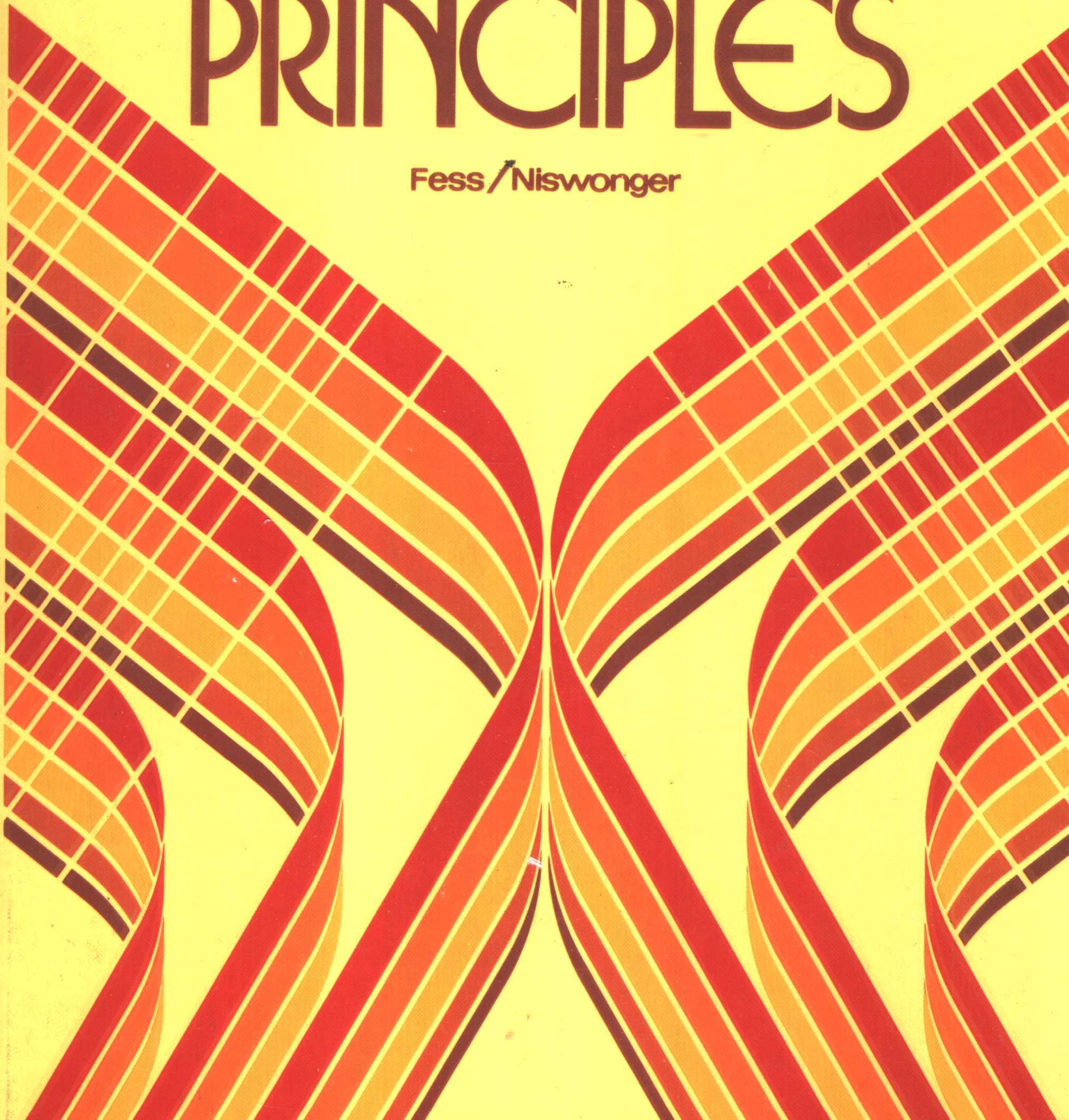


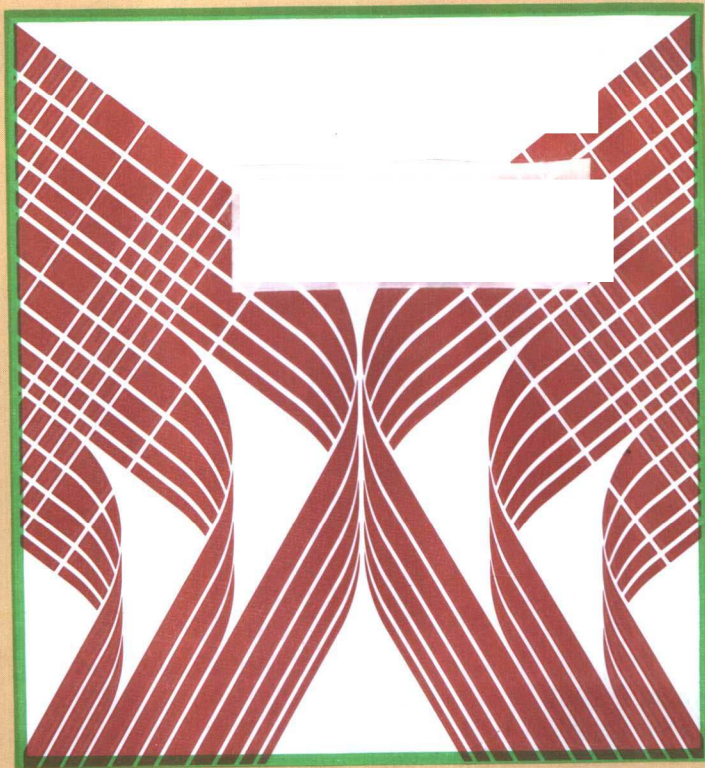
13th Edition

ACCOUNTING PRINCIPLES

Fess/Niswonger



ACCOUNTING PRINCIPLES



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PREFACE

The thirteenth edition of ACCOUNTING PRINCIPLES, like its predecessors, is a student-oriented text. It presents the fundamental accounting concepts and procedures in a logical, concise, and clear manner. The text therefore permits instructors to focus on utilizing this foundation as the basis for clarifying issues and solidifying the student's understanding of accounting and its uses. This 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.

Both accounting principles and practices are presented in a balanced approach, starting in the very first chapter, so that students can obtain an understanding of the sources of financial information and the uses of such information. 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. Sufficient fundamental principles and terminology are thus presented to enable students to understand accounting as it is applied in serving not only the business world but all of society.

Many innovations are included in this edition. Learning objectives have been added to provide a sense of direction for the study of the text material. To this end the objectives of the text are presented first and then each chapter begins with a listing of the objectives for that chapter. In this manner, the objectives 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. It should be noted that 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 has been added as Appendix A. The terms included in the glossary are printed in color the first time they are presented in the text. To facilitate locating Appendix A, the glossary pages are colored.

Users of earlier editions will recognize the continuance of many successful features. However, some modification has been made. By a judicious change in the form of business practice selected to illustrate the concepts presented in Chapter 1, the introduction of the concept of depreciation has been left for discussion until Chapter 3 when the student is better able to appreciate, understand, and master the

concept. This change has been accomplished without the loss of reality in the business situation presented in Chapter 1.

The chapters on accounting systems (Chapters 10, 11, and 12) have been revised to place more emphasis on the principles of accounting systems design. Increased emphasis has also been placed on internal control by expanding the discussion and illustrations of such concepts as internal accounting controls and internal administrative controls. In addition, the most up-to-date advances in data processing technology and methods, such as electronic funds transfer and point of sale processing, have been added. The discussion of accounting, governmental, and other influential organizations in the development of accounting principles has been expanded in Chapter 13. An expanded discussion of financial reporting for price-level changes appears in Chapter 26. The discussion of financial analysis in Chapter 27 emphasizes both solvency analysis and profitability analysis.

The chapter on income taxes and their effect on business decisions (Chapter 24) has been relocated and additional discussion and illustrations are presented that focus on the minimization of income tax expense and the effect of the tax on business decisions. As in past editions, concepts and practices in both financial and managerial accounting are presented in an integrated approach. The latest developments in accounting and business, including the management report section of the annual report, financial forecasts, zero-base budgeting, price-level accounting, and FASB pronouncements are included.

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 E, a complete set of financial statements from the annual report of one company 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*.

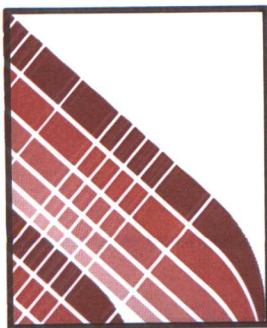
Four short practice sets, each requiring the recording, analysis, interpretation, and reporting of accounting data for a single month, are available for use in developing greater student proficiency or for review purposes. A study guide, solutions to the study guide, student check sheets, transparencies of solutions to problems, objective tests (two for each chapter), examination problems, true-false questions, multiple-choice questions, a computerized testing program, and other teaching aids are also available.

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 Professors Richard E. Flaherty, Arizona State University; Clayton A. Hock, Miami University; Gary John Previts, Case Western Reserve University; and Gene Willis, University of Illinois, Champaign-Urbana.

The authors also acknowledge their indebtedness to Professor Carl Warren, University of Georgia, who served as consulting editor. We are also grateful 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.

Philip E. Fess
C. Rollin Niswonger

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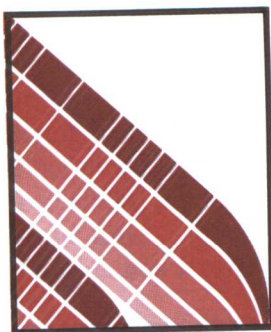
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EVOLUTION OF ACCOUNTING

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 undertakings."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

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

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.

CORPORATE ORGANIZATION

The expanded business operations initiated by the Industrial Revolution required increasingly large amounts of money to build factories and purchase machinery. This need for large amounts of capital resulted in the development of the corporate form of organization, which was first legally established in England in 1845. The Industrial Revolution spread rapidly to the United States, which shortly after the Civil War became one of the world's leading industrial nations. The accumulation of large amounts of capital was essential for establishment of new businesses in industries such as manufacturing, transportation, mining, electric power, and communications. In the United States, as in England, the corporation was the form of organization that facilitated the accumulation of the substantial amounts of capital needed.

Almost all large American business enterprises, and many small ones, are organized as corporations largely because ownership is evidenced by readily transferable shares of stock. The shareholders of a corporation control the management of corporate affairs only indirectly. They elect a board of directors, which establishes general policies and selects officers who ac-

tively manage the corporation. The development of a class of owners far removed from active participation in the management of the business created an additional dimension for accounting. Accounting information was needed not only by management in directing the affairs of the corporation but also by the shareholders, who required periodic financial statements in order to appraise management's performance.

As corporations became larger, an increasing number of individuals and institutions looked to accountants to provide economic information about these enterprises. Prospective shareholders and creditors sought information about a corporation's financial status and its prospects for the future. Government agencies required financial information for purposes of taxation and regulation. Employees, union representatives, and customers demanded information upon which to judge the stability and profitability of corporate enterprises. Thus accounting began to expand its function of meeting the needs of a relatively few owners to a public role of meeting the needs of a variety of interested parties.

PUBLIC ACCOUNTING

The development of the corporation also created a new social need — the need for an independent audit to provide some assurance that management's financial representations were reliable. This audit function, often referred to as the "attest function," was chiefly responsible for the creation and growth of the public accounting profession. Unlike private accountants, public accountants are independent of the enterprises for which they perform services.

Recognizing the need for accounting services of professional caliber, all of the states provide for the licensing of certified public accountants (CPAs). In 1944, fifty years after the enactment of the first CPA law, there were approximately 25,000 CPAs in the United States. During the next three decades the number increased fivefold. By 1981 the number had exceeded 200,000.

Auditing is still a major service offered by CPAs, but presently they also devote much of their time to assisting their clients with problems related to planning, controlling, and decision making. Such services, known as management advisory services, have increased in volume over the years until today they comprise a significant part of the practice of most public accounting firms.

INCOME TAX

Enactment of the first federal income tax law in 1913 resulted in a tremendous stimulus to accounting activity. All business enterprises orga-

nized as corporations or partnerships, as well as many individuals, were required to maintain sufficient records to enable them to file accurate tax returns. Since that time the income tax laws and regulations have become increasingly complex, many so-called "loopholes" have been closed, and the impact of the tax liability has generally tended to increase. As a consequence businesses have depended upon both private and public accountants for advice on legal methods of tax minimization, for preparing tax returns, and for representing them in tax disputes with governmental agencies.

It should also be noted that accounting has influenced the development of income tax law to a great degree. Had not accounting progressed to a point where periodic net income could be determined, the enactment and enforcement of any income tax law undoubtedly would have been extremely difficult, if not impossible.

GOVERNMENT INFLUENCE

Over the years government at various levels has intervened to an increasing extent in economic and social matters affecting ever greater numbers of people. Accounting has played an important role by providing the financial information needed to achieve the desired goals.

As the number and size of corporate enterprises grew and an ever increasing number of shares of stock were traded in the market place, laws regulating the activities of stock exchanges, stockbrokers, and investment companies were enacted for the protection of investors. These regulations involve accounting requirements. To protect the public from excessive charges by railroads and other monopolies, commissions were established to limit their rates to levels yielding net income considered to be a "fair return" on invested capital. This rate-making process required extensive accounting information. Regulated banks and savings and loan associations also had to meet record-keeping and reporting requirements and permit periodic examination of their records by governmental agencies. As labor unions became larger and more powerful, regulatory laws were enacted requiring them to submit periodic financial reports. With the enactment of social security and medicare legislation came record-keeping and reporting requirements for almost all businesses and many individuals.

As the federal government exercised increasing control over economic activities, accounting information became more essential as a basis for formulating legislation. One of the areas in which the government has influenced economic and social behavior has been through the income tax. For example, contributions to charitable organizations have been encouraged by permitting their deduction in determining taxable income. Controls over wages and prices have also been enacted at various times in