

**Third
Edition**

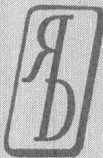
**Fundamentals
of Financial
Accounting**

**Welsch
and
Anthony**

Third edition

FUNDAMENTALS OF FINANCIAL ACCOUNTING

1981



Richard D. Irwin, Inc.

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Preface

This Third Edition retains all of the features favorably commented upon by numerous faculty members who used the prior editions. It has been updated in all respects, and approximately 80 percent of the assignment material has been replaced or revised. Additional problems contribute a measure of greater depth and analytical substance.

The chapter sequence has been rearranged somewhat. Chapters 1 and 2 of the prior edition have been consolidated into one chapter. Consolidated statements now follows long-term investments (Chapters 13 and 14). Chapter 17, Financial Reporting and Changing Prices, has been completely rewritten to emphasize the underlying concepts of *FASB Statement No. 33*. The authors present a unique illustration of general price level restatement and current cost application especially designed to be understandable to beginning accounting students.

To lend an unusual level of flexibility in use and to increase readability, chapters have been divided into two or more separate parts. The objectives of each part are concisely delineated and the questions for discussion, exercises, and problems are grouped separately by part (both in the text and the Solutions Manual). [A complete list of *key words*, with specific page citations, is given at the end of each chapter.] The demonstration cases, with solutions, in the various chapters have been carefully selected and written to provide a comprehensive overview of the chapter.

Major portions of each chapter have been rewritten to incorporate the latest developments in financial accounting and to increase comprehension. Numerous illustrations are provided to supplement the written discussions. All of the new features significantly increase the level of flexibility of the text in use.

The prior extensive list of teaching and student aids has been expanded and revised. In addition to the textbook, these aids are:

Available to students:

1. Study Guide (coordinated with the sequence of each chapter; includes comprehensive outlines, illustrations, and sample examination questions with answers).
2. Working Papers (includes all forms, with captions, needed for solving all exercises and problems).

3. Practice Set (application of the complete accounting information processing system as discussed in the textbook).

Available to the instructor:

4. Comprehensive *Teachers Manual* (includes answers to all questions class discussion, exercises, and problems; also, includes suggested course plans and instructional ideas).
5. List of Check Figures (includes check figures for exercises and problems; available in quantity for distribution to students).
6. Bank of Examination Questions (coordinated by chapter).
7. Teaching Transparencies (as used by the senior author for mass sections).

Many accounting instructors prefer to divide the first course in accounting into two parts—the first semester or quarter focusing on financial accounting and the second on management accounting. Many texts, however, are not arranged so that such an approach is feasible with a single text.

This volume and its companion, *Fundamentals of Management Accounting*, are designed to provide material for a fully coordinated first course. As their titles indicate, this volume deals with the fundamentals of financial accounting, and its companion with the fundamentals of management accounting. Each volume can be used either for a one-semester or a one-quarter course. Both are designed to provide maximum flexibility for the instructor in the selection and order of materials for the classroom. They emphasize those aspects of accounting we believe essential for interpretation and use of accounting information. Mechanical and procedural details are minimized, while the conceptual, measurement, and communication aspects are emphasized.

This book is an introduction to **financial accounting**, which has as its primary subject the communication of relevant financial information to external parties. We strongly believe that a certain level of knowledge of the accounting model, the measuring processes involved, the data classifications, and terminology, is essential to the interpretation and effective use of financial statements. We have provided the necessary information in this volume. The key to effective use of financial statements is to understand what they do and do not say, the measuring approaches used, and the standards observed in their development. This is the case both for students who will continue their study of accounting and for those who will not. The materials are arranged to meet the requirements of a wide range of academic institutions and curricula.

This volume represents a significant departure from the traditional financial accounting textbook in several respects. First, it provides the instructor with comprehensive discussions of a broad range of subject areas rather than the bare minimum. This approach means that more materials are

presented than generally can be covered in the *undergraduate* financial course in accounting (however, it is completely adequate for such a graduate course). Importantly, this coverage gives the instructor a great amount of flexibility to select those topics appropriate to the situation. In contrast, a textbook that provides only the minimum materials imposes on the instructor the unfortunate choice of having to (a) present a *de minimus* course or (b) devote considerable time developing supplementary textual and homework assignments. Secondly, this text discusses a number of topics not traditionally included in an elementary textbook. In our judgment, much of the traditional material is essential; however, the recent thrusts and changes in financial accounting make it imperative that certain significant topics be accorded comprehensive treatment. This volume avoids superficial treatment of these new directions by giving special emphasis to concepts, rationale, measurement, and reporting. Certain traditional procedural topics are presented in appendixes should coverage of them be desired.

The primary features of this book and the instructional materials that accompany it are as follows:

- At the outset, the characteristics of the environment in which the accounting process operates is emphasized.
- At the outset, the student is presented with a comprehensive description of the end products of the financial accounting process—the external financial statements and related disclosures. This volume presents the maximum amount of material that can ordinarily be covered in a one-semester undergraduate course. Therefore, some choices usually must be made by the instructor.
- Accounting is viewed as an information processing model designed to enhance communication by the entity to the users of its financial reports.
- The discussions emphasize concepts, standards, and generally accepted accounting principles as the rationale for the way certain things are done in accounting.
- Throughout the chapters, the measuring approaches used in accounting and in reporting to decision makers are emphasized.
- Throughout, the focus is on the corporation rather than on the sole proprietorship or the partnership. Actual case examples are utilized. As a consequence, income taxes, dividends, earnings per share, capital stock, the *APB Opinions*, and the *FASB Statements* are discussed.
- Relevant topics, not ordinarily treated in a first course, are discussed. These include cash flow, present value, consolidated statements, purchase versus pooling, statement of changes in financial position (both working capital and cash bases), compensating balances, price level effects, and current value.

- One or more *appendixes* follow some of the chapters. These appendixes focus on the clerical and mechanical aspects of the accounting process such as special journals, subsidiary ledgers, payrolls, and petty cash. Separation in appendixes facilitates their exclusion, or order of selection, without affecting the continuity of the course.

These features are of particular importance to nonaccounting majors since the first semester usually is their only exposure to the fundamentals of financial accounting. For example, most of the external financial statements coming to the attention of the nonaccounting majors, both in school and in real life, will be consolidated statements. Similarly, an understanding of the effects of general inflation and specific price changes on financial information is essential in these times to the interpretation of reported results.

Answers to questions such as how much time should be spent on each chapter, how much homework should be required, and what materials should be omitted, depend on the objectives of the particular course, the time constraints, and the backgrounds of the students. As mentioned above, we have arranged the topical materials to permit maximum flexibility in selecting among various options and in giving varying topical emphasis to fit practically all situations. Appendixes, parts of chapters, and even entire chapters may be omitted without adversely affecting the continuity of the course. The Solutions Manual includes comments and suggestions that are particularly helpful in selecting among a number of possible options.

The subject matter of the 17 chapters and 8 appendixes, which comprise this volume, has been arranged in what we believe to be a pedagogically sound sequence; nevertheless, considerable rearrangements can be made if the instructor so desires. Each chapter has a summary and almost all have a demonstration case, with a suggested solution. The purpose of the demonstration cases is to tie together the various subtopics discussed in the chapter. Following each chapter are study materials classified as (a) discussion questions, (b) short exercises (suitable for homework, class illustrations, and examinations), and (c) comprehensive problems and cases. Each of these groups of study materials is arranged to follow the topical sequence of the chapter.

The list of students and faculty members to whom the authors feel a sense of gratitude for ideas and suggestions is too long to enumerate here. With respect to this volume, we are particularly grateful to the following individuals who devoted considerable time in discussions, reviewing parts of the manuscript, and testing materials: Professors William H. Beaver, Stanford University; Wayne S. Boutell, University of California; Robert S. Eskew, Purdue University; John C. Fellingham, University of Texas at Austin; Walter T. Harrison, University of Texas at Austin; Robert L. Kellogg, University of Texas at Austin; and Daniel G. Short, University of Texas at Austin.

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Suggestions and comments on the text and the related materials are invited.

Glenn A. Welsch
Robert N. Anthony

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Perspectives— Accounting objectives and communication

The objective of this book and its companion volume, *Fundamentals of Management Accounting*,¹ is to develop your knowledge of, and your ability to use, accounting information. This volume, on **financial accounting**, focuses on the role of accounting information in the decision-making processes of parties external to the business; that is, owners, investors, potential investors, creditors, and the public at large. The second volume, on **management accounting**, focuses on the role of accounting information in the decision-making processes of managers with responsibilities inside the organization. Whether you ultimately become an owner, a manager, an investor, or a creditor, or even if your only interest in an organization is that of a concerned citizen, an understanding of accounting will enhance significantly your competence as a decision maker. As you study these two volumes you will develop an understanding of how accounting information is used in resource-allocation decisions in all types of organizations such as profit-making enterprises, nonprofit endeavors, governmental entities, and social programs. In practically all organizations, long-term success depends in large part on the quality of the resource-allocation decisions that are made. Accounting information, in the broad sense, is used to aid in the decision-making process and to measure the financial results after the decisions are made and implemented.

This book is designed for students who have had no prior academic study of accounting. The chapters usually are divided into parts to facilitate

¹ Robert N. Anthony and Glenn A. Welsch, *Fundamentals of Management Accounting*, 3d ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1981). © 1981 by Richard D. Irwin, Inc.

study and to provide flexibility in priority selection of materials consistent with the time available. Appendixes to the chapters also are provided to permit flexibility; they include (1) more advanced discussion of selected topics and (2) strictly procedural aspects of selected topics.

PURPOSE OF THE CHAPTER

The purpose of this chapter is to present a broad perspective of the objectives of accounting and of the environment (i.e., the surroundings) in which it operates. To accomplish this purpose, the chapter is divided into two parts:

Part A: The objectives and environment of accounting

- Defines accounting with emphasis on its fundamental objective of providing financial information that is useful in making business and economic decisions.
- Describes the features of the environment that bear most directly on accounting.

Part B: Communication of accounting information

- Introduces periodic financial statements as the primary means of communicating financial information about an organization.

Behavioral and learning objectives for this chapter are provided in the *Teachers Manual*.

PART A: THE OBJECTIVES AND ENVIRONMENT OF ACCOUNTING

ACCOUNTING DEFINED

Accounting is an information system designed to **measure, record, and report** in monetary terms the flows of resources into (inflows) and out (outflows) of an organization, the resources controlled by the organization, and the claims against those resources. In doing this, accounting collects, processes, evaluates, and reports financial information that is considered to be particularly useful in decision making. In addition, accounting involves judgmental and interpretative roles in analyzing, reporting, and using the financial results.

Accounting serves those that use the information it provides in three related ways:

1. Accounting provides information that is helpful in making decisions. Most important decisions, regardless of the type of endeavor involved, are based, in part, upon complex financial or monetary considerations. Accounting provides an important information base and a particular

analytical orientation that help the decision maker assess the potential financial implications and potential outcomes of various alternatives that are being considered. The primary role of accounting is to facilitate decision making.

2. Accounting reports the results of past decisions. Once a decision is made and implementation starts, important and often subtle financial effects occur. These financial effects often are critical to the success of the endeavor. Thus, the evolving effects of the decision must be measured continuously and periodically reported so that the decision maker can be appropriately informed of continuing and new problems, and of successes, over time. **Accounting provides a continuing measurement of the financial effects of a series of decisions already made, the results of which are communicated to the decision maker by means of periodic financial statements.**
3. **Accounting keeps track of a wide range of items to meet the score-keeping and safeguarding responsibilities imposed on all organizations.** These include how much cash is available for use; how much customers owe the company; what debts are owed by the organization; what items are owned, such as machinery and office equipment; and inventory levels on hand.

Economics has been defined as the study of how people and society end up choosing, with or without the use of money, to employ scarce productive resources that could have alternative uses to produce various commodities and distribute them for consumption, now or in the future, among various persons and groups in society.² This definition suggests a relationship to the definition of accounting. Like economics, accounting has a conceptual foundation. It focuses on the collection, measurement, and communication of information on the flows of scarce resources of specific entities. Accounting generally is viewed as encompassing the **financial planning process** (discussed in *Fundamentals of Management Accounting*), which focuses on the planning and projection of **future** flows of scarce resources. Thus, accounting collects data and measures, interprets, and reports on those human activities that are the focus of economics. Economics attempts to *explain* economic relationships primarily on a conceptual level, whereas accounting attempts to *measure* the economic relationships primarily on a practical level. However, accounting measurements must be made as consistent as is feasible with economic concepts. Accounting must deal with the complex problems of measuring the monetary effects of **exchange transactions** (i.e., resource inflows and outflows), the resources held, and the claims against those resources for each entity. Throughout these two volumes many of the theoretical and practical issues that arise in the measurement process will be discussed from the accounting viewpoint.

² Paul A. Samuelson, *Economics*, 9th ed. (New York: McGraw-Hill Book Co., 1975).

A COMPLEX ENVIRONMENT

In various ways we are associated with social, political, and economic organizations, such as businesses, churches, fraternal organizations, political parties, states, counties, schools, environmental groups (both public and private), chambers of commerce, and professional associations. Many of these organizations are complex and pose critical problems on which decisions must be made. The future quality of our society depends in large measure upon the collective decisions of the managers of such organizations. These organizations are essential to the workings of a society; indeed, they constitute much of what we call "society."

Fundamental to a dynamic and successful society is the ability of each organization to measure and report its accomplishments, to undergo critical self-analysis, and, by means of sound decisions, to renew itself and grow so that the individual organization and societal objectives are served best. Essentially, society, and the various organizations that comprise it, thrives in direct proportion to the efficiency with which it allocates scarce resources: human talent, materials, services, and capital. To accomplish this broad goal, organizations and persons interested in specific organizations need information about how the resources that the organization controls were generated and used. Accounting information is designed to meet this need.

Therefore, accounting is said to be a man-made art and continuously is undergoing change to meet the evolving needs of the society. Since the environmental characteristics of a society are diverse and complex, accounting always is facing new challenges. For example, the current inflationary spiral necessitates the development of accounting concepts and procedures that will report separately real-value and inflationary effects (see Chapter 17).

Throughout this textbook you will study how accounting is responding to the environment in the United States. In the next few paragraphs we will discuss two environmental characteristics—**measurements in dollars** and the **types of business entities**—because they have pervasive effects on accounting concepts and procedures.

Measurements in dollars

A monetary system is one way for the measurement and communication of the flow of resources in and out of an organization. In a monetary system, the unit of exchange (dollars in our case) is the common denominator of measurement, the medium of exchange, and a store of value. Thus, the monetary unit provides a basis for expressing, in large measure, the available resources and the resource flows of both the society as a whole and the various organizations that comprise society. Accounting is concerned directly with measuring and reporting available resources and their flows. Accounting provides monetary measurement of inputs (resources received) and outputs (goods produced and services rendered), and, as a consequence, it provides benchmarks for evaluating the efficiency of orga-

nizational performance. It also measures the available resources held and the claims against those resources.

Accounting measures the resources and resource flows of organizations within a society in terms of the monetary unit of that society. Thus, accounting uses the monetary system of each country within which it operates. One of the critical problems in accounting is the conversion of financial amounts from one monetary system to another monetary system in measuring resources and resource flows for multinational activities. Since accounting measures and reports financial resources in terms of each society's monetary unit, it is based on what is called the **unit-of-measure assumption** (see Exhibit 2-6). The common denominator or "meterstick" used for accounting measurements in the United States is the dollar; the assumption is that the dollar is a useful measuring unit.³

Types of business entities

This book will focus primarily on accounting for business entities. In our environment there are three main types of business entities. Since they will be referred to often throughout this volume, their primary characteristics are explained below.

A **sole proprietorship** is a business that is owned by one person. This type of business entity is common in the fields of services, retailing, and farming. Generally, the owner is also the manager. Legally, the business and the owner are not separate entities—they are one and the same. However, accounting views the business as a **separate entity** to be distinguished from its owner.

A **partnership** is an unincorporated business that is owned by two or more persons known as partners. The agreements between the owners are set forth in a partnership contract. The contract specifies such matters as division of profits each period and distribution of resources upon termination of the business. As in the case of a sole proprietorship, a partnership is not legally separate from its owners. Legally, each partner is responsible for the debts of the business (i.e., each general partner has what is called **unlimited liability**). However, accounting views the partnership as a separate business entity to be distinguished from its several owners.

A **corporation** is a business that is incorporated under the laws of a particular state, and whose owners are known as shareholders or stockholders. Ownership is represented by shares of capital stock that can be bought and sold freely. When a proper application is filed by the organizers, the state issues a charter which gives the corporation the right to operate legally as an entity, separate and apart from its owners. The owners enjoy what is called "limited liability"; that is, they are liable for the debts of

³ The exchange unit (dollars) changes in purchasing power due to the effects of inflation and deflation; simply put, the dollar does not always command the same amount of *real* goods. Thus, money does not have the most basic element of any measurement unit, that is, uniformity in magnitude. During inflation and deflation the monetary unit is not uniform in magnitude because one unit will command fewer, or more, real goods respectively than before.