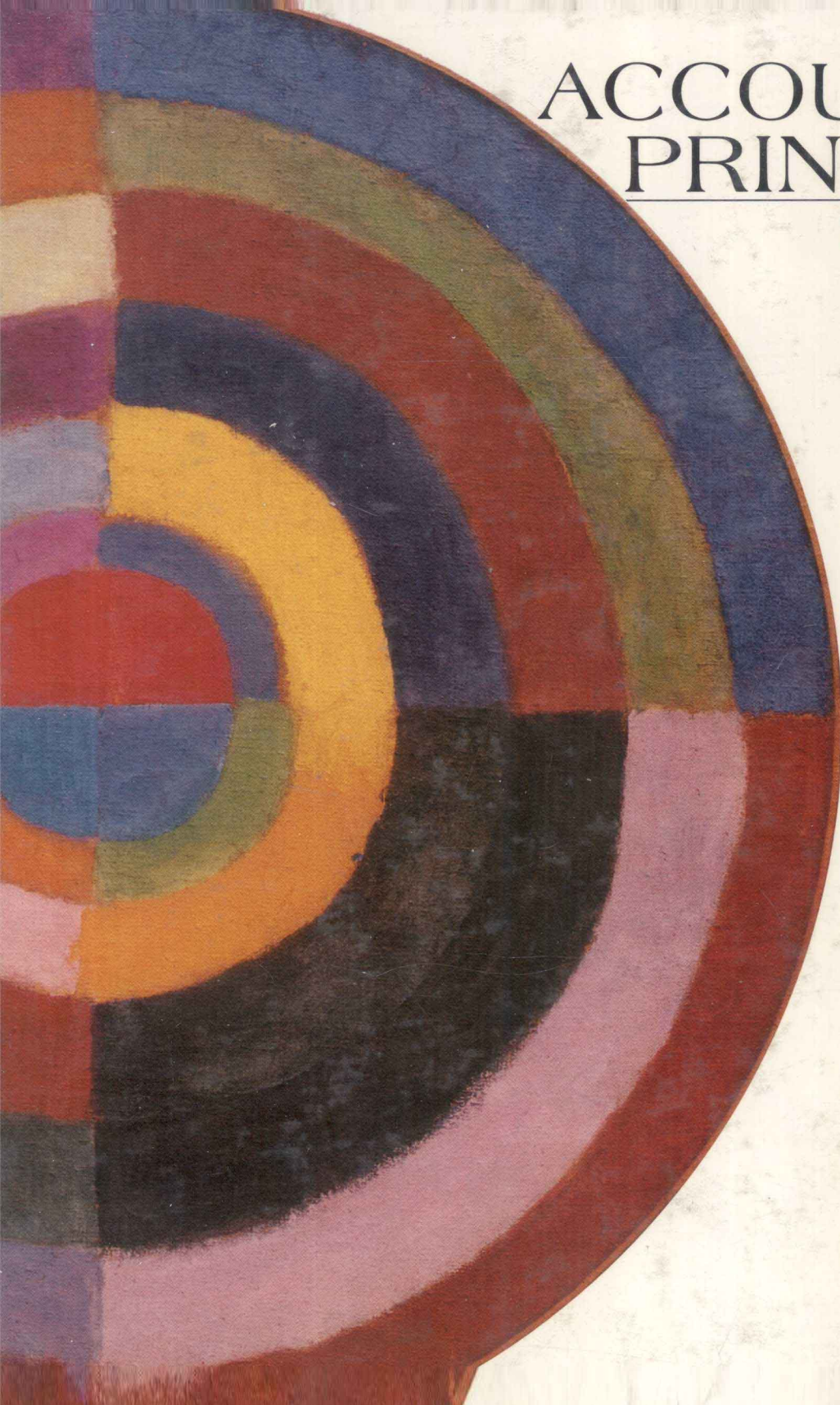


14th Edition

ACCOUNTING PRINCIPLES

WARREN · FESS · WARREN



14th Edition
**ACCOUNTING
PRINCIPLES**

PHILIP E. FESS, CPA, PhD
Professor of Accountancy
University of Illinois, Champaign-Urbana

CARL S. WARREN, CPA, PhD
Professor of Accounting
University of Georgia, Athens



Published by

SOUTH-WESTERN PUBLISHING CO.

CINCINNATI WEST CHICAGO, ILL. DALLAS PELHAM MANOR, N.Y. PALO ALTO, CALIF.

**Cover photograph: *Premier Disque* by Robert Delaunay from
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ISBN: 0-538-01220-X

Library of Congress Catalog Card Number: 83-50729

56789K76

Printed in the United States of America

Preface

The fourteenth edition of ACCOUNTING PRINCIPLES is a student-oriented text. It presents the fundamental accounting concepts and procedures in a logical, concise, and clear manner. It provides a foundation that allows instructors to focus on clarifying issues and increasing the student's understanding of accounting and its uses. This student orientation is one of the principal reasons why this text has been used by more students than any other for more than 50 years and why it is still the leader in teaching principles of accounting.

After an "Introduction" which presents a summary of the beginnings of accounting in 1494 to the present, accounting principles and practices are presented in a balanced approach. The fundamental concepts and principles are presented in a business environment that enables students to understand accounting as it is applied in serving not only the business world but all of society. Such an approach is designed to fulfill the needs of college students planning a career in accounting, as well as those studying business administration, liberal arts, law, and other disciplines.

Many innovations are included in this edition of ACCOUNTING PRINCIPLES. A section on professional ethics has been added to Chapter 1. In the first five chapters, the focus is on the basic structure of accounting, including accounting for merchandising enterprises. The fundamentals are presented without such complexities as special journals and subsidiary ledgers, and ten-column work sheets are used to facilitate understanding.

Chapter 6 emphasizes the qualities of a properly designed accounting system, including the principles of internal control and the use of special journals and subsidiary ledgers. The remaining chapters build on these first six chapters, which emphasize the foundation of accounting systems.

Chapters 7–11 have been reorganized to present the basic concepts of financial accounting. These chapters begin with cash and, in balance sheet order, proceed through receivables and temporary investments, inventories, plant assets and intangible assets, and current liabilities. Chapter 12 ties together the generally accepted accounting concepts and principles presented in the first 11 chapters and expands the discussion to include additional accounting principles.

Chapter 13, "Reporting Changes in Price Levels", has been added to respond to the increasing emphasis in accounting for changing price levels. Chapters 14–18 present the special accounting issues related to partnerships and corporations. In the concluding chapter, on consolidated financial statements and other reports, the work sheet approach has been added as an aid to preparing consolidated statements. The presentation is such that those instructors who wish to do so may omit the work sheet material. In addition, accounting for foreign operations has been added to Chapter 18.

Chapter 19 continues to emphasize the basic concepts applicable to the use of the statement of changes in financial position. Appendix E has been added for those who wish to use the work sheet in preparing the statement.

Chapters 20–27, which present financial analysis and other managerial concepts, continue to emphasize control accounting and decision-making. For possible use in conjunction with Chapter 22 on accounting for manufacturing enterprises, Appendix F has been added on the manufacturing work sheet. The chapter on income taxes and their effect on business decisions (Chapter 27) has been updated to reflect current changes in the Internal Revenue Code. In Chapter 28, the discussion of personal financial statements has been significantly revised to reflect changes due to the issuance of recent professional pronouncements.

A mini-case has been added at the end of each chapter. The mini-cases are designed to stimulate student interest by presenting situations with which students may easily identify. Each case emphasizes important chapter concepts.

Those familiar with earlier editions will recognize the continuance of many successful features. Learning objectives are presented at the beginning of each chapter to serve as stimuli for the student's study and learning. Five self-examination questions are provided at the end of each chapter. After studying the chapter, the students can answer these questions and compare their answers with those appearing in Appendix C. In this manner, students can assess the degree to which they understand the material presented in each chapter. Appendix C presents an explanation of both the correct and incorrect answers for each question and thus increases understanding and further enhances learning.

A glossary of technical terms and common business and accounting expressions is included as Appendix A. The terms included in the glossary are printed in color the first time they are presented in the text.

As in the preceding edition, the variety and volume of the questions, exercises, and problems presented at the end of each chapter provide a wide choice of subject matter and range of difficulty. They have been carefully written and revised to be both practical and comprehensive. An additional series of problems is provided (Appendix B), and the working papers correlating with the problems are designed to relieve students of the burden of repetitive details so that attention may be more effectively directed to mastery of the underlying concepts. In Appendix G, a complete set of financial statements from the annual reports of two companies and selected statements for other companies are reproduced. Notes to facilitate the use of this appendix are presented in the manual. These notes cross-reference the concept, form, or method illustrated in the appendix to the appropriate chapter in the text, and often include relevant data extracted from *Accounting Trends and Techniques*.

Four manual practice sets and two computerized practice sets are available for use in developing greater student proficiency or for review purposes. Each set requires the recording, analysis, interpretation, and reporting of accounting data. A study guide with solutions, student check sheets, transparencies of solutions to text problems, objective tests (including a set of multiple-choice tests), examination problems, true-false questions, multiple-choice questions, a computerized testing program, teaching outlines, and other teaching aids are also available.

Throughout the text, relevant statements of the Financial Accounting Standards Board and other authoritative publications are discussed, quoted, paraphrased, or footnoted. The authors acknowledge their indebtedness to the American Accounting Association, the American Institute of Certified Public Accountants, and the Financial Accounting Standards Board for permission to use materials from their publications.

The authors acknowledge with gratitude the helpful suggestions received from many instructors who have used earlier editions. Although space limitations prohibit a listing of all of those who have made significant contributions, we acknowledge with sincere thanks the detailed suggestions and recommendations submitted by Professor Gene Willis, University of Illinois, Champaign-Urbana.

Philip E. Fess
Carl S. Warren

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**TEXT
OBJECTIVES**

Describe the evolution and the basic structure of the accounting profession and of the concepts of accounting.

Describe and illustrate accounting systems for merchandising and manufacturing enterprises.

Describe and illustrate accounting systems for sole proprietorships, partnerships, and corporations.

Describe and illustrate accounting concepts for planning, controlling, and analyzing business operations.



Introduction:

Evolution of Accounting

Accounting has evolved, as have medicine, law, and most other fields of human activity, in response to the social and economic needs of society. As business and society have become more complex over the years, accounting has developed new concepts and techniques to meet the ever increasing needs for financial information. Without such information, many complex economic developments and social programs might never have been undertaken. This introduction is devoted to a brief résumé of the evolution of accounting.

PRIMITIVE ACCOUNTING

People in all civilizations have maintained various types of records of business activities. The oldest known are clay tablet records of the payment of wages in Babylonia around 3600 B.C. There are numerous evidences of record keeping and systems of accounting control in ancient Egypt and in the Greek city-states. The earliest known English records were compiled at the direction of William the Conqueror in the eleventh century to ascertain the financial resources of the kingdom.

For the most part, early accounting dealt only with limited aspects of the financial operations of private or governmental enterprises. There was no systematic accounting for all transactions of a particular unit, only for specific types or portions of transactions. Complete accounting for an enterprise developed somewhat later in response to the needs of the commercial republics of Italy.

DOUBLE-ENTRY SYSTEM

The evolution of the system of record keeping which came to be called "double entry" was strongly influenced by Venetian merchants. The first known description of the system was published in Italy in 1494. The author, a Franciscan monk by the name of Luca Pacioli, was a mathematician who taught in various universities in Perugia, Naples, Pisa, and Florence. Evidence of the position that Pacioli occupied among the intellectuals of his day was his close friendship with Leonardo da Vinci, with whom he collaborated on a mathematics book. Pacioli did the text and da Vinci the illustrations.

Goethe, the German poet, novelist, scientist, and universal genius, wrote about double entry as follows: "It is one of the most beautiful inventions of the human spirit, and every good businessman should use it in his economic under-

takings.”¹ Double entry provides for recording both aspects of a transaction in such a manner as to establish an equilibrium. For example, if an individual borrows \$1,000 from a bank, the amount of the loan is recorded both as cash of \$1,000 and as an obligation to repay \$1,000. Either of the \$1,000 amounts is balanced by the other \$1,000 amount. As the basic principles are developed further in the early chapters of this book, it will become evident that “double entry” provides for the recording of all business transactions in a systematic manner. It also provides for a set of integrated financial statements reporting in monetary terms the amount of (1) the profit (net income) for a single venture or for a specified period, and (2) the properties (assets) owned by the enterprise and the ownership rights (equities) to the properties.

When the resources of a number of people were pooled to finance a single venture, such as a voyage of a merchant ship, the double-entry system provided records and reports of the income of the venture and the equity of the various participants. As single ventures were replaced by more permanent business organizations, the double-entry system was easily adapted to meet their needs. In spite of the tremendous development of business operations since 1494, and the ever increasing complexities of business and governmental organizations, the basic elements of the double-entry system have continued virtually unchanged.

INDUSTRIAL REVOLUTION

The Industrial Revolution, which occurred in England from the mid-eighteenth to the mid-nineteenth century, brought many social and economic changes, notably a change from the handicraft method of producing marketable goods to the factory system. The use of machinery in turning out many identical products gave rise to the need to determine the cost of a large volume of machine-made products instead of the cost of a relatively small number of individually handcrafted products. The specialized field of cost accounting emerged to meet this need for the analysis of various costs and for recording techniques.

In the early days of manufacturing operations, when business enterprises were relatively small and often isolated geographically, competition was frequently not very keen. Cost accounting was primitive and focused primarily on providing management with records and reports on past operations. Most business decisions were made on the basis of this historical financial information combined with intuition or hunches about the potential success of proposed courses of action.

As manufacturing enterprises became larger and more complex and as competition among manufacturers increased, the “scientific management concept” evolved. This concept emphasized a systematic approach to the solution of management problems. Paralleling this trend was the development of more sophisticated cost accounting concepts to supply management with analytical techniques for measuring the efficiency of current operations and in planning for future operations. This trend was accelerated in the twentieth century by the advent of the electronic computer with its capacity for manipulating large masses of data and its ability to determine the potential effect of alternative courses of action.

¹Goethe, Johann Wolfgang von, *Samtliche Werke*, edited by Edward von der Hellen (Stuttgart and Berlin: J. G. Cotta, 1902–07), Vol. XVII, p. 37.