

Second Edition

A SURVEY OF ACCOUNTING

What the Numbers Mean

DAVID H. MARSHALL

FINANCIAL REPORT

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A Survey of Accounting

What the Numbers Mean

Second Edition

by David H. Marshall, MBA, CPA, CMA
Millikin University

IRWIN

Homewood, IL 60430
Boston, MA 02116



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Sponsoring editor:	Jeff Shelstad
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Production manager:	Irene H. Sotiroff
Designer:	Larry J. Cope
Artist:	Kim Meriwether
Compositor:	BiComp, Inc.
Typeface:	11/12 Times Roman
Printer:	R. R. Donnelley & Sons Company

Library of Congress Cataloging-in-Publication Data

Marshall, David H.

A survey of accounting : what the numbers mean / by David H. Marshall.—2nd ed.

p. cm.

Includes index.

ISBN 0-256-11301-7

1. Accounting. 2. Financial statements. I. Title.

HF5635.M36 1993

657'.3—dc20

92-16798

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0 DOH 9 8 7 6 5 4 3 2

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About the Author

David Marshall has been marching to the beat of a different drummer during most of his career. While an undergraduate at Miami University, he developed a career plan that called for achieving partnership status in a public accounting firm, and then at about age 50, retiring to an idyllic campus setting to spew forth accumulated wisdom from the “real world.” After three years in the U.S. Navy, his accounting career did begin in public accounting. But, after about three years he accepted an assistant controller position with a publicly held real estate owner, operator, and development firm. Three years later he became controller of a major candy manufacturer. And three years after that he decided to shorten the time originally set for a move to academia. After a year spent earning an MBA from Northwestern University, he was hired to teach accounting at Millikin University in Decatur, Illinois. After four years of teaching, he was named the university’s Vice President for Business Affairs. He held that post for three years before returning to the faculty. After all of those three-year stints, he had learned that he really wanted to teach.

Marshall served Millikin University as Professor of Accounting and Chair of the Departments of Accounting and Management Information Systems. He was named Distinguished Faculty Lecturer in 1984, and received the Teaching Excellence and Campus Leadership Award in 1992. One of his teaching principles was that students should work to see the “big picture”; that is, relate course concepts to their application in the business world.

The idea for this text developed from the requirement that Millikin’s industrial engineering majors take an accounting course. A traditional financial accounting principles course was available, but Marshall believed that a financial statement user’s approach was more appropriate, with coverage of product costing, cost behavior patterns, budgeting, standard costs, and capital budgeting included

in the course. After much assistance from colleagues, reviewers, and students, the result of his belief is the book you now have in your hands.

In May 1992, Marshall retired from the faculty of Millikin University, and accepted a post-retirement position as Director of Planned Giving in the Advancement Division. He is still very interested in accounting education, especially the developments resulting from the efforts of the Accounting Education Change Commission.

Preface

The word *accounting* most often conjures up images of tedious figures, thick glasses, and headaches. However, the savvy businessperson realizes that accounting has come to be known as the *language of business* with good reason. Accounting conveys important financial information that is used in the management planning, control, and decision-making processes integral to achieving organizational objectives. Some command of this language is a necessity for those who wish to participate in these processes.

In 1989 the Accounting Education Change Commission was formed “to foster changes in the academic preparation of accountants consistent with the goal of improving their capabilities for successful professional careers.” In the exposure draft of Position Statement No. 2, “The First Course in Accounting,” the Commission stated:

The two primary objectives of the first course in accounting are (1) to make clear the ways in which accounting is an information development and communication function that supports economic decision making, and (2) to prepare students to obtain additional knowledge. The knowledge and skills provided by the first course in accounting should facilitate subsequent learning even if the student takes no additional academic work in accounting or directly related disciplines. For example, the course should help those who complete it in performing financial analysis; in deriving information for personal or organizational decisions; and in understanding business, governmental, and other organizational entities.¹

Typical undergraduate business students are required to complete two entry-level accounting courses covering topics in finan-

¹ Accounting Education Change Commission, Exposure Draft of Position Statement No. 2, “The First Course in Accounting” (Torrence, Calif., 1992), p. 3.

cial and managerial accounting. The author of this text believes that over the years, many of the textbooks used in those courses have become increasingly encyclopedic. The result has been the teaching of a great deal of accounting detail without having students obtain a “big picture” of financial statement and accounting information use. One of the objectives of this text is to provide that “big picture” while meeting the objectives for a first course in accounting identified by the Accounting Education Change Commission. When supplemented with appropriate cases and other materials, this text can be used in both the financial and managerial entry-level courses taken by undergraduate business majors. Students who intend to pursue an accounting major will also have to learn the procedures of accounting, which can be taught in courses or with laboratory cases (e.g., practice sets) designed for those students. The majority of students in the entry-level courses will not become accounting majors. This book is aimed at helping them learn how to become effective users of accounting information while providing a solid foundation for those students who will pursue advanced study in accounting.

Many students whose academic interests are not in the business field can also benefit from exposure to accounting. These students, however, often have a restricted curriculum and may simply not be interested in investing two elective courses in acquiring some basic accounting tools. The structure of this book lends itself to a one-semester course that provides a basic understanding of accounting information. Students who could benefit from this approach include undergraduate majors in the following areas:

- Engineering
- Behavioral sciences
- Public administration
- Prelaw programs

Professionals in any of these broad disciplines are likely to be confronted with financial management issues early in their careers. In fact, accounting issues are likely to touch the majority of career paths open to a student today. MBA students who do not have a background in undergraduate business study or feel the need for a refresher course will value the opportunity to gain or revive certain key business skills.

The text takes the reader through the basics: what accounting information is, what it means, and how it is used. Students examine financial statements and discover what they do and do not communicate. This knowledge will help them gain the decision-making and problem-solving abilities so crucial outside the academic environment.

This book is for the benefit of the many who simply want to know “what the numbers mean.”

ORGANIZATION

Chapter 1 presents a basic description of accounting and its evolution. Emphasis is placed on developments that have occurred to meet the needs of the users of accounting information and on dispelling the misconception that accounting standards are just a code of rules. The remainder of the text is divided into two major topic areas: financial accounting topics (Chapters 2 through 11) and managerial accounting topics (Chapters 12 through 16).

In presenting these two aspects of accounting, the spiral approach is used. In this teaching method, a general sketch is presented, and each chapter fills in a few of the finishing details until the reader possesses the full picture. The spiral approach is based on the belief that students can better navigate a subject matter if they are given a glimpse of the big picture first. Thus the objectives of the course are clear from the beginning, and the student can keep them in sight throughout the learning process.

Following this model, the first chapter of each section outlines the pertinent fundamental relationships and presents appropriate terminology so that the student is given an overview before exposure to the details. In the following chapters, the fundamentals are elaborated and developed until the picture is sufficiently fleshed out. The focus throughout the presentation is on understanding the meaning of the numbers in financial statements, their relationship to each other, and how they are used in evaluation, planning, and control. In taking the spiral approach, an instructor focuses on the function, not the formation, of the financial statements.

Highlights

The financial accounting portion (Chapters 2 through 11):

- Chapter 2—Getting the big picture

A model of the accounting process and the role of financial statements.

The introduction of a schematic diagram that illustrates the interrelationship of various financial statements and facilitates understanding the effects of various transactions.

- Chapter 3—Introducing basic concepts

Return on investment.

Return on equity.

Liquidity.

- Chapter 4—Understanding the method

The bookkeeping system in general terms.

A powerful transaction analysis scheme featuring the “horizontal model,” which builds on the schematic diagram presented in Chapter 2.

Introduction of journal entries and T-accounts with emphasis on the horizontal model as the way to understand the effect of transactions on the balance sheet and income statement.

- Chapters 5 through 10—Examining the specifics

The elements of the balance sheet, income statement, and statement of cash flows in relation to the schematic diagram.

The *unique* and valuable explication of Explanatory Notes in Chapter 10, crucial to understanding financial statements as a whole.

Knowledge of business practices as a foundation for an understanding of accounting for transactions.

- Chapter 11—Using the knowledge

Financial statement analysis: from financial data to decision making.

The managerial accounting portion (Chapters 12–16):

- Chapter 12—Getting the big picture

An introduction to cost accounting systems and cost classifications. Diagrams of cost flow, cost systems, and cost behavior.

- Chapters 13 through 16—Examining the specifics and putting them to use

An in-depth look at the specific uses of cost data in the planning, control, and decision-making processes.

The relationship between cost data and other factors involved in these processes.

NOTABLE FEATURES

Text

- **Business Procedure Capsules** are used throughout the chapters to highlight and discuss various business practices and their financial statement impact. Understanding these business practices facilitates a more complete understanding of financial statements in general.




- **Learning Objectives** guide students conceptually by providing a framework for each chapter.
- **Chapter Summaries and Key Terms and Concepts** promote greater retention of important points and definitions.
- **The 1991 Annual Report of Armstrong World Industries, Inc.**, is presented in Appendix A and is referred to frequently in the financial accounting portion of the text. This real-world example piques student interest and gives students a hands-on experience. In addition, students are asked to obtain their own example of an actual annual report.
- **End-of-chapter Exercises and Problems** illustrate important concepts and applications. Problems that require use of the Armstrong World Industries, Inc., annual report in Appendix A are identified with the logo shown here in the margin. The pencil logo, also shown in the margin, identifies questions requiring written answers.
- **Solutions** to odd-numbered exercises and problems are included in Appendix B in order to reinforce learning and minimize frustration as well as to facilitate the use of the book as a self-study or Continuing Professional Educational resource.

Supplements

- **Instructor's Manual and Test Bank** featuring teaching/learning objectives, chapter outlines, teaching observations, exercise and problem solutions, quiz/exam questions, and take-home quizzes.
- **Study Guide and Workpapers** (by Wayne McManus) for student use, including several hundred matching, true/false, and multiple choice review questions with answers.
- **Transparency Acetates** (supplied as transparency masters in the first edition) provide instructors with a framework for chapter-by-chapter discussions. Some are figures lifted from the text, others simply organize the material under discussion.
- **Irwin's Computerized Testing Software**, an advanced-feature test generator, allows you to add and edit questions; save and reload tests; create up to 99 different versions of each test; attach graphics to questions; import and export ASCII files; and select questions based on type, level of difficulty, or keyword. This software provides password protection of saved tests and question databases, and can run on a network. Irwin's free customized exam preparation service, Teletest, is also available.

ADDITIONAL NOTES FROM THE AUTHOR

In this text, I have followed a pragmatic approach in explaining the information content and use of financial statements and financial

data. Students should be encouraged to read *The Wall Street Journal* and other business publications regularly, and instructors should attempt to call to students' attention current developments relating to the course material.

Users of this text are cautioned that accounting is not a spectator sport and that comprehension of the material does require actually working through the problems. Reviewing solutions without first attempting the problems will significantly dilute the learning process.

I hope the approach and scope of coverage in this text have achieved my identified objectives and, in addition, have adequately filled the user's need. Any ideas for increasing the effectiveness of this text are welcomed.

ACKNOWLEDGMENTS

The first edition of this text had a long gestation period, and I am grateful for the encouragement and support of my colleagues at Millikin University. Dr. C. R. Decker (Grover M. Hermann Professor of Business Policy and former Dean of the Tabor School of Business and Engineering) and R. A. Mannweiler (current Dean of the Tabor School) persevered in challenging me to write. Professor Daniel F. Viele developed Exhibit 2–5. Millikin provided the time I needed to write in the form of an academic leave during the fall of 1985. Without that leave this book would still be just an idea. My thanks also go to Mr. Stuart Koop, Director of the Mueller Computer Center at Millikin while the manuscript was being prepared. He and his staff provided valuable technical assistance in that process.

Mr. Wayne McManus, a onetime colleague at Millikin University, has provided assistance in several respects. His suggestions for improving this text proved almost as beneficial as his creation of the Study Guide and Workpapers.

For several years, Armstrong World Industries, Inc., has provided copies of its annual report for classroom use. This link to reality has been a valuable teaching aid. I am grateful for Armstrong's permission to include its 1991 Annual Report as Appendix A. In addition to the report itself, Armstrong also makes available a "Special Edition" brochure that explains many elements of the annual report. Adopters of this text are encouraged to request annual reports for subsequent years and "Special Edition" brochures from Armstrong World Industries, Inc. The 1991 "Special Edition" brochure, and multiple choice questions and answers

supplied by Armstrong World Industries, Inc., have been reproduced in the Instructor's Manual and Test Bank.

Although the approach to the material and the scope of the coverage are the results of my own conclusions, truly new ideas are rare. The authors whose textbooks I have used in the past have influenced many of my ideas for particular accounting and financial management explanations. Likewise, students and colleagues through the years have helped me clarify illustrations and teaching techniques. Many users of the first edition—both teachers and students—have offered comments and constructive criticisms that have been encouraging and helpful. All of this input is greatly appreciated.

In addition, the following persons have provided valuable feedback after reviewing manuscript versions of this text. I am grateful for their supportive comments and constructive criticisms.

Sally Adams, California State University—Chico

Maureen Anderson, University of St. Thomas

Ted Compton, Ohio University

Dave Evans, Johnson County Community College

Keith Howe, Brigham Young University

Zabi Ravae, Middle Tennessee State University

Paul Schlachter, Florida International University

James Sisson, Oregon State University

David H. Marshall

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