

A SURVEY OF ACCOUNTING

WHAT THE NUMBERS MEAN



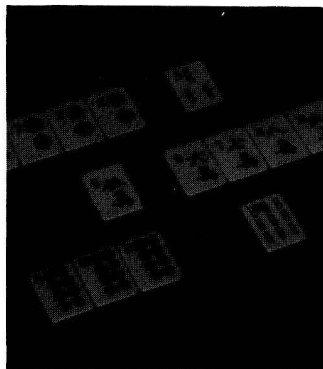
DAVID H. MARSHALL

A Survey of Accounting What the Numbers Mean

by David H. Marshall, MBA, CPA, CMA
Professor of Accounting
Millikin University

IRWIN

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Boston, MA 02116



On the Cover

The mah-jongg tile game, whose origins are Chinese, was brought to the American market by Joseph P. Babcock, in 1920. He adapted the rules and added arabic numerals to the tiles to better suit the Western market. At first glance the game is reminiscent of dominoes, but it is actually more similar to rummy.

The object of the game is to accumulate points by assembling established combinations of tiles. Each tile is autonomous, but acquires relevance only when placed in context or in meaningful sequence. Similarly, accounts can stand alone. Decision makers can most effectively understand their significance and use their informational content, however, when they are brought together in combination to comprise complete financial statements.

Tiles Courtesy of Sheila Schiller

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A Survey of Accounting What the Numbers Mean

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 order to learn the accounting language, typical undergraduate business students are required to complete two entry-level accounting courses covering topics in financial and managerial accounting. This curriculum provides students who are majoring or minoring in any area of business studies the essential background in accounting necessary in the business world.

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. This book takes the position that the time has come for the academic community to recognize this need and take steps toward meeting it. Students interested in augmenting their capabilities by learning about the financial foundations common to many fields should have the opportunity to do so. The structure of this book lends itself to a one-semester course that provides a basic understanding of accounting information.

A Survey of Accounting: What the Numbers Mean is designed especially for nonaccountants who realize the value of possessing basic ac-

counting knowledge. Some students who could benefit in this regard include undergraduate majors from

- 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 the how they are used in evaluation, planning, and control. In taking the spiral approach, an instructor focuses on the function and 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, including journal entries. A powerful transaction analysis scheme, which builds on the schematic diagram presented in Chapter 2.
- 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 1988 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.
- **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.

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 their 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

This text has 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, and his staff for the technical assistance they provided in the actual manuscript preparation.

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 1988 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.

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. Their 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.

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Accounting—Present and Past

The objective of this text is to present enough of the fundamentals of accounting to permit the nonaccountant to understand the financial statements of an organization operating in our society, and to understand how financial information can be used in the management planning, control, and decision-making processes. Although usually expressed in the context of profit-seeking business enterprises, most of the material is equally applicable to not-for-profit social service and governmental organizations.

Accounting is sometimes called *the language of business*, and it is appropriate for people who are involved in the economic activities of our society—and that is just about everyone—to know at least enough of this language to be able to make decisions and informed judgments about those economic activities.

LEARNING OBJECTIVES

After studying this chapter, you should understand:

- A definition of accounting.
- Who the users of accounting information are, and why they find accounting information useful.
- Several of the categories of accounting, and the kinds of work that professional accountants in each category perform.
- The development of accounting, from a broad historical perspective.
- That financial statements do not result from following a codified set of hard and fast rules; that there are, in fact, alternative methods of accounting for and reporting similar economic activities.
- That the Financial Accounting Standards Board (FASB) is the current standard-setting body for generally accepted accounting principles.
- The reasons for the FASB's Conceptual Framework project.
- The objectives of financial reporting for business enterprises.