

THE FUNDAMENTALS OF ACCOUNTING

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WITH THE COLLABORATION OF
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ARNO PRESS

A New York Times Company
New York • 1978

Editorial Supervision: LUCILLE MAIORCA

Reprint Edition 1978 by Arno Press Inc.

Reprinted from a copy in the Princeton
University Library

THE DEVELOPMENT OF CONTEMPORARY ACCOUNTING THOUGHT
ISBN for complete set: 0-405-10891-5
See last pages of this volume for titles.

Manufactured in the United States of America

Library of Congress Cataloging in Publication Data

Cole, William Morse, 1866-1960.
The fundamentals of accounting.

(The Development of contemporary accounting
thought)

Reprint of the ed. published by Houghton
Mifflin, Boston.

Includes index.

1. Accounting.	I. Geddes, Anne Elizabeth,
joint author. II.	Title. III. Series.
HF5635.C67 1978	657 77-87265
ISBN 0-405-10894-X	

PREFACE

THE most striking development in the educational field of late is the rush of students to the commercial departments of our secondary schools and our colleges. Whatever else is or is not taught in such departments, accounting (in the colleges) or book-keeping (in the secondary schools) is taught. All over the country, moreover, correspondence schools and evening schools are teaching accounting. Thousands of students of accounting are graduated from one or another kind of school every year, and yet professional accountants are constantly calling for good men and cannot get them. This is not because the demand is tremendous, for the number of practicing accountants in the country is not large, but because the supply is small. Comparatively few who study accounting prove competent for responsible positions.

Accounting requires a certain type of native mental capacity, as well as a certain amount of training. That type of native capacity happens to be rare. Two essentials for accounting, as distinguished from bookkeeping, are a highly developed analytical faculty and a good imagination. The first is rare at best, and it does not commonly go along with the second. It is futile to try to produce accountants from material that is lacking in either faculty. Any teacher of the subject should understand at the start that of the many who fancy themselves called few will ever be chosen. Yet though few can ever be accountants, every person charged with executive responsibility should know the fundamentals of accounting, for he cannot understand the reports of his own business (if he has a good accountant) unless he knows what the accountant is talking about, and he cannot direct even elementary accounting (if he has not a good accountant) unless he knows what constitutes good accounting. Every student of public affairs, moreover, should be able to interpret financial reports, both public and private, and know what business facts lie behind them. The study of accounting, therefore, is not futile even for those who cannot be accountants.

A result of the rush of college students to commercial studies,

and away from the humanities, is alarm on the part of college authorities regarding the mental training that under the new régime their students will get. However regrettable may be the neglect of the humanities, because of the limitation of the field to which the new studies largely confine themselves, there need be no loss of mental training. As philosophy and mathematics are disciplinary studies, and in the old program are desired not only for their content, but for their disciplinary value, in the new program accounting may, so far as discipline is concerned, take their place. It is a compound of philosophy and mathematics — that is, the only method of teaching it that makes either successful accountants or successful interpreters of accounts is the method of teaching philosophy and mathematics. Accounting must proceed by reasoning, not by rule: it is not a body of arbitrary facts, true merely because they are true, and therefore to be memorized: it is a body of plain common sense, developed out of hard thinking about facts that have been, and imagination to see what future need will arise for record to-day of facts that are. It calls for mental activity of the highest type: it is not *virginibus puerisque*.

Yet its value both as a disciplinary study and as vocational training depends wholly upon the method of instruction. No one will ever use accounts successfully who is not able to think in abstract terms about them, for like mathematical terms and philosophical concepts they are to great extent abstractions — except the simple bookkeeping items of cash, accounts receivable, etc. One reason, moreover, why, with thousands of students graduating in accounting annually, professional accountants are not able to get good men is that so much of the work of the students has been of the memorizing rather than the reasoning variety. The students have taken accounting as if it were a body of scientific facts to be memorized rather than a philosophy of accounting conduct.

The method of this book is the philosophical. It starts with the simplest obvious fact needing record, property and ownership, and from this develops the need of particular accounts. Not for several chapters is any need found for the always confusing nominal accounts, and then they develop naturally after the statistical need for them has arisen. The technique of bookkeeping does not appear until the ninth chapter, and then it results from a

need of labor-saving devices. This technique is dwelt upon only enough to show the feasibility of most of the information that the accountant desires. Indeed, though bookkeeping is the tool of accounting, it is a tool so simple in principle that to ask any one who does not intend to be either a bookkeeper or a professional accountant to spend many months in studying it is almost an educational crime. Indeed, the whole method of procedure is based on the fact that nothing is of interest until some need of it, or curiosity about it, is felt.

Though the book deals with fundamentals, it is not superficial; for fundamentals are always the contrary of superficialities. As far as it goes, it is complete. It does not avoid a matter because it chances to be abstract or difficult; if it did, it would have neither disciplinary nor practical value. It attempts to give all the fundamental considerations of accounting. What more there is to accounting is the application of these principles to situations in which careful analysis, based on detailed knowledge of the particular business, has found a way of application, sometimes through a maze of complexity of business relations.

On the part of the senior author, the selection of material and the method of exposition follow twenty years of University experience in teaching accounting. The junior author, on the other hand, who has but recently been a student of accounting, under methods of instruction similar to those incorporated here, and of late has been assisting the senior both in some of his teaching and in the practice of accounting, brings to the collaboration the combined point of view of the student, the young instructor, and the practitioner.

To give concreteness to the principles worked out here, appended to every chapter are questions and problems which test the reader's ability to apply his principles. These are intended not for repetitious drill, but as illustrations of how the principles apply to concrete facts. If any one wishes drill, he can easily make additional problems for himself. Those given afford large variety.

W. M. C.

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November 22, 1920

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THE FUNDAMENTALS OF ACCOUNTING

CHAPTER I INTRODUCTION

An Accountant like an Editor. The accountant may be compared in some respects to the editor of a newspaper or a magazine. The business man requires to be constantly informed about the conditions and operations of his business, just as he requires to be informed of the conditions and operations of the business world with which he has dealings. It is, indeed, more immediately important that he shall know just how things are going on within his own business than it is that he shall know how things are going on outside, for since his own business is under his direct control, he is responsible for its guidance day by day, whereas adjustment to the outside business world with which he has necessary dealings is often a matter of weeks or months — never too soon begun, but less serious if an error is made, for more time is available for correction. However well informed he may be about people's demand for goods or for services, unless he is conducting his own business in such a way that he can provide goods or services when wanted, he is failing to conduct business successfully. It is important, therefore, that a business man shall be informed with frequency about his own business, and that this information shall cover a large variety of facts, such as his stock of goods on hand, the cost of that stock of goods (whether purchased or manufactured), the expenses of conducting his business (so subdivided that he can know whether his expenses in any particular direction are running higher than formerly or are out of relation to the amount of business done), the amount of indebtedness he has soon to pay, the amount of money coming in and soon to be available for paying debts, the amount of cash in hand, the amount of investment in his business, the profits which he is making, and the availability of those profits for withdrawal.

What the Accountant Edits. Just as the editor must get into the hands of the public at frequent intervals information with regard to the news of the world or with regard to some special field of activity or learning, so the accountant must get into the hands of the business man at reasonably frequent intervals such information as has been enumerated. Usually there are several persons in the employ of a business whose task is in part to prepare information for the general manager, but usually such information is either not in the particular shape most useful for the manager or is not so correlated with other information as to bring out the larger facts that the manager needs to know. It is the task of the accountant to put the information in the desired shape and to correlate various kinds of information, or, as we commonly say, "edit" the information. Because the accountant must prepare information for the general manager or other officer, he usually occupies a more or less confidential position, and often is a vice-president of a corporation. He must have the knack of preparing information in shape for use by others, he must have sufficient imagination to see what sort of information the various officials will desire, and he must have sufficient power of analysis to see how to get the sort of information that will enable the operating officers of the business to tie up the various parts of the business with each other and with the outside business world — and he should provide them with such information even if they have not realized the need of such particular information. It is his task, in a sense, to foresee what information about the business will be later required and to see that such information will be available at the proper time. He must anticipate the need for information, so that he may have his lines laid before the occurrence of the event, for the procurement of that information as soon as the event happens. This is just the task of the editor of a newspaper or a magazine, for he not only tells people what they already wish to know, but he gives them what they are glad to know, though they had not previously known that they needed to know it.

Many Kinds of Accounting. Just as there are various types of editors, some of them preparing daily news for the general public, some preparing literary articles for those who are interested in literary matters, some who are preparing technical matters for the

technical public, so there are various types of accountants who are preparing information for various types of business managers. Rarely an accountant is also the bookkeeper, and has prepared the preliminary figures as well as edited those figures and provided the editorial matter to correlate them properly for the manager. More often the accountant does not prepare original figures, but merely edits the figures of other people, combining them in various ways and drawing from them important conclusions that only a trained person could see. Many of the figures are statistical, not expressed in dollars and cents, but are quite as important as financial figures. The matters of accounting are almost as various and different in nature as the matters which are published in newspapers and magazines. It would be virtually impossible for any man to prepare himself to edit all kinds of newspapers and magazines, for some of them are extremely technical and a man must be an expert in certain lines of knowledge before he can edit a newspaper in those technical lines. Similarly, a man is not competent to edit the records of a highly technical business, like those of a chemical works, until he is familiar with the processes of the chemical plant and until he has made a study of the accounting problems connected with certain technical operations.

Limitations of Accountants. No effort is made in this book to take up more than a few of the technical matters of accounting, and such matters are far more numerous than the person of limited acquaintance with accounts would usually suppose. The peculiar and technical matters of accounting are not merely those made necessary by the peculiarities of certain industries: they are often common to all industries, but peculiar to certain relations of business, such as peculiar partnership arrangements, peculiar corporation organization, settlement of bankruptcies, purchase and sale of rights where a long period elapses between the purchase and the delivery, and agreements in which various contingencies are involved. All these matters need peculiar kinds of records in order that at any time during the history of the transaction or later one may see how the various persons concerned in the transaction were financially related to it. In an elementary book it is undesirable to take up complicated relations, for no one is competent to understand them and to make or control the record of them unless

he is thoroughly familiar by experience with the record-making for more or less simple transactions — else the records which he may make will confuse the complicated sort of transaction with the transaction which is of a more simple sort, and it will be impossible from the record to interpret the actual facts of the case. Unfortunately a great many persons who have familiarized themselves with the fundamentals of accounts have thought that they had mastered the whole subject and have undertaken to make record of transactions which they did not at all understand; and later, when a dispute has arisen regarding the transactions, the records have proved inadequate and have often led to wrong settlement merely because the person who made the record pretended to be more competent than he was. It is quite as important that a person studying accounts know what he does not understand, and thus know what to avoid, as it is that he shall know how to do those things which he is quite sure that he understands. Just as one may know a great deal of law and yet be incompetent, and know one's self to be incompetent, in certain complicated and weighty matters of law, so a person who knows much of accounting can sometimes give best proof of his knowledge by indicating frankly what he is not competent to do.

Relation between Accounting and Bookkeeping. It has been suggested that the accountant is like the editor in that he does not usually provide the original figures on which he bases any report. This is because the accountant is not usually, except by chance, a mere bookkeeper; though, like the editor, he often directs what sort of thing shall be written and how it shall be written. The task of the bookkeeper is to record known facts, and these facts may be known because they are very simple and of an obvious sort, or they may be known because an accountant or some one else has analyzed a business transaction and has told the bookkeeper exactly what is the situation to be recorded. The task of the bookkeeper, though important, does not ordinarily involve a very keen analysis of a business situation. The processes of bookkeeping, though requiring intelligence, very great accuracy, and general good common sense, are chiefly those of routine. When need arises for analysis of a complex situation, or for statement of a complex situation so that the record will be perfectly clear not only in itself but in rela-

tion to other elements of a business, decision is usually made by an accountant who has had training in both the larger aspects of figures and the significance of business relations. The task of the accountant may be described generally as that of analysis and correlation of various figures so that the important facts about a business, both the details and the larger meanings, may appear in their proper light and emphasis. Perhaps the best way to indicate his duty is by the common figurative illustration of the distinction between seeing the forest and seeing the trees. The bookkeeper is bound to see the individual tree, as he makes his record, for that is his job; but often he does not realize what is the general appearance of the forest as a whole, the relation of the various kinds of trees in the forest to one another, and what is the relation of the forest as a whole not only to the pastures and the fields and the cultivated portions of the country in which it lies, but also to the hills, the valleys, and the plains. It is the duty of the accountant to see the forest in all its surroundings as well as in itself, and he is not much concerned with the individual trees.

Dependence on Bookkeeping. Yet the accountant could not do his work without the bookkeeper, and the language which he speaks is in part the language of bookkeeping. He must, indeed, understand bookkeeping before he can be an accountant. In fact, an accountant usually is required to be a better bookkeeper than most bookkeepers, for he is obliged to untangle situations which have been unfortunately recorded on the books, and he often must direct the bookkeeping to serve his ends. This, on the other hand, does not necessarily mean that he must be an expert in the technique of all sorts of bookkeeping, for bookkeeping as a matter of fact involves but very few principles. Though there are thousands of bookkeeping forms all good in their way, an accountant does not need to be familiar with them all, for they are all based on a few fundamental principles, and a person who understands those principles thoroughly is able to see how they have been applied to the various forms of books that he may come upon. Variations in the form of books are due almost entirely to the modern attempt to apply labor-saving devices, and since the circumstances of almost every business are somewhat different from those of other businesses, the application of labor-saving devices in each will differ in

detail from the application in others. A careful examination will enable any one familiar with the fundamental principles to learn from any set of books exactly how the system is working, and he is therefore just as competent to interpret those books and to pass judgment upon them as if he had made a previous special study of that particular form and had had the person who devised the system tell him how it is intended to work. Since an understanding of all bookkeeping principles is essential to an accountant's work, in the following pages the fundamental principles of bookkeeping will be first discussed, and then a study of the general application of labor-saving devices to those fundamental principles will follow. Virtually nothing further will be said about bookkeeping forms.

Accounting for Non-Accountants. In the early part of this introduction emphasis was laid upon the necessity of an accountant's editing the figures which are to be presented to a general manager, but it should be just as clearly understood that a business man as well as an accountant should have a certain familiarity with the interpretation of an accountant's figures, for there is not uniform practice with regard to the statement of such figures, and a man often finds it necessary to interpret the figures of other businesses where the forms of statement not only are entirely unlike his own but are in fact unfortunately chosen. Any man in an executive position in a business, whether he has anything directly to do with accounts or not, and any man having dealings with general business, as an investor or a student of public affairs, needs a certain familiarity with accounting procedure and statements, so that he may judge how business affairs, both public and private, are being conducted. Attention is devoted in this book, therefore, as much to the interpretation of accounts as to their construction.

CHAPTER II

DOUBLE ENTRY AND THE BALANCE SHEET

Basis of Double Entry. The basis of double entry is a realization that in modern business there are no assets lying about without claimants. To everything having value some one is a claimant. If in a business there is any property, or any right, or any intangible quality that brings value, like a reputation that draws trade, some one claims that property or right or quality. If one is to have a statement of a business at any particular time, therefore, one will need to know exactly what property, rights, and qualities are in the business and who may claim those particular elements which go to make up the business as a whole. We must distinguish, moreover, one kind of asset from another, for otherwise every time we contemplate a particular transaction we might need to visit some part of the establishment to learn whether that transaction is possible for the business as it now stands — we cannot ordinarily pay debts with equipment, nor sell merchandise if we have only raw material, nor pay dividends if we have only stocks and bonds. Similarly we must distinguish one kind of claims to the assets from other kinds of claims, for different claims are enforceable in different ways and may be met at different times. Since, however, as already indicated, all values are claimed by some one, it must follow that the total values attached to the list of assets must equal the total claims which are established against the business by persons, including the proprietors, whose claims are recognized by it. So even the simplest statement that can be drawn up for a business must be “in balance” — i.e., the asset side will exactly equal or balance what we may call the “ownership-claim” side. Equality is always there, for if any value is in the business it must belong to some one, and that ownership must be recorded both on the books and on such a statement. There is no way by which total assets can increase without a parallel increase in claims to assets; there is no way by which total assets can decrease without a parallel decrease in claims to assets; there is no way by which total claims to assets can increase without a parallel increase in assets to be