



Advanced Accounting

Fischer • Taylor • Leer
Second Edition

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P R E F A C E

A second edition of a successful book permits the authors to update material which has been altered by pronouncements of authoritative bodies and to offer expanded discussion and illustrations on complex topics. Updating is most pronounced in the areas of accounting for governmental units and nonprofit organizations, estates and trusts, insolvency, and foreign operations. There is continued emphasis on the relationship between theory and practice.

One of the new features of the revised edition is a student study guide, which is designed to reinforce understanding by highlighting essentials and providing immediate feedback for self-evaluation of mastery of a subject area. Available for consolidation problems is a set of preprinted work sheets, which substantially lessen the time necessary to solve a problem without sacrificing the application of consolidation principles.

The second edition retains a design that permits flexibility in its use. There is ample material for a program that devotes two quarters or semesters to advanced accounting topics. From the following independent modules, schools that desire less exposure may select the areas that are most important for their objectives:

- Accounting Theory

- Real Estate and Franchise Accounting

- Income Presentation, including earnings per share, interim and segmental reporting

- Business Combinations:

 - Chapters 5 through 9 provide basic coverage.

 - Chapters 10 through 12 present specialized topics.

- Foreign Operations

- Partnerships

- Governmental Accounting

- Accounting for Nonprofit Organizations:

 - Chapter 18 Accounting for Nonprofit Universities and Hospitals

 - Chapter 19 Accounting for Voluntary Health and Welfare Organizations

- Estates and Trusts

- Insolvency

ACCOUNTING THEORY (CHAPTER 1)

The introductory chapter provides a broad, theoretical framework that establishes a foundation for the student before the practical applications are explored. The recent "Statements of Financial Accounting Concepts" are discussed as they relate to information standards, accounting measurement, and income determination.

REAL ESTATE AND FRANCHISE ACCOUNTING (CHAPTER 2)

The topics of real estate and franchise accounting provide practical applications of revenue recognition concepts reflected in accrual and installment accounting, cost recovery methods, and long-term construction contract accounting. The chapter has been completely revised to identify more clearly the revenue and expense elements of real estate transactions and their respective accounting treatment. Franchise accounting is discussed in conformity with the recent Statement of Financial Accounting Standards dealing with the area.

INCOME PRESENTATION (CHAPTERS 3 AND 4)

The concepts of income presentation are discussed as an introduction to these chapters. Discontinued operations are considered, and case illustrations are used to analyze the accounting and statement presentation of such operations. Actual excerpts from published financial statements are provided to illustrate the disclosure associated with discontinued operations. Interim and segmental reporting are discussed. The calculation of earnings per share is presented using an easy-to-follow format. The procedures used provide for determination of the dilutive nature of a security prior to its inclusion in the EPS calculation.

BUSINESS COMBINATIONS (CHAPTERS 5-12)

The topic of intercompany bonds is included in a new chapter that also provides more complete coverage of intercompany leasing. To improve students' understanding of intercompany bond holdings, concepts are developed first using straight-line amortization before proceeding to amortization under the effective interest method. More detail has also been provided on the preparation of a consolidated statement of changes in financial position. Flexibility has been increased by including complete procedures for investments maintained under the simple equity method, the sophisticated equity method, and the cost method.

The following unique features were retained to assist the students' learning process:

Chapter 5 is a complete discussion of purchase versus pooling theory, which serves as a foundation for the chapters that follow. No consolidation methods are discussed until later chapters.

Work sheets are presented in an easy-to-follow horizontal format, which includes columns for consolidated income, minority interest, controlling retained earnings, and the balance sheet. Procedures for balance sheet work sheets only, which are commonly found on the CPA examination, are contained in an appendix to Chapter 10.

Innovative scheduling is used to accomplish the usually difficult tasks of transferring equities in a pooling, distributing the disparity between cost and book value in a purchase, and distributing income to minority and controlling interests.

FOREIGN OPERATIONS (CHAPTER 13)

The recently issued FASB Statement No. 52 is given complete coverage, including a comprehensive illustration of the translation of financial statements denominated in a foreign functional currency. The accounting for foreign currency transactions and hedging transactions are thoroughly discussed, along with the potential effect on income of such transactions. Special implications regarding highly inflationary economies, intercompany profits, income tax allocation, and financial statement disclosure are presented.

PARTNERSHIPS (CHAPTERS 14 AND 15)

Major tax and nontax differences between partnerships and corporations are explained in order to identify the appropriateness of these competing business forms. Equity theories previously discussed are employed to help the student understand the logic behind partnership accounting. The traditional topics of dissolution and liquidation are clearly and amply illustrated. Reference is made to the Uniform Partnership Act throughout the chapters in order to emphasize the influence of legal provisions on accounting for partnerships.

GOVERNMENTAL ACCOUNTING (CHAPTERS 16 AND 17)

The portion of the book devoted to governmental accounting has been completely revised to be in conformity with the Municipal Finance Officers Association 1980 edition of *Governmental Accounting, Auditing, and Financial Reporting*, as well as with its *Statement 1*. The major changes reflected in the revision are:

- (1) General purpose financial statements with columns for each fund type and account group constitute the basic financial statements necessary for presentation in conformity with generally accepted accounting principles.
- (2) Funds are categorized as either governmental, proprietary, or fiduciary.
- (3) Recording procedures have been altered for some items, such as budgetary entries, interfund transfers, and bond proceeds.

Each fund and account group is discussed and illustrated separately to simplify understanding and to improve teaching effectiveness.

ACCOUNTING FOR NONPROFIT ORGANIZATIONS (CHAPTERS 18 AND 19)

At the request of users of the first edition, the chapter on nonprofit organizations has been expanded into two chapters. Chapter 18 covers nonprofit universities and hospitals, while Chapter 19 deals with the growing field of voluntary health and welfare organizations. The segregation permits expanded discussion with more detailed illustrations that improve understanding.

ESTATES AND TRUSTS (CHAPTER 20)

The topic of estates and trusts has been revised to incorporate changes resulting from the Revenue Act of 1978 and the Economic Recovery Tax Act of 1981. The chapter dwells on the necessity of planning for death, if maximum retention of assets is to be accomplished.

INSOLVENCY (CHAPTER 21)

The chapter on insolvency has been revised to incorporate the provisions of the Bankruptcy Reform Act of 1978. Various relief procedures for individuals and companies that are in financial difficulty are presented.

The text includes 268 questions, 200 exercises, and 229 problems. All relevant CPA problems and theory questions from past examinations have been adapted for use in the text. The questions are designed to help the student review the important points of each chapter. Exercises are an efficient means of focusing on specific applications of the chapter without the time commitment necessary for problems. Problems integrate several procedures and calculations into broader application of the chapter's contents. Problems range in difficulty from those requiring procedural applications to those requiring reasonably complex analytical skill. The authors have found it helpful to assign selected questions and exercises prior to class discussion to provide reinforcement to the students' reading. Problems may then be used after class presentation to integrate and solidify knowledge.

We are indebted to the American Institute of Certified Public Accountants and the Financial Accounting Standards Board for their permission to quote material and to use relevant CPA examination questions and problems. We are grateful to the Municipal Finance Officers Association, and in particular to Richard J. Haas, who permitted us to review the manuscript of *Governmental Accounting, Auditing, and Financial Reporting*. For their creative contributions, we thank Mary Paxton and Maureen Ruppel. We appreciate the care in preparation and proofing by G. R. Gehrig and David Carter.

Comments of users were extremely helpful in preparation of the second edition, especially those of Professors Roy Tuttle, Ray Weatherwax, and Carol Walkowiak. We welcome reactions of readers.

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CHAPTER 1

ACCOUNTING THEORY



Contemporary accounting is a service-oriented discipline concerned with measuring and communicating economic or financial data which relate to the activities of economic entities. Accounting is a dynamic discipline which is influenced by numerous environmental factors and by an underlying theoretical structure. In general, accounting can be divided into the following functional areas: managerial, financial, tax, and governmental or not-for-profit accounting. A major emphasis of this text is on financial accounting, which is concerned with measuring enterprise resources and obligations and subsequent changes in these items due to activities which affect the entity. Considerable attention is given to contemporary problems of income determination, accounting for special business entities, and accounting for financially-troubled entities. Another area of emphasis is accounting for nonprofit organizations, including governmental entities. The discussion focuses on the unique accounting methods used to secure the control of activities of such entities. Before attention is focused on these basic areas of concern, however, a brief discussion of accounting and its supportive theory is in order. This discussion is not designed to be all-inclusive, but rather to present aspects of accounting theory which relate to the topics contained in this text.

THE PURPOSE OF ACCOUNTING

The basic purpose of accounting is to measure and communicate relevant financial data for making economic decisions. The specialized data needed for each type of decision require that the various users of financial information be identified. For example, management may need information in a different form or degree of detail than the information needed by other parties. These other parties could include existing or potential creditors and shareholders, as well as those who have a less direct financial interest in the entity, such as employees, unions, financial analysts, and governmental agencies.

As a result of the diversity of specific users of financial accounting data, and the diversity of their specific economic needs, the decision processes of these users have not been adequately described. However, an economic framework which is fundamental to all users has been identified. This framework involves the efficient allocation of scarce resources among competing entities, and is designed to maximize individual and enterprise wealth, as well as to achieve broad social goals.

Informational Needs of Users

Financial accounting data should be the basis for determining whether resources should be allocated to an entity, and how the resources should be allocated. Such information may be provided through a system of reporting which includes financial statements and other supplementary means of communicating an entity's wealth at a point in time and the measurement of changes in wealth over a period of time.

The following basic assumption is useful in identifying the informational needs of users, and in specifying the objectives of financial reporting through which such information is communicated:

Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows Thus, investors, creditors, employees, customers, and managers significantly share a common interest in an enterprise's ability to generate favorable cash flows. Other potential users of financial information share the same interest, derived from investors, creditors, employees, customers, or managers whom they advise or represent or derived from an interest in how those groups (and especially stockholders) are faring.¹

An analysis of this assumption suggests that the benefits of decisions with respect to the allocation of resources are reflected in the amount of cash which is distributed to those who provided the resources. Thus, the primary goals of an economic entity can be measured in terms of the cash which will ultimately be returned on invested capital.

Information Standards

For a financial reporting system to have maximum utility, given cost/benefit considerations and the needs of users, it should satisfy certain standards or qualitative criteria. These criteria, which provide a basis for evaluating alternative accounting and reporting methods, are concerned with the relevance, reliability, neutrality, and comparability of accounting information.²

¹ *Statement of Financial Accounting Concepts, No. 1*, "Objectives of Financial Reporting by Business Enterprises" (Stamford: Financial Accounting Standards Board, 1978), par. 25.

² *Statement of Financial Accounting Concepts, No. 2*, "Qualitative Characteristics of Accounting Information" (Stamford: Financial Accounting Standards Board, 1980).

Relevance. Accounting information is relevant if it pertains to the economic decisions or actions considered by users. Relevant data should influence or be capable of making a difference in the probabilities of occurrence surrounding an action or decision by the user, such as a decision to buy a security. The relevance or predictive value of data will be enhanced if the data are provided on a timely basis and in an understandable form. Of the various information standards, relevance is of extreme importance, in that data which satisfy all other standards will be marginally useful if they are not relevant to the needs of users.

Reliability. The overall utility of information is also seriously influenced by the reliability or ability of the information to represent or measure the attributes (conditions or events) of interest. Reliability is affected by the verifiability and representational faithfulness of the accounting measurement. Verifiability refers to the bias or judgment required of the one measuring an attribute. Completely verifiable information means that given identical measurement processes or models, independent measures would reach the same conclusion regarding the attribute of interest. In statistical terms, verifiability is measured by the dispersion of independent measurements about the mean of the measurements, which are derived from a common measurement model. For example, the closing price of a security is much more verifiable than the expected value of the security six months hence, as evidenced by comparing the dispersion of the two sets of values which result from independent measurements. Representational faithfulness refers not to the bias or judgment required of the measurer but rather the ability of the measurement model to portray what it purports to portray. Accuracy may be determined by measuring the difference between the mean value produced by the measurement model and the true (although perhaps unknown) value of the attribute. For example, the historical cost of an asset, even though more verifiable, may not be as representationally faithful with respect to measuring the asset's value as the net present value of cash flows traceable to the asset.

Neutrality. Neutrality suggests that financial reporting should not favor one or more user groups or be designed to induce a particular behavior by biasing the selection of what is to be disclosed. Certainly financial reporting should be expected to influence behavior and have a purpose but it should not bias the output in order to achieve some predetermined political or nonpolitical goal.

Comparability. The comparability of financial data is a function of the differences between accounting methods used by various entities to record similar events. Such *interfirm comparability* suggests that the utility of financial data will be enhanced if the similarities and differences between entities are reflected over time. Comparability is also influenced by a single entity's changes in accounting methods used to

measure similar events. This *intrafirm comparability*, which involves the consistent application of accounting methods within an entity over time, is an important criterion against which the utility of financial data should be assessed.

THE ACCOUNTING ENTITY

The concept of an entity is indispensable to accounting because it defines the boundaries of accounting activity; therefore, the economic entity must be defined. An entity may be viewed as a unit that controls economic resources which are employed to produce a good or service. Although divisions, profit centers, and branches may be viewed as accounting entities in their own right, they also become a part of a larger entity. The boundaries of an entity are not confined to legal creations but many encompass several entities. For example, even though a parent corporation and its subsidiaries are separate and distinct legal entities, they may be viewed as one reporting entity for accounting purposes.

Equity Theory

When the entity has been defined, a decision must be made as to how it should be viewed theoretically, since the viewpoint adopted could affect the determination of net income, the valuation of assets, the definition of equity, and disclosure requirements. This need to define a viewpoint is not unique to the accounting profession. In the visual arts, for example, given a distinct object, such as a tree, an artist develops an interpretation of the object. A realistic view would suggest different techniques and produce a different result than would a surrealist or cubist viewpoint.

The theoretical framework of accounting consists, in part, of theories which explain the nature of the equities comprising a business unit, and which also support the accounting principles applicable to that particular entity. This body of theory, often referred to as equity theory, consists of several mutually exclusive concepts. The difference between these concepts is in the manner in which a particular entity is viewed. For example, should the entity be viewed with regard to owners, or creditors, or management, or all providers of capital, or some legal concept? Certainly a choice of one of these viewpoints would influence the accounting principles used and the nature of the resulting financial statements.

It is rare that accounting for an entity can be traced entirely to one equity theory. In fact, there are aspects of accounting within a particular organization which are traceable to more than one theory. Therefore, to understand the basis for applying specific accounting principles to a given entity, the student of accounting must understand the various equity theories. Of these theories, the proprietary, entity, and fund

theories have had the most significant impact on the development of modern accounting thought.

Proprietary Theory. The proprietary theory elects to focus on the owners or proprietors of a business unit rather than viewing the unit as a distinct business entity in its own right. As one author stated:

According to the proprietary viewpoint, the standing and operations of a business firm are interpreted according to the manner in which they affect the proprietors or owners of the business. Whether the business be conducted in the form of an individual proprietorship, a partnership, or a corporation, the proprietary viewpoint looks at the business through the eyes of the owners. Thus, despite the fact that the corporation has a distinct legal identity, the proprietary viewpoint looks upon it essentially as a means whereby several individual entrepreneurs can conveniently carry on business together. At most, the corporation is regarded as an agent, representative, or arrangement through which the individual entrepreneurs or shareholders operate.³

According to proprietary theory, the wealth and activity of the business unit are analyzed in terms of how they relate to the owners of the business. Assets are viewed as belonging to (or as the property of) the owners, and liabilities are viewed as obligations of the owners, or "negative assets." This emphasis suggests the balance sheet equation of assets minus liabilities equals proprietorship ($A - L = P$). Income under the proprietary theory is an increase in the owner's wealth, versus the entity's wealth, in that revenues are viewed as increases in proprietorship, and expenses as decreases in proprietorship. Thus, the major objective of a business is that of increasing the proprietor's wealth, and therefore primary emphasis is placed on asset and liability measurement as a means of accurately measuring changes in the proprietary interest or wealth.

The proprietary theory is one of the oldest equity theories supporting the development of accounting. It was frequently discussed in accounting textbooks of the nineteenth century and was extremely relevant to the predominant business forms of that time, i.e., proprietorships and partnerships. The proprietary theory is still relevant, even though the corporate form of organization has become widespread. For example, the corporate concept of net income, which views interest and income taxes as expenses, represents the increase in wealth of the owners rather than that of all providers of capital. The inclusion in net income of the parent corporation's share of subsidiary net income also suggests a proprietary viewpoint which emphasizes the wealth of the owners. The treatment of a sole proprietor's salary as a distribution of income, rather than as an expense, provides an example of how the proprietary theory influences accounting for other forms of organizations.

³ John W. Coughlan, *Guide to Contemporary Theory of Accounts* (Englewood Cliffs: Prentice-Hall, Inc., 1965), p. 155.

Entity Theory. In direct contrast to the proprietary theory is the entity theory, which views the business unit as a separate and distinct entity, possessing its own existence apart from the owners. The capital structure of the firm is made up of creditors and stockholders (owners), both of whom are investors concerned with the success of the entity, thus suggesting a balance sheet equation of assets equal equities. The assets are viewed as rights which accrue to the entity, not the owners, while the equities are viewed as a common group of investors, often divided formally into the liabilities (the creditors' equity) and the stockholders' equity. The liabilities of the entity can normally be valued more objectively and independently than stockholders' equity and, therefore, are viewed as the specific obligations of the entity. The creditors and stockholders have different rights with respect to income, risk, control, and liquidation; nevertheless, they are viewed as being, in substance, members of a common equity element. According to the entity theory, the major objective of the business is generating income, and therefore primary emphasis is placed on the determination of income available to all investors and the importance of the income statement.

A strict interpretation of the entity theory would view income, excluding any charges representing cost of capital, as accruing to the entity, not the equities (owners). Paton and Littleton state that:

If the corporation were viewed as merely an aggregation of individual investors, it would be consistent to hold that the earnings of the enterprise belonged to the investors from the moment of original realization. Emphasis on the entity point of view, on the other hand, requires the treatment of business earnings as the income of the enterprise itself until such time as transfer to the individual participants has been effected by dividend declaration.⁴

The entity theory is most applicable to the corporate form of organization, which is characterized as a legal unit separate from its owners. This distinct identity is illustrated by the fact that unsatisfied creditors cannot seek recovery from the personal assets of the owners of the corporation, and that changes in the ownership structure of the corporation do not dissolve the entity. The classification of corporate owners' equity and the expensing of salaries paid to employee-shareholders are further evidence of the entity theory.

Fund Theory. The fund theory views the entity as consisting of economic resources (funds) and various restrictions or claims against the use of these resources, thus suggesting an accounting equation of assets equaling restrictions against the use of these assets. Liabilities and owners' equity may be viewed as restrictions on the use of specific assets or assets in general. The theory is asset centered, and places primary emphasis on the administration and appropriate use of these funds versus

⁴ W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Iowa City: American Accounting Association, 1965), p. 8.