

SCHATTKE
JENSEN
AND BEAN

Financial Accounting

Concepts and Uses



FINANCIAL ACCOUNTING

concepts and uses

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FINANCIAL ACCOUNTING
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Preface

Our basic philosophy in writing this book is that accounting produces information useful in economic decisions, that the most effective use of accounting information is by those who understand accounting measurements, including the limitations of these measurements, and that a good understanding of accounting measurements is gained only by thorough study of underlying concepts and their applications.

This book, based on the financial accounting portion of our earlier text, **ACCOUNTING: CONCEPTS AND USES**, has several noteworthy features that reflect our basic approach:

- Complete and fairly rigorous coverage of financial accounting topics;

- Ample material to allow flexibility in topic selection by the instructor;

- Emphasis on the nature and objectives of accounting;

- Ample discussion of the funds statement and consolidated reports;

- Updated material from all relevant APB opinions, with special emphasis on APB Statement No. 4;

- Concise coverage of bookkeeping techniques and a management information oriented study of data processing and the computer.

Organization

The book's five parts are organized on the pedagogical principle of cumulative learning units. The text provides an effective progression from a panoramic view of accounting to a consideration of accounting's detailed structure, and back to a broad perspective of accounting. Each part depends on the preceding one to reinforce earlier learning; at the same time, each part has an independent structure suitable as a self-contained examination unit. Parts II, IV, and V are organized internally to give the instructor wide flexibility in his selection of chapters to be covered.

The end products of financial accounting are the financial statements businesses give to investors, creditors, and other interested parties. These statements are introduced in Part I, The Framework of Finan-

cial Accounting. Chapters 1 and 2 stress the role and objectives of financial accounting, thus provide the basic goals to which all subsequent discussion can be related. Chapter 2 is based on Accounting Principles Board Statement No. 4 on basic concepts and principles (we thank the American Institute of Certified Public Accountants for permission to quote from the statement). Chapters 3 and 4 give a strong conceptual introduction to the financial statements. The balance sheet is covered in Chapter 3, while the income and fund statements are discussed in Chapter 4.

Part II, Processing Accounting Data, has a concise treatment of the accounting cycle in Chapters 5 and 6, and a discussion of data processing systems for management information in Chapters 7 and 8. The accounting cycle includes the bookkeeping aspects of accounting, to be sure, but a prior knowledge of the objectives of accounting makes the discussion of the cycle more meaningful and lifts it above mere memorization of routine procedures. A knowledge of the accounting cycle is important to understanding the usefulness and limitations of accounting and provides important tools for subsequent analysis. Discussion of data processing systems logically follows the accounting cycle. Chapter 7's discussion of data processing tools, including the usual journals and ledgers, is preceded by ample consideration of why such systems are useful. Chapter 8 covers the principal computer hardware and software developments, including COBOL programming, and the accountant's role in computer-based management information systems.

Part III, Measurement of Assets, Liabilities, and Income, stresses broad classes of items and concentrates on similarities in treatments instead of exhaustive coverage of particular items. There is sufficient technical coverage to provide a firm foundation for later courses in financial accounting without sacrificing the appeal of a generalized approach. As far as possible, we emphasize reason, theory, and usefulness, rather than procedures.

The corporation is emphasized in Part IV, Owners' Equity. Two chapters are devoted to principal accounting problems of (1) corporations and (2) parent-subsidiary relationships and business combinations. A single chapter stresses the main features of accounting for single proprietorships and partnerships.

After a thorough exposition of the detailed structure of financial accounting in the three preceding sections, the book ends with a panoramic view of accounting in Part V, Accounting Theory and Analysis. Chapters 17 (accounting theory), 18 (statement analysis) and 19 (fund and cash flows) serve to reinforce and develop general concepts introduced in earlier chapters. Chapter 20 discusses the important role of income taxes in financial statements and in investor decisions. This last section of the book helps the student integrate his knowledge of accounting toward the end uses of accounting.

Each chapter of the book is followed by a number of questions and problems. Case problems—often based on actual situations—are included in most chapters. The problems are meant to stimulate thought as well as cover the application of concepts introduced in the chapter.

The real value of a textbook is determined by its impact on the student. We are confident that a student who completes this book will have a good understanding of the purposes and objectives of accounting and an appreciation of accounting as a tool of modern management and investing. Students continuing their accounting studies will have a solid base on which to build.

A textbook is never perfect and can never satisfy all the needs of its users. In particular, a beginning text in accounting involves some necessary compromises between what is found in practice, what is traditional in pedagogy, and what the authors prefer. We can only hope that our attempt yields some insights, stimulates thought, and leads to interesting class discussions. If it does, our efforts will be amply rewarded.

Use of the Text

The text is designed to give the user maximum flexibility in selecting financial accounting topics to fit the emphasis he finds desirable and the time constraints he faces. The chapters are arranged in the order favored by the authors. In particular, we suggest the first four chapters be taken first and given more than proportional emphasis: Chapter 19 could follow Chapter 4 to provide early and complete coverage of the funds statement. For a course with severe time limitations, part or all of the material in chapters 7, 8, 15, 16, 17, 18, and 20 may be omitted without disturbing the sequence of development.

Not all chapters are the same length or difficulty. Some topics in financial accounting are more complex than others, and adequacy of treatment rather than number of pages has been our guide. Several chapters have appendices and optional material that may be covered at the instructor's discretion.

Acknowledgments

To our professors, colleagues and students, all of whom directly or indirectly helped to shape this book, we are grateful. To those past users of the predecessor text who kindly sent their comments, we are indebted. James R. Gigone and James H. Bernatow, both of the First National Bank of Boulder, made useful suggestions about our discussion of computers. We gratefully acknowledge the help and encouragement given by our editor, Sigurd W. Hermansen. All these individuals have helped to improve the book. The shortcomings, errors, and omissions that remain we grudgingly claim as our own.

Contents

PART I. The Framework of Financial Accounting

- 1 ACCOUNTING IN THE MODERN WORLD 3**
Development of Accounting | Problems of Communication | Accounting as a Communication Process | Accounting and Other Disciplines | Financial Accounting | Interested Parties | Summary
- 2 THE NATURE AND OBJECTIVES OF FINANCIAL ACCOUNTING 16**
The Nature of Financial Accounting | Economic Resources and Obligations | Changes in Economic Resources, Economic Obligations, and Residual Interest Measurement | Objectives of Financial Accounting | A Capsule Look Ahead | Summary | Appendix 2-1: Financial Statements of General Motors Corporation
- 3 THE STATEMENT OF FINANCIAL POSITION 49**
The Function of the Statement of Financial Position | Assets | Liabilities | Owners' Equity | Asset Valuation | Asset Valuation and Income Determination | Statement of Financial Position Classifications | Other Balance Sheet Forms | The Balance Sheet and Enterprise Position | Balance Sheet Disclosure | Summary
- 4 THE INCOME STATEMENT, FUNDS STATEMENT, AND OTHER STATEMENTS OF CHANGES 79**
The Concept and Nature of Income | The Accounting Measurement of Income | Single-step Income Statements | Disclosure in Income Statements | Use of Income Data | The Statement of Retained Earnings | The Statement of Funds | Other Statements of Changes | Summary

PART II. Processing Accounting Data

- 5 THE ACCOUNTING CYCLE 127**
Accounting Transactions | Ledgers | The Framework of Double-Entry Bookkeeping | Journals | Trial Balance | Preparation of

*the Financial Statements | The Closing Process | Ruling Accounts
| Summary*

6 ADJUSTING ENTRIES 160

The Need for Adjusting Entries | Accrual of Expenses | Accrual of Revenue | Unearned Revenues or Collections in Advance | Prepaid Expenses | Depreciation, Amortization, and Depletion | Bad Debts Expense | Merchandise Inventory | Summary | Appendix 6-1: Working Papers

7 PROCESSING ACCOUNTING DATA 201

Management Information Needs | Some Documents: Inputs of the Data Processing System | Manipulating Data Manually | Specialized Journals | Subsidiary Ledgers | Pegboard Accounting | Limitations of Manual Data Processing | Mechanized Data Processing | Punched-Card Data Processing | Summary

8 USING THE COMPUTER TO PROCESS ACCOUNTING DATA 244

The Electronic Computer | Planning for the Computerized Management Information System | The Computerized Data Processing System | Programming the Computer | Real-Time Data Processing | Management Information Systems and the Accountant | Summary

PART III. Measurement of Assets, Liabilities, and Income

9 CASH AND TEMPORARY INVESTMENTS 279

Monetary Assets | Liabilities | Cash | Temporary Investments | Summary | Appendix 9-1: Bank Reconciliations

10 SHORT-TERM RECEIVABLES AND PAYABLES 301

Accounts Receivable | Accounts Payable | Notes Receivable and Payable | Sales and Purchase Controls | Summary

11 LONG-TERM INVESTMENTS AND LONG-TERM LIABILITIES; OTHER MONETARY ASSETS AND LIABILITIES 328

Long-Term Investments | Long-Term Liabilities | Other Monetary Assets | Other Liabilities | Summary

12 INVENTORIES AND OTHER SHORT-TERM UNEXPIRED COSTS 352

Prepaid Expenses | Items Included in Inventory | Cost of Inventory Items | Determination of Inventory Costs and Cost of Goods Sold | First-In, First-Out (FIFO) | Last-In, First-Out (LIFO) | Weighted Average | Comparison of Results of the Cost Methods | Inventory Methods and Reality | Adjustments of Inventory Cost | Market

Valuations | Inventory Errors | Control and Safeguarding of Inventory | Summary | Appendix 12-1: Manufacturing Costs

13 PLANT AND EQUIPMENT AND OTHER LONG-TERM UNEXPIRED COSTS 385

Types of Long-Term Unexpired Costs | Measuring Cost | Subsequent Treatment of Unexpired Costs | Natural Resources | Plant and Equipment and Other Assets Subject to Depreciation | Amortization of Intangibles | Disposition of Long-Term Unexpired Costs | Long-Term Asset Problems | Presentation in Financial Statements | Summary

PART IV. Owners' Equity

14 STOCKHOLDERS' EQUITY 425

Corporate Equities | Issuance of Capital Stock | Rights of Shareholders | Preferred Stock | Subsequent Operations of Corporations | Corporate Equities—Illustrated Transactions | Stockholders' Equity Section—Illustrated Transactions | Summary

15 CONSOLIDATED FINANCIAL STATEMENTS AND BUSINESS COMBINATIONS 448

Parent-Subsidiary Relationship | Criteria for Consolidated Statements | Consolidated Balance Sheet | Consolidated Income Statement | Limitations of Consolidated Statements | Business Combinations—Purchase vs. Pooling | Summary

16 SOLE PROPRIETORSHIPS AND PARTNERSHIPS 473

Sole Proprietorships | Partnerships | Admission of New Partners | Dissolution of a Partnership | Converting a Partnership to a Corporation | Theoretical Issues | Partnership Form vs. Corporate Form | Summary

PART V. Accounting Theory and Analysis

17 ACCOUNTING THEORY: IMPORTANCE, DEVELOPMENT, AND PROSPECTS 495

Interested Parties: Needs and Pressures | Historical Development of Accounting Principles and Standards | Where Are We Now? | Where Are We Going? | The Purposes of Accounting | Summary of Financial Accounting Theory | Summary | Appendix 17-1: Current Costs

18	ANALYSIS OF FINANCIAL STATEMENTS	527
	<i>Investors' Decisions Statement Analysis—A Final Warning Analysis of Operating Results Analysis Utilizing Both Income Statement and Balance Sheet Use and Quality of Assets Analysis with a Creditor Emphasis The Composite Picture Beyond Financial Analysis Overall Critique of Financial Analysis Summary</i>	
19	FUND FLOWS AND CASH FLOWS	558
	<i>The Meaning of Funds Uses of Funds Statements Sources of Funds and Uses of Funds Preparing the Statement of Funds The Schedule of Working Capital Changes Complications in Preparing Funds Statements Statement of Cash Flows Summary</i>	
20	FEDERAL INCOME TAXES	598
	<i>The Federal Income Tax Law The Individual Taxpayer The Corporate Taxpayer Income Tax Rates "Tax Option" Corporations Capital Gains and Losses Minimum Tax and Maximum Tax Relationship of Accounting Income and Taxable Income Allocation of Income Tax Expense Summary</i>	
	INDEX	624

Part I

The Framework of Financial Accounting

1

Accounting in the Modern World

Accounting plays an important role in our complex, highly developed society. In a society such as ours, production tends to be complicated and involve the combined, continuous efforts of many individuals, while consumption involves choices among a series of alternatives. As a result, exchanges and interactions are necessary and members of our society, who operate in many different roles, are faced with the need to make many decisions. At times these decisions are difficult to make because the situation is complicated and there is a lack of information. It is at this point that accounting becomes relevant.

Basic purpose

The purpose of accounting is to provide quantitative information, primarily financial in nature, that is useful in making economic decisions. Systematic and reliable information of a financial nature aids in making satisfactory choices, especially when the effects of the decision are widespread. Of course, even in those areas where it is used, accounting information is not used exclusively. Other factors, such as human relationships, political implications, power, and prestige, are significant in making important decisions. Nevertheless, although it is only one of the factors in economic decisions, accounting information is often an important input that decision makers neglect at their peril.

Accounting information is provided for a variety of users and about a variety of entities—both individuals and organizations. Ac-

counting reports about business enterprises, the main focus of this book, are used by managers in guiding enterprises and by investors and others in evaluating enterprises. Reports about other organizations are used to plan and control operations and to give members and other interested parties information about the organization. Individual income tax returns, a specialized type of accounting report, are used by individuals to plan their actions and by the government as a basis for levying and collecting taxes. Whenever someone applies for credit—whether buying a car, opening a charge account, or getting a student loan—he has to provide financial information that may well take the form of an accounting type report. For example, loan and credit applications often require information about the assets and debts of a person and also some estimate of his income. Governments at all levels prepare accounting information that is used in decisions by citizens or their representatives. An example is the budget of the United States, which sets forth expected operations of the federal government in considerable detail. Decisions about the federal budget are among the most far reaching in our society.

There is no need to develop the theme of the importance and usefulness of accounting information any further. Instead we now turn to the questions, how did accounting develop, and what is the place of accounting in our society?

DEVELOPMENT OF ACCOUNTING

Accounting has developed and changed in response to changes in man's economic life. The earliest accounting reports were in the form of crude records of those agricultural goods brought into village temples and storehouses to provide a livelihood for the priests and military protectors of the village. Simple records were sufficient for the simple economic interactions of the time. The development of trade between villages, and later, between countries, and the increased complexity of economic interactions led to the development of more sophisticated systems of accounting records. As Europe awoke out of the Dark Ages and trade became more widespread in the fourteenth and fifteenth centuries, some important developments also took place in accounting. The first treatise on double-entry bookkeeping, written in 1494 by the Italian monk, Fr. Luca Paciolo, described the accounting that was used by the busy Italian merchants of the fifteenth century.

The accounting of Paciolo's day, which was a relatively simple system designed to be used by the owner-manager of the small enterprise, has been surprisingly durable. It remains the foundation of the

more complicated systems used today. It was and is effective in businesses where the owner can have close personal supervision over operations.

Today there are many small business firms of this type, but the principal force in economic life is the large organization, typified in the United States by the large corporation. A relatively simple accounting system is not adequate for large complex organizations. As a result of the development of large scale enterprises in the nineteenth and twentieth centuries, accounting developed and expanded to meet the needs of these organizations. In fact, it is probably accurate to say that accounting information has been an essential factor in operating large scale organizations, which, because of their complexity, must rely heavily on the flow of information.

New developments in modern society provide a continuing challenge to the field of accounting. If accounting fails to develop, it may become irrelevant and may hinder the accomplishment of society's goals. In fact, the lack of good financial information can be viewed as a contributing factor in the failure of some organizations and as a limiting factor in the growth of others.

Accountants have responded vigorously to the challenge of the large organization, and particularly to the challenge of the large business enterprise. Improvements have been made in financial reporting, and accounting principles have been and are being articulated to enhance the reliability of financial reports. Internal systems of management accounting have evolved to give individual managers financial information about the performance of the areas under their control. New methods of planning and control have been developed. And the computer has provided a new tool for processing information efficiently and for analyzing operations.

Not all of the difficulties of accounting have been solved. The rapid expansion of knowledge and of the economy continue to pose new problems and raise old problems in new forms. Since accounting is inextricably tied to the intricate network of economic interactions in our modern world, the solution of certain accounting problems depends on the solution of more general problems. An example of such a problem in accounting is the question of how to deal with inflation in accounting reports. Inflation itself is a serious general economic problem. Until such problems are satisfactorily dealt with in economic theory, income taxation, and in other areas, accountants will not be completely successful in solving the specific accounting problems arising from inflation.

Another reason that accounting continues to be faced with serious problems and challenges is that accounting is concerned with communication of business data. Before we consider the usefulness of

accounting reports in the modern world, we will discuss this communication aspect of accounting.

PROBLEMS OF COMMUNICATION

As language, both oral and written, developed in primitive cultures, some of the interesting concepts and problems of our modern life also appeared. One problem is that language, whether spoken or written, involves something of an abstraction from reality. Language communicates a person's thoughts about or interpretations of reality, rather than reality itself.

All communication involves:

1. A person's perceptions.
2. The fitting of those perceptions into a communication system with its various symbols and sounds.
3. The receiving of the communication by a second perceiver.
4. That perceiver's assimilation of the communication on the basis of his understanding and interpretation of the sounds and symbols involved.

Notice the many potential areas of difficulty in this process. There is the problem of the exact meaning of the symbols and sounds of the language employed. Not all words mean the same thing to everyone. Furthermore, the meanings of words change through time, although people often cannot agree as to the amount and direction of change. Another problem lies in the possibility of error on the part of either percipient from such causes as mistakes, incorrect spelling or reading, incorrect punctuation, and so forth. Underlying all of these possibilities of distortion is the inability of any communication to convey completely all that is perceived.

Thus, any communication process has its limitations—limitations that often lie in the very nature of the process of perception and transference of information. Most communication processes also change and evolve as new situations and needs arise. Therefore, a valid understanding at one point of time is no guarantee of understanding at some later time.

ACCOUNTING AS A COMMUNICATION PROCESS

Accounting should be thought of as a communication process. It employs a set of symbols and words to convey information about financial matters. The symbols and words used in accounting were invented and defined by individuals in their search for a means of communicating such information. Accounting is a human instrument and has many human limitations; but, in addition, it has limitations of