SALMONSON EDWARDS HERMANSON

A SURVEY OF BASIC

ACCOUNTING

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PREFACE

This fourth edition of *A Survey of Basic Accounting* is designed for use by those who wish to obtain a basic understanding of financial and managerial accounting. Accounting topics are introduced and discussed on the assumption that the reader has no prior knowledge of accounting.

We have sought in this book to introduce topics in a manner that emphasizes the output of the accounting process. While some attention is directed toward procedures and techniques used to accumulate accounting information, the major emphasis is on the content of accounting reports and on the interpretation and possible uses of this information.

This fourth edition has been thoroughly updated and substantially revised. A new introduction to the text appears in this edition. The first 12 chapters are devoted to a discussion of topics that relate largely to the determination and reporting of net income and financial position and to the basic theory underlying the financial statements of business corporations. Here again we have deliberately sought to emphasize certain subject matter because we believe that knowledge of it is crucial in gaining an understanding of financial accounting and financial reporting. For example, we direct attention to the alternative approaches to accounting for inventories and plant assets since these approaches may produce substantially different measurements of net income and of financial position. We also discuss such matters as the theory underlying accounting statements, the appraisal of financial position and the adequacy of earnings, stockholders' equity, debt financing and investments, changes in financial position, and inflation accounting. We omit largely procedural matters, such as payroll accounting and specialized journals.

The remaining eight chapters deal with topics that are likely to be of concern to management in directing the internal affairs of a business. The topics discussed include income determination, cost concepts, and cost systems in manufacturing operations; responsibility accounting and segment analysis; the budget; cost-volume-profit analysis; short-term decisions; tax considerations; and capital budgeting. We believe that knowledge of the topics included is essential to every reader who aspires to an executive position in business if he or she expects to understand accounting reports, to plan and control the operations of a business, and to communicate with other executives. Appendix A covers the increasingly important topic of international accounting and is a new feature of this edition.

We have designed this text for use in a one-term survey-of-accounting course. It will provide students who have no prior knowledge of accounting with the background necessary for further courses dealing with the accumulation, interpretation, and use of accounting information.

Various approaches may be taken in using this book in a one-quarter or a one-semester course. For a primarily "financial" course, one could focus attention on the first 12 chapters. If management accounting is to be emphasized, one could cover Chapters 1–4 and then concentrate on the last eight chapters. Alternatively, a balanced approach could be taken by covering all the chapters or by covering selected chapters from both groupings.

Questions, exercises, and problems are provided at the end of each chapter in sufficient quantity for use in classroom discussion and for assignment as homework. An instructor's manual and a combination study guide and work papers booklet for students are available. The student booklet has been strengthened considerably with the addition of from 15–25 multiple choice questions with answers and explanations for each chapter.

We are indebted to a number of members of the faculties of our respective universities for helpful comments on the organization and content of this book. In addition, we would like to acknowledge specifically the assistance of Martin A. Bubley, Northern Illinois University; V. Bruce Irvine, University of Saskatchewan; Gerald L. Johnson, California State University, Fresno; Larry N. Killough and Rosalind Cranor, both of Virginia Polytechnic Institute and State University; Richard D. Lamb, University of New Hampshire; Lawrence Rittenberg, University of Wisconsin; Deborah A. Wheless, University of Alabama; and Donald L. Wilson, University of Georgia.

Barbara Howard and Dianne Hermanson provided capable and efficient service in typing the manuscript. But we, of course, bear full responsibility for any deficiencies in the text.

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INTRODUCTION: THE ACCOUNTING ENVIRONMENT

Many decisions are made daily in our society that have economic consequences, such as whether our savings should be invested in a savings account, in government bonds, or in shares of stock issued by business corporations. We may feel that our savings can be quite safely invested in a savings account or a government bond, but we are far less certain about the outcome of an investment in shares of stock. To make an informed decision, we need information about the economic activity of corporations that issue such shares. It is at this point that accounting enters the picture, since accounting is a primary source of information on economic activity.

Economic activity includes the production, exchange, and consumption of scarce goods and is found everywhere in our society. Accounting is nearly as extensive. Accounting is needed to show what activity was accomplished at what cost. This statement is true whether resources are used by individuals, business firms, or not-for-profit entities such as churches, units of government, and hospitals. Although accounting is used in all types of organizations, attention in this text will center on accounting and reporting by business firms.

ACCOUNTING DEFINED

Accounting *is the process used to measure and report relevant financial information regarding the economic activity of an organization or unit.*[1] This information is stated in monetary terms.

When people first study accounting, they often confuse it with bookkeeping. Bookkeeping involves the recording of business activities and is a very mechanical process. Accounting includes bookkeeping but goes well beyond it. Accountants prepare financial statements; conduct audits; design accounting systems; prepare special studies, forecasts, and budgets; do income tax work; and analyze and interpret financial information.

In performing their work, accountants *observe* the economic scene and *select* (or identify) those events they consider evidence of economic activity, such as the purchase and sale of goods and services. Then these events are *measured* in financial terms and *recorded* to provide a permanent history of the financial activities of the organization. In order to *report* upon what has happened, accountants *classify* their measurements of recorded events into meaningful groups and *summarize* these measurements to avoid excessive detail. Finally, accountants may be asked to *interpret* the contents of their statements and reports. Interpretations involve explanations of the uses, meanings, and limitations of accounting information.

Accounting may also be defined as an *information system* designed to provide, through financial statements, relevant financial information. In designing this system, accountants keep in mind the types of users of the information (for example, owners and creditors) and kinds of decisions users make which require financial information. Usually, information provided by accounting relates to the economic resources owned by an organization, claims against these resources, changes in both resources and claims, and results of using these resources for a given period of time.

EMPLOYMENT OPPORTUNITIES IN ACCOUNTING

In our society, accountants typically are employed in (1) public accounting, (2) private industry, or (3) the not-for-profit sector. Within each of these areas, specialization is possible; an accountant may, for example, be considered a professional in auditing, systems development, budgeting, or cost or tax accounting.

Public Accounting

To become a **certified public accountant (CPA),** a person must pass a national examination prepared and graded by the **American Institute of Certified Public Accountants (AICPA)**—the accounting equivalent of the American Bar Association or American Medical

[1] A complete discussion of the objectives of financial reporting is contained in FASB, *Statement of Financial Accounting Concepts No. 1,* "Objectives of Financial Reporting by Business Enterprises" (Stamford, Conn., 1978). Further reference will be made to this FASB Statement in Chapter 12.

Association. After passing the CPA examination and meeting certain other requirements (such as work experience), an individual may be licensed by a state to practice as a certified public accountant. As an independent professional accountant, a CPA may offer clients auditing, management advisory, and tax services. Clients may be business firms, individuals, or not-for-profit organizations.

Auditing. When a business seeks a loan or wants to have its securities traded on a stock exchange, it is usually required to provide statements on its financial affairs. Users of financial statements may accept and rely upon them more freely when they are accompanied by an **auditor's opinion (or report).** The auditor's opinion pertains to the fairness of the statements.[2] In order to have the knowledge necessary for an informed opinion, the CPA conducts an audit (examination) of the accounting and related records and seeks supporting evidence from external sources.

Management advisory services. Often from knowledge gained in an audit, CPAs offer suggestions to their clients on how to improve operations. CPAs may be engaged to provide a wide range of management advisory services, many of which tend to be accounting related. For example, services may include the design and installation of an accounting system or services in the areas of electronic data processing (computers), inventory control, budgeting, or financial planning.

Tax services. CPAs also provide expert advice for the preparation of federal, state, and local tax returns to determine the proper amount of taxes due. Because of high tax rates and complex tax laws, tax planning is of equal importance. Proper tax planning requires that the tax effects of business decisions be known and considered before the decisions are made.

Private (Industrial) Accounting

Accountants employed by a business are referred to as private, industrial, or management accountants. A private business may employ only one accountant, or several, who may or may not be CPAs. Management accountants may possess a CMA rather than (or in addition to) a CPA designation. A Certificate in Management Accounting (CMA) is issued to persons who have passed an examination prepared and administered by the Institute of Management Accounting (IMA). The IMA was established by the National Association of Accountants, which is an organization for accountants primarily employed in private industry.

Management accountants may specialize in providing certain services. For example, they may be concerned with recording events

[2] For an example of an actual auditor's opinion, see Appendix B at the end of the text. Included in Appendix B is a complete set of financial statements of the type often presented to external users by a major corporation.

and transactions and with preparing financial statements. Alternatively, they may be engaged in accumulating and controlling the costs of goods manufactured by their employer. Still others may be specialists in budgeting—that is, in the development of financial plans relating to future operations. Many private accountants become specialists in the design and installation of systems for the processing of accounting data. Others are internal auditors and are employed by a firm to see that its policies and procedures are adhered to in its departments and divisions. These latter individuals may earn the designation, Certified Internal Auditor (CIA), granted by the Institute of Internal Auditors.

Accounting in the Not-for-Profit Sector

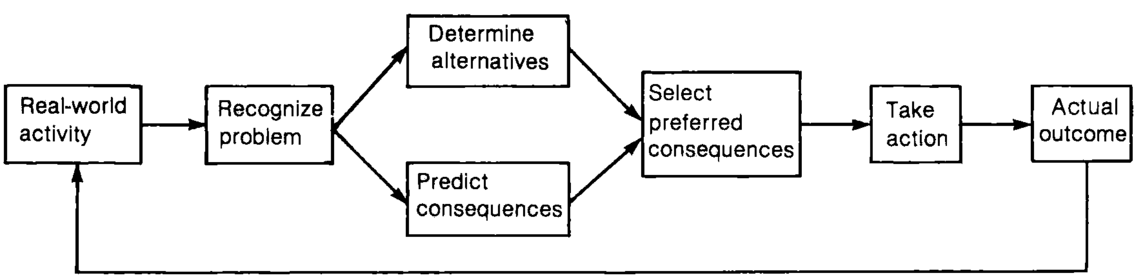
Many accountants, including CPAs, CMAs, or CIAs, are employed by not-for-profit organizations, including governmental agencies at the federal, state, and local levels. The governmental accountant is likely to be concerned with the accounting for and control of tax revenues and their expenditure. Accountants are also employed by governmental agencies whose function is the regulation of business activity—for example, the regulation of public utilities by a state public service commission.

Some accountants are also employed in the academic part of the profession. Here attention is directed toward teaching accounting, researching the uses and limitations of accounting data, and improving accounting information and the theories and procedures under which it is accumulated and communicated.

THE NEED FOR ACCOUNTING INFORMATION: THE DECISION-MAKING PROCESS

The need for accounting information in making economic decisions has been noted, but little has been said about the decision-making process. Basically, as shown in Illustration 0.1, any decision-making process involves (1) recognition of the existence of a problem, (2) determination of alternative courses of action considered solutions to the problem, (3) prediction of the possible outcome of each alternative, (4) selection of the preferred outcome as determined by refer-

Illustration 0.1
A MODEL OF THE DECISION-MAKING PROCESS



ence to the decision maker's personal preferences or previously set goals, and (5) implementation of the alternative chosen.

A problem is caused, at least in part, by events occurring in the world of human activity and scarce resources. Existence of the problem must then be recognized or there can be no decision. The nature of the problem must be understood so that alternatives, which are possible solutions to the problem, can be determined. The list of alternatives should be complete so the best solution may be found.

To determine the best solution, the consequences of each alternative must be predicted. Still, different decision makers may make different decisions even though they predict the same consequences from the same alternatives. This is so because different individuals have different preferences and every consequence may have multiple dimensions.

Implementing a decision causes new events to occur. New problems will arise that will, in turn, bring about a recycling of the whole process.

As a practical illustration, assume that a bank has received requests for loans from Company X and Company Y. The bank has a problem in that limited funds are available for loans. It is in doubt as to which loan will meet its objectives relative to risk, interest earnings, use of the money, date of repayment, ability to repay, and similar matters.

To solve the problem, the bank gathers information that helps it to *predict the outcome of granting each loan.* The predicted outcome of each loan is based on such factors as the rate of interest that can be charged, how the money will be used, and when it will be repaid. Projected results of the alternatives are compared with set objectives of the bank, and a decision is reached. This decision may be influenced by the personal preferences of the banker making the loan. The banker may conclude that as far as the bank is concerned, a loan to X does not differ significantly from a loan to Y. The banker may, however, have a strong preference for loaning money to X because X intends to acquire pollution control equipment, while Y intends to acquire new smelting equipment.

Having made the decision, the bank's position with its environment is now changed. New problems will arise requiring new information and future decisions.

In predicting the outcome of granting each of the above loans, the bank relied, in part, upon accounting information. Virtually every attempt to predict the future involves a review of the past. So in making its predictions, the bank relied upon the accounting records of the past financial activities of each company.

External Users

The bank attempting to decide whether to loan money to Company X or Company Y is considered an external user of accounting infor-