

FINANCIAL ACCOUNTING



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FINANCIAL ACCOUNTING

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Preface

Financial Accounting is the first volume of a two-volume financial/managerial set designed for use in introductory accounting courses at two-year colleges, four-year colleges, and universities. The companion volume is *Managerial Accounting* by Ray H. Garrison. Many accounting instructors have found that greater depth of coverage can be obtained by dividing the first course in accounting into two parts—the first term focusing on financial accounting topics and the second on managerial accounting topics. This two-volume financial/managerial set is designed to provide this type of coverage, with the two volumes together providing a comprehensive introduction to the accounting process. Either the financial or the managerial volume, however, may be used alone or with other texts.

The authors' goal in *Financial Accounting* is to present accounting information as an essential element of the decision-making process in a business environment. The material describes basic standards and principles that underlie accounting information, indicates how accounting information is accumulated, and explains how such information can be used by management in directing the affairs of an organization.

The authors recognize that students taking the first accounting course may seek a variety of careers. Some students may continue their studies in business administration, others may choose accounting as a major, and still others may take accounting as part of their liberal arts education. All of these students will find the ability to use and interpret accounting information valuable both in their careers and their personal lives.

Using the text

The corporation form of business organization is used to illustrate financial accounting in the text. (Appendix A covers single proprietorship and partnership accounting.) The first four chapters deal with the accounting cycle. The first part of Chapter 4 covers the work sheet and may be omitted without affecting the continuity of coverage. Chapter 5 discusses the accounting theory underlying financial accounting and incorporates concepts presented in the latest FASB pronouncements on the conceptual framework. Chapters 6–13 cover various financial statement elements such as inventory; cash; receivables and payables; long-lived assets including plant assets, natural resources, and intangibles; and long-term debt and investments. The first portion of Chapter 11 covers payroll and may be omitted by those choosing to do so. Chapter

14 concerns consolidated financial statements. Chapter 15 deals with the statement of changes in financial position. Chapter 16 covers financial statement analysis and interpretation. The last chapter discusses the topic of inflation accounting, with many references to *FASB Statement No. 33*.

There are three appendixes to the text. As was stated earlier, Appendix A covers simple proprietorship and partnership accounting. Appendix B contains compound interest and present value tables. Appendix C contains the financial statements and accompanying notes taken from the 1979 annual report of the General Electric Company. Many of the concepts discussed in the text are illustrated in these financial statements.

Each chapter has at least one demonstration problem followed by questions, exercises, two series of problems, and from one to four business decision problems. There is sufficient end-of-chapter material to provide the instructor with several alternative assignments while covering the concepts included in the chapter.

Supplementary material available

An extensive array of supplementary material for student use accompanies the text.

The list of check figures gives key figures for the A and B Series problems and the business decision problems. Students can determine whether they are “on the right track” in working a problem by comparing their solution with the key figure given for the problem.

The study guide corresponding by chapter to the text contains chapter goals, an outline, and questions and exercises. Its purpose is to strengthen the student’s understanding of chapter material immediately after reading the chapter. Normally, the student should work the study guide material after studying the new terms for a chapter but before turning to the questions, exercises, and problems for that chapter. Many of the questions and exercises are in fill-in-the-blank format. Solutions to the questions and exercises are contained in the back of the study guide so that answers may be checked by the student.

A set of working papers is available for use in working assigned problems and decision problems. The working papers in many instances are partially filled out to reduce the pencil pushing required to solve the problems.

A practice set is available to the student. It illustrates the use of special journals for a corporation and may be used anytime after Chapter 8.

Acknowledgments

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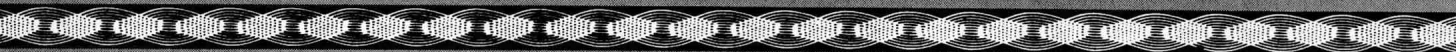
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FINANCIAL ACCOUNTING






Chapter 1



An introduction to
financial accounting



PURPOSES OF THE CHAPTER

This chapter is designed to communicate an understanding of the nature of accounting and its various functions in society. Accounting information is used for decision making in all types of organizations—business and nonbusiness—as well as by both managers and individual citizens. Every person in society would benefit from some knowledge of accounting since it is used wherever economic resources are employed.

Accountancy is a professional field which can lead to careers in a variety of areas, including public accounting firms, business firms, and governmental organizations. The work of the accountant centers on systems design, interpretation of financial data, and the preparation or review of financial statements. Financial statements show the results of an organization's operations over a given period of time, its current financial condition, and changes in its financial position.

This first chapter introduces the concepts and techniques used in financial accounting to carry out this reporting function and introduces the environment in which financial accounting operates. Financial accounting is concerned primarily with reporting to users of financial data who are outside the organization.

THE ENVIRONMENT OF ACCOUNTING

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 a bank, in government bonds, or in the shares of stock issued by business corporations. We may feel that our savings can be quite safely invested in a savings account or in 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. And it is here that accounting enters the picture, since accounting is a primary source of information on economic activity.

Since economic activity includes the production, exchange, and consumption of scarce goods, it is found everywhere in our society. Accounting is nearly as extensive. Accounting is needed to show what was accomplished at what cost. This 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, our attention in this text will center on the accounting and reporting by business firms.

*Accounting*¹ is the process used to measure and report to various users relevant financial information regarding the economic activity of an organization or unit.² Relevant information has some bearing upon a decision to be made. This information is primarily financial in nature; that is, it is stated in money terms.

When persons first study accounting, they often confuse bookkeeping

¹ When undertaking initial study of any discipline, new terms are usually encountered. To aid in becoming familiar with the language of accounting, these terms (at their first occurrence in each chapter) are set in boldface, italic type and are also listed and defined at the end of the chapter.

² A complete discussion of the objectives of financial reporting is contained in FASB, "Objectives of Financial Reporting by Business Enterprises," *Statement of Financial Accounting Concepts No. 1* (Stamford, Conn., 1978). Further reference will be made to this in Chapter 5.

and accounting. Bookkeeping involves the recording of business activities and is a very mechanical process. Accounting includes bookkeeping but goes well beyond it in scope. Among other functions, accountants prepare financial statements, conduct audits, design accounting systems, prepare special studies, prepare 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. (The purchase and sale of goods and services are examples.) Then they *measure* these selected events in financial terms. Next, they *record* these measurements 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. The preparation of accounting reports will require that accountants *summarize* these measurements even further. 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. Attention may also be drawn to significant items through trend or ratio analysis.

Accounting may also be defined as an *information system* designed to provide, through the medium of financial statements, relevant financial information. In designing the system, accountants keep in mind the types of users of the information (owners, creditors, etc.) and the kinds of decisions they make that require financial information. Usually, the information provided relates to the economic resources owned by an organization, the claims against these resources, the changes in both resources and claims, and the 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 an expert in auditing, systems development, budgeting, cost accounting, or tax accounting.

Public accounting

A *certified public accountant (CPA)* must have passed a rigorous national examination prepared and graded by the *American Institute of Certified Public Accountants (AICPA)*—the accounting equivalent of the American Bar Association or the American Medical Association. Having passed the CPA examination and having met certain other requirements, such as having a certain number of years of experience, an individual may be licensed by the state to practice as a certified public accountant. As an independent professional, 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 seeks to have its securities traded on a stock exchange, it is usually required to provide statements on its financial affairs. Users of these statements may accept and rely upon them more freely when they are accompanied by an *auditor's opinion (or report)*.