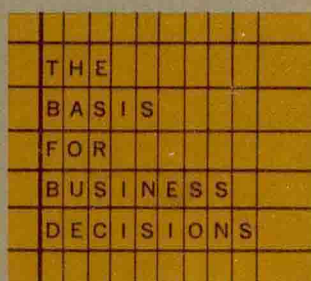
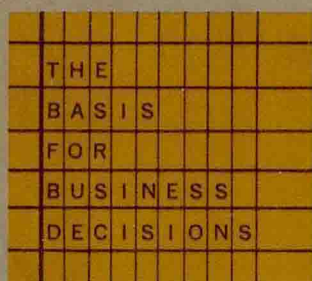
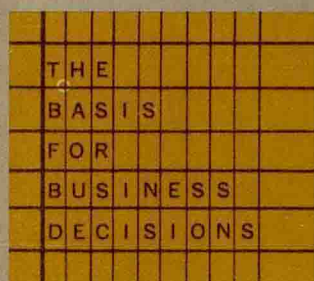


ACCOUNTING



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Preface

The first course in accounting attempts to meet the needs of students who have elected or plan to elect accounting as a major, students of business administration who need a good understanding of accounting as a background for a business career, and students in other social science and professional areas who will find the ability to use accounting data intelligently a valuable accomplishment. This book is designed to serve the needs and interests of all three groups.

In developing the material in this book, consideration has been given to a number of modern trends in accounting instruction:

Selection of subject matter. In recent years the subject matter of accounting has broadened, and new areas clamor for admission to the list of topics standard for an introductory course. Indeed, it has been proposed at one time or another that almost every facet of accounting be included in the introductory text. We have avoided the temptation to make perfunctory comment on the widest variety of material in order to be able to point to its inclusion in the book. The topics chosen have been treated at an introductory level, but each topic has been given sufficient coverage to enable the student to gain a useful degree of understanding of the subject matter.

The first five chapters give an overview of the accounting cycle. In Chapters 6 to 9, on accounting for sales, purchases, and cash transactions, the issues of internal control are emphasized. The problem of valuation receives considerable attention in the chapters on specific classes of assets and liabilities, and the special problems that arise in accounting for partnership and corporate ownership equity are thoroughly covered in Chapters 15 to 20. The functional classification of expenses and its relation to expense analysis and allocation are discussed in Chapter 24. An introductory consideration of direct costing and the issues raised by this approach to cost determination appears in Chapter 26, on cost accounting. Chapter 27 contains a discussion of the way in which income taxes influence business decisions and the relation between accounting income and taxable income. Chapter 28, on analysis of financial statements, includes a discussion of fund-flow information and how such data can be developed without the use of traditional extensive working-paper techniques. Because of the importance of advanced planning in the con-

trol of business operations, a full chapter, Chapter 29, is devoted to budgeting and the use of budget data by management. These examples are illustrative of the attempt to give the introductory student a wide-angle view of today's accounting problems, with sufficient depth and focus to make the exposure meaningful.

Emphasis on the use and interpretation of accounting data. Accounting data are used by business managers, investors, governmental agencies, and every citizen who is interested in questions of public policy which turn, in part at least, on accounting information. In the past perhaps undue attention has been given in the introductory course to the viewpoint of investors and the public, and too little to the managerial viewpoint. At present there are some who would apparently swing the pendulum of accounting instruction far over to the managerial side, devoting primary if not sole attention to the use of accounting data by management. We feel that none of the pertinent viewpoints should be slighted in an introductory text. Careful attention is given to the effect of various business transactions on financial statements and to the problems that arise in interpreting accounting information from the viewpoint of investors and the public. An equal amount of attention is devoted to the ways in which accounting data can serve management in controlling and planning business operations.

A reasonable perspective on procedures. The major objective of a first course in accounting is to foster an understanding of accounting and the way it serves in developing useful information about economic organizations. We believe that some attention to procedure is necessary if a student is to gain reasonable facility in dealing with and interpreting accounting data. Accordingly, procedural matters are not neglected, but discussion of some purely technical procedures has been omitted and discussion of procedural details minimized. For example, the coverage of prepayments and accruals is arranged so as to avoid the issue of reversing entries, a purely technical bookkeeping procedure. The essential features of special journals and control accounts are covered clearly but compactly in a single chapter, which is sufficient for understanding, but does not belabor the point. Material on payroll accounting procedures and the voucher system is placed in the latter half of the text, and may be omitted in a course if desired. Problem material is balanced; the instructor who wishes to give minimum attention to procedure and the one who wants to place relatively more weight on this area will both find problem material suitable to their objectives.

Emphasis on accounting theory. We believe that the logic and theory underlying accounting are not a separate topic but an integral part of any discussion of accounting problems. Accordingly, as each topic is developed, there is consideration of the nature of the problem and the reasoning behind the accounting procedures designed to cope with it. At the same time, to the extent appropriate in an introductory discussion, the student is made aware of differences between theory and accounting practice and the reasons for the differences.

Complete package of instructional aids. A comprehensive set of instructional aids is provided. Some of these are included in the text; others are published separately.

Discussion questions. A series of questions designed as a basis for classroom discussion and to aid the student in testing his understanding of the text material is given at the end of each chapter.

Problem material with time and difficulty ratings. Two sets of problems for each chapter, Group A and Group B problems, are included in the text. The problems in the two groups are of similar difficulty, require about the same solution time, and can be worked on similar accounting forms. Instructors may thus choose problems from both groups or may alternate, using Group A problems in one year or in one class and Group B problems in another.

Working papers. Working papers for the problem material are published separately from the text. Partially filled-in accounting work sheets are available for Group A problems; on these work sheets headings and some preliminary data have been entered. Specially designed blank accounting forms suitable for both Group A and Group B problems are also available.

Practice sets. Two practice sets have been prepared. One is for use with material in the first half of the book; the other, for use with material in the second half of the book. Each practice set consists of two separate items: the narrative of transactions and the solution forms.

Study guide. Written by Lyle H. McIff of Utah State University, the study guide makes available to the enterprising student an aid in mastering accounting principles. Specially designed to accompany the text, it contains for each chapter: (1) an informal discussion of the chapter's objectives; (2) an outline of the important points; (3) objective questions for review, with answers included to help the student evaluate his understanding of the subject; and (4) short exercises, with answers. The study guide will be found useful also in classroom discussion and for examination review.

The authors are indebted to the following persons who reviewed the manuscript and made many helpful suggestions: Dean O. J. Curry, North Texas State College; and Profs. Irving K. Christiansen, John Carroll University; Robert K. Jaedicke, Stanford University; Elzy V. McCullough, Louisiana State University; Thomas M. Dickerson, Western Reserve University; Catherine E. Miles, Georgia State College of Business Administration; Raymond C. Dein, University of Nebraska; Emanuel Grody, East Los Angeles Junior College; Raymond R. Orie, University of Pittsburgh; T. E. Fitzgerald, Temple University; Phil Loprinzi, University of Portland; Othel D. Westfall, The University of Oklahoma, and Dennis Gordon, University of Akron.

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1

Accounting: the basis for business decisions

Accounting has often been called the “language of business” because people in the business world—owners, managers, bankers, salesmen, attorneys, engineers, investors—use accounting terms and concepts to describe the events that make up the existence of businesses of every kind. The analogy between learning accounting and learning a language is not perfect, but the similarities are significant. You will find that many of the terms used in accounting have meanings that differ from the meanings attached to the same words in ordinary nonaccounting usage. It is usually true that as a person gains familiarity with a language he begins to understand better the country in which that language is spoken and the customs and actions of people who speak it. Similarly, as you gain a knowledge of accounting you will increase your understanding of the way businesses operate and the way in which business decisions are made. Finally, a language is a man-made means of communication; languages change gradually to meet the changing needs of society. Accounting, too, is a man-made art, one in which changes and improvements are continually being made in the process of communicating business information.

THE PURPOSE AND NATURE OF ACCOUNTING

The underlying purpose of accounting is to provide financial information about any economic entity, usually a business enterprise. This information is needed by a business manager to help him plan and control the activities of his organization. It is also needed by outsiders—owners, creditors, investors, and the public—who have supplied money to the

business or who have some other interest that will be served by information about its financial position and operating results.

If someone gave you the task of making a record of what went on in a business enterprise and you knew nothing about the way in which this was ordinarily done, you would, after a little experimentation, probably arrive at a system somewhat similar to that which has evolved in accounting.

First, you would find it necessary to create some systematic record of business transactions, in terms of money. In essence, a business is a collection of economic resources devoted to a particular purpose or goal. An orderly description of these resources, their source, and the way in which they are employed to promote a growth in value would be the natural starting point in fulfilling your assignment. Goods and services are purchased and sold; credit is extended to customers, debts are incurred, cash is received and expended—these are typical of the events you would record. It would soon be obvious that not all business events can be described in monetary terms. You would probably not be able to show in your record such significant happenings as the appointment of a new chief executive or the signing of a labor contract, except as these happenings in turn affected future business transactions.

Once you had compiled a narrative record of events as they occurred, you would find it advisable to sort various transactions and events into related groups or categories. In science the systematic classification of animals, minerals, and plants into categories based upon a scheme of natural relationship is the first step in gaining a greater understanding of natural phenomena. Classification would serve your purpose equally well by enabling you to reduce a mass of detail into compact and usable form. For example, grouping all transactions in which cash is received or paid out would be a logical step in developing useful information about the cash position of the company.

In order to be helpful to anyone, the information you have recorded and classified would have to be summarized in the form of a report or statement, that is, a concise picture of the significant findings gleaned from your detailed records. You would probably attempt to show where the business stood at the time of your report, and the process by which it had arrived at this position.

These three rather natural and logical steps—recording, classifying, and summarizing—form the basic process by which accounting data are created. Accounting as we know it today has evolved over a period of several hundred years. During this time certain rules, conventions, and procedures have become accepted as standard. Some of these rules are simply traditional and, like driving on the right side of the road, operate to reduce confusion. Others follow logically from the objectives which accounting is designed to attain. Knowing the rules of accounting construction is a prerequisite to understanding the way accounting data are developed and what they mean.

Accounting extends beyond the process of *creating* data. The ultimate objective of accounting is the *use* of these data, their analysis and interpretation. A good accountant is always concerned with the significance of the figures he has produced. He looks for meaningful relationships between events and financial results; he studies the effect of various alternatives; and he searches for significant trends that may throw some light on what will happen in the future.

Interpretation and analysis are not the sole province of the accountant. If managers, investors, and creditors are to make effective use of accounting information, they too must have some understanding of how the figures were put together and what they mean. Strangely enough, an important part of this understanding is to recognize clearly the limitations of accounting reports. A business manager, an investor, or a creditor who lacks training in accounting may fail to appreciate the extent to which accounting data are based upon estimates rather than upon precisely accurate measurements.

Persons with little knowledge of accounting may also fail to understand the difference between accounting and bookkeeping. *Bookkeeping* means the recording of transactions, the record-making phase of accounting. The recording of transactions tends to be mechanical and repetitive; it is only a small part of the field of accounting and probably the simplest part. A person might become a reasonably proficient bookkeeper in a few weeks or months; to become a professional accountant, however, requires several years of study and experience.

The work of accountants

In terms of career opportunities, the field of accounting may be divided into three areas:

1. Private businesses employ accountants to perform accounting functions ranging all the way from bookkeeping to designing accounting systems, preparing various reports and statements, and interpreting the results. The chief accounting officer of a private business of any size is usually called the *controller*, in recognition of the fact that one of the primary uses of accounting data is to aid in controlling business operations. The controller manages the work of the accounting staff. He is also a part of the management team charged with the task of running the business, setting its objectives, and seeing that these objectives are met.

2. *Certified public accountants* are independent professional persons, comparable to physicians or lawyers, who offer accounting services to clients for a fee. The CPA certificate is a license to practice granted by the state on the basis of a rigorous examination and evidence of practical experience. Although the CPA performs a wide variety of accounting-related services, his principal function is to review the accounting records of a business concern and issue a report in which he expresses his professional opinion as to the fairness and dependability of the financial state-