay debts, and carry on activities in the same manner as an individual. This new organizational form permitted the pooling of capital by many individuals to acquire the economic resources necessary to produce newly invented goods or to expand operations. Since many different individuals provided financial resources to carry out these business functions, a need arose to account to these investors and creditors for the use of their resources. This accounting took the form of financial reports that summarized the increase or decrease in resources over a period of time and the current status of the resources. In the United States, this concept of separate legal entities became popular as states such as New

York, Vermont, and Massachusetts passed corporation laws and created new entities with the same attributes as their English counterparts.

As the Industrial Revolution took hold in the United States, companies grew in size. Large personal fortunes were invested in corporations, marking the beginnings of Standard Oil, American Telephone and Telegraph, Ford Motor Company, and other twentieth-century industrial giants. Accounting systems became even more important following the adoption in 1913 of the Sixteenth Amendment to the U. S. Constitution giving the federal government the power to tax income. This placed added emphasis upon the concept of income to measure the ability of individuals and corporations to supply resources to the government for expanded social and defense needs.

A serious problem emerged as the need for accounting increased. Because the discipline had grown so rapidly, and because business activities were changing at an ever-increasing pace, accounting procedures had to be developed without extended debate or discussion. Accountants developed methods that seemed to meet the needs of their respective companies, resulting in diverse procedures among companies in accounting for similar activities. The comparability of the resulting financial reports, therefore, was often questionable. Management could manipulate the records and produce significantly different results depending upon the desired objective. During the 1920s, the differences led to financial statements that were often inflated in value. Market values of stocks rose higher than the underlying real values warranted until the entire structure collapsed in the Great Depression of the early 1930s. The government of the United States, under the leadership of President Franklin D. Roosevelt, vigorously attacked the depression, and among other things, created the Securities and Exchange Commission (SEC). This new agency was given a responsibility to protect the interests of stock investors by preventing a recurrence of the conditions that led to the stock market crash in 1929. In 1933, Congress passed the Securities Act and in 1934, the Securities Exchange Act. The broad power granted to the SEC by Congress will be more fully discussed in a separate section. The emergence of the SEC forced the accounting profession to unite and to become more diligent in developing accounting principles and ethics to govern the profession. The SEC required independent audits of companies that came under its jurisdiction. This was a great boost to the field of auditing, and has resulted in a tremendous increase in the number of certified public accountants who fill the role of external auditor.

World War II brought a pause in the growth of the profession, but the prosperity that followed the war and the introduction of electronic data processing equipment into business systems created needs for increasingly sophisticated accounting systems. New high-technology industries such as television, aerospace, electronics, and synthetic fibers required systems that could organize vast amounts of accounting data into financial reports needed to meet varied users' needs. More responsibility was forced onto the professional accountants by the courts as class-action civil suits and even criminal suits were brought against accountants who were accused of being negligent in performing their functions.

In the late 1970s, several Congressional committees studied the profession, and even proposed legislation to further control accounting and overcome perceived weaknesses in it. These included the Metcalf Committee, a Senate committee that published a mammoth report in 1977 called the *Accounting Establishment*, and the Moss Committee, a House of Representatives committee that drafted and introduced legislation to regulate the accounting profession. Because of these activities, several changes were made within the structure of the accounting profession to answer some of the criticism of the congressional committees. The SEC was asked to report annually to Congress to evaluate the progress of the profession. The SEC annual reports have generally been positive, and the attempt to regulate the profession externally has been abandoned by Congress, at least for the present. The profession, however, recognizes a need to continually strive to improve the quality of its work if it wishes to retain the right of self-regulation.

This brief review of accounting history demonstrates clearly how accounting in the United States has changed to keep pace with a rapidly changing economy. Similar changes have occurred in other countries, and more international co-operation in accounting is taking place each year. With the past as a guide, it can be assumed that there are many exciting challenges ahead for those who are part of the accounting profession. The organizations that have been and will continue to be instrumental in helping direct these changes are identified and discussed later in the chapter.

PUBLIC ACCOUNTING

Members of certain professions—notably medicine and law—are charged with an especially high degree of public responsibility. Characteristics of such a profession include the licensing of members and a restriction on entry into the profession based upon such variables as education, experience, and the passing of a qualifying examination. Public accounting acquired these characteristics early in its development. England and its related countries in the British Empire identified its professionals as "Chartered Accountants" (CAs), and in the United States the designation became "Certified Public Accountant" (CPA).

The CPA Certificate

Public accounting developed rapidly in response to the need to add a degree of credibility to the financial statements being issued to investors and other users. The first CPA certificate was issued by the State of New York in 1896. It followed the pattern developed in England where the first CA certificate was issued in 1854. The establishment of laws providing for public accounting certification quickly spread to other states. By 1908, there were sixteen states issuing CPA certificates, and by 1925, all states and territories