

Handbook of Modern Accounting

Third Edition

Edited by Sidney Davidson and Roman Weil

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Modern

Accounting

THIRD EDITION

Edited by

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Preface

Accounting is an information system—an information system designed to communicate meaningful economic information about an entity to interested parties. The communication process involves preparers and users of the information. This handbook is designed to help both the preparers and the users of accounting information. For preparers—mainly accountants—there is a vast array of accounting topics and suggested treatments. For users—managers, shareholders, and others seeking to understand a firm—there is a simple but comprehensive explanation of the meaning of accounting terms and of financial statements.

The accounting message frequently summarizes substantial compilations of data. The analysis of accounting data and financial statements is increasingly being carried on by means of mathematical and statistical techniques. The title, *Handbook of Modern Accounting*, emphasizes the decision to incorporate descriptions of the newest concepts and techniques that are reshaping accounting as well as to provide the time-tested theories and procedures of accounting. The volume offers a balanced coverage of the new and the old, the emerging and the traditional topics.

This handbook provides comprehensive and authoritative information on accounting in a conveniently organized and succinctly stated form. Those faced with accounting problems can find guidance toward answers. The handbook contains many practical, how-to-do-it forms and information. However, the contributors have avoided a “cookbook” approach and have spiced their sections with observations on the philosophical background and likely development of each accounting topic.

There will be occasions, of course, when the reader will wish to know more about a specific subject than is set forth here. Although it is obvious that a complete book could be written on any of the subjects dealt with in a chapter, the contributors were limited in space. To compensate for this, each author has included a bibliography at the end of the chapter so that the reader who is interested in a subject will be directed to further sources of authoritative information. The bibliography lists a few books or articles that the author believes will be helpful in acquiring a deeper understanding of the subject.

This handbook is the work of many people. The contributors were selected because of the knowledge they possess of the subjects assigned to them. As a group, they form a good cross section of accounting thought, representing accounting professors, public accounting, and industry. To each of them, we express our appreciation.

Much credit for the completion of the handbook must be given to Sandra

Myers. She was indefatigable in her styling and efforts and in dealing with the vast amount of correspondence involved in the preparation of the handbook. She was assisted in these efforts by Raymonde Rousselot and K. Xenophon-Rybowiak. Lynne Lackenbach, a consultant to McGraw-Hill, worked expertly and cooperatively on copy editing and book production.

To all who participated—chapter authors, editorial assistants, copy editors, proofreaders, and publisher—goes our appreciation. Without them, this handbook would not have been possible.

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CHAPTER 1

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ACCOUNTING CONCEPTS

Accounting's claim to status as an intellectual discipline depends largely on its emergence as the primary analytical discipline concerned with providing information about enterprise status and progress. Accounting is analytical in the sense that it takes a great mass of transaction data and, through classification and summarization, reduces that mass of data to a relatively small number of highly significant and interrelated items, which, if presented properly, tell much about the status and progress of the given enterprise. Any type of analytical classification depends on a few basic concepts supported by a large number of subordinate concepts. Accounting is no exception. Without an understanding of these concepts, one can neither apply accounting effectively nor understand the reports produced by accountants.

To some, accounting appears to be primarily procedural in nature. Emphasis appears to be placed on record keeping and preparation of financial statements, rather than on conceptually based analysis. This appearance is deceiving. Recording is preceded by transaction analysis. From the development of a chart of accounts for a given enterprise to preparation of its financial statements, accounting is concerned primarily with analyzing the nature and effect of its transactions. Thus recognition and development of the conceptual foundation of accounting is of first importance to all those concerned with it.

The Nature of Concepts. Concepts are essential ideas that permit the identification and classification of phenomena or other ideas. Thus we must have a concept of an asset to separate assets from those items that are not assets. In turn, we must have a concept of current assets in order to separate current assets from noncurrent assets. Not until the essential nature of such concepts is known can one recognize the differences and similarities necessary to make the desired separations. Neither can one understand reports that include some classification unless one is informed as to the meaning of or the essential differences between each of the several classes. Accounting is in large measure a classificatory art, depending for its classifications on a variety of distinctions and differences that have been found useful to those evaluating the status and progress of business enterprises.

To be complete, a concept must state all that the given class includes and all that it excludes—all that it is, and all that it is not. This is no small task. For

example, one may start with a definition of an asset, which states simply that an asset is "anything of value owned," a satisfactory concept for simple situations. One who is familiar with business activities finds that certain types of leases give to the lessee such rights to use the property that for some purpose the lessee has the equivalent of ownership. We tend to modify our rudimentary concept of an asset to include such lease arrangements. Other arrangements suggest other modifications of the basic concept until it becomes complex rather than simple. Because so many of the concepts with which accounting deals are both abstract and very complex, they are not easily stated in any complete sense. We find it necessary to use broad, general terms to describe most concepts and rarely meet the requirements of a complete statement.

Expressed concisely, concepts are definitions. Rarely are these complete, although definitions are often extremely useful in conveying one's understanding to another.

Kinds of Concepts. A more complete understanding of the nature of concepts may be obtained by examining some of their characteristics, which provide separation of concepts into different classes. Thus, we have "ideal" and "real" concepts. Ideal concepts are established for the purposes of theoretical discussion and do not necessarily bear any direct relationship to the real world. For example, lawyers use the concept of "the prudent man" in discussing the rights and obligations of parties to certain contracts. Economists use the concept of "an economic man" to describe the assumed action of an individual in certain circumstances. One cannot go to the real world and pick out either a prudent man or an economic man who fits completely the characteristics included in the concept. Nevertheless, these are important concepts for discussion purposes, particularly in working out theoretical explanations of behavior.

Real concepts represent phenomena or ideas in the real world, such as one's concept of an automobile or of a building or of the Supreme Court. Real-world concepts can be tested against actual observable things or actions.

Accounting must deal with both abstract and real-world phenomena, but accounting to date has given very little attention to ideal concepts, finding its chief usefulness in the world of reality. Ideal concepts are likely to become more useful as accountants give more attention to the development of theory.

The distinction between "native" and "borrowed" concepts is also useful to our understanding. Native concepts are those that are indigenous to the field itself. Borrowed concepts are used within the field but are taken from other disciplines. Accounting's concept of retained earnings, for example, is a native concept; that is, it has been developed by accountants for accounting purposes and is not particularly relevant to other fields of interest. The concept of opportunity cost, however, used by cost accountants in discussing decision theory, is largely borrowed from economics. Accounting has a great number of borrowed concepts taken from law, from economics, and from finance. It also has a substantial number of native concepts, some of which are well developed and some of which are still rudimentary in nature. In this chapter, our concern is primarily with concepts native to the field of accounting.

Another distinction among concepts may be pointed out in terms of the fields of interest within accounting. There are concepts relevant to financial account-

ing, to managerial accounting, to tax accounting, and to auditing. Certain concepts are relevant to all these fields. Other concepts have a very specialized usefulness. In this chapter, we are concerned primarily with concepts of general interest throughout accounting.

The Importance of Changes in Accounting Concepts. As a subject of study, accounting would be much easier to master if its concepts were fixed and established for all time. It would also be a much less interesting field and certainly less useful. Accounting concepts are continually evolving and changing. This is particularly true of its native concepts. Two reasons may be cited for this evolutionary situation. First is that, as a relatively new field, accounting continues to understand its concepts better year by year as it works with them more intensively and thoughtfully. Even our most experienced practitioners and our most advanced theorists have not yet had the opportunity to exhaust the possible applications of all accounting concepts, so that our understanding increases from time to time as new applications are made available to us. This becomes particularly evident when innovative businesspeople devise new transactions or new modifications of old transactions. Often these bring to light aspects of a concept that had not previously been sufficiently explored.

A second reason is that some concepts, particularly abstractions that cannot be tested against real-world phenomena, tend to change as the perceptions, needs, and expectations of those affected by the application of the concepts change. For example, a historical study would establish that the quantity and quality of information included in the published financial statements of corporations have increased significantly in this country over the last 30 years and the trend appears to be continuing. An increased interest in financial data by investors, creditors, financial analysts, and others together with recognition of the securities market as a major means of resource allocation affecting all interests in the economy has greatly influenced our views of what should be disclosed and thereby some important concepts.

This change is both quantitative and qualitative. Not only is a broader range and a larger amount of detail called for, some critics insist that the fundamental basis of financial reporting should be modified. Accounting first developed as a simple record of transactions. The monetary amounts of transactions provided a ready means of quantifying, recording, and accumulating completed transactions. To separate "reality" from speculation, wishful thinking, and outright misstatement, rules were established restricting accounting to completed transactions, and the concepts of historical cost (transaction price) and stewardship reporting became important influences in accounting theory and practice.

More recently, in the face of continuing inflation and dramatic changes in specific price levels over long periods of time, historical cost and stewardship reporting have been criticized as irrelevant to investment decisions, and a strong case has been made for some form of current value as a more relevant basis for corporate financial reporting. A number of authoritative bodies have indicated an awareness of this recommended change in emphasis and its effect if implemented. General price-level adjustments, greater disclosure of current values, and changes in the realization concept have been proposed. For the

foreseeable future, the most likely prospect appears to be a period of probable experimentation and change. Whatever may be the situation in other disciplines, it appears highly likely that in accounting we shall have a continuing study and reevaluation of our essential concepts.

Interrelatedness of Accounting Concepts. Another characteristic of great importance is the interrelationship among concepts. Very few of our native concepts stand by themselves; most of them depend to a considerable extent on others. The concept of full disclosure is related to the idea of fair presentation. Our idea of fair presentation in turn is based on concepts of financial position and results of operations. These in turn are influenced by our notions of what constitutes a transaction, what is an asset, and what is a liability. A change in our notion of an asset might have considerable influence on either or both of our concepts of revenue and expense, which in turn influence the concept of net income. One could carry on with this sort of explication endlessly, but it may be enough to emphasize that many concepts are tightly interrelated one with another, and that as any one of them grows and evolves or is modified, there is likely to be a series of influences on related concepts.

This suggests that any attempt to discuss concepts in an orderly fashion is necessarily difficult. No single concept can be discussed by itself without some attention to those related to it. One scarcely knows where to begin with such a discussion, because it is hard to demonstrate that any single concept is so basic to all other concepts that it can be discussed separately from them.

Relationship of Postulates to Concepts. An adequate appreciation of the nature and limitation of our concepts requires that we give some attention to the postulates that lie at their roots. Postulates are assumptions—not arbitrary, deliberate assumptions, but necessary and often unrecognized assumptions, which typically reflect our best judgment of the facts of a situation or the trend of events. For example, in recognizing a liability, we assume that the creditor will hold the debtor for payment, and that the debtor will make such payments. These are assumptions. They are assumptions that have been borne out in the past by the facts, and they are supported by legal institutions making them to some extent enforceable. Yet, in a number of cases, creditors have not held debtors to payment and, in even more cases, debtors have been unable to pay. Thus there is an element of assumption in recognizing a liability as a real obligation. Where such an assumption seems invalid, that is, where we have evidence to believe that a liability will not be paid, we would not recognize it as a valid liability. Thus any postulate, any assumption, should be observed only if there is no persuasive evidence to the contrary. Where evidence to the contrary does exist, the most reasonable assumption in the circumstances should be made, and we should account accordingly.

Some people object to the term “postulates” and particularly to interpretation of that term as assumptions, on the grounds that accounting should not be based on assumptions. Although one can be sympathetic with the attitude that we should not make arbitrary or unfounded assumptions, a more realistic approach is to recognize that postulates unavoidably exist in a world of uncertainty.

Accounting statements must be prepared and issued before the ultimate consequences of certain actions can be known. Assumptions about the future course of events cannot be avoided under such circumstances.

A Conceptual Framework. A recent development of great importance is a continuing effort by the Financial Accounting Standards Board (FASB) to construct a "conceptual framework" for financial accounting and reporting. The project is at once an exploration of basic concepts and a discussion of pervasive principles, and extends beyond the scope of this chapter. Four Statements of Financial Accounting Concepts have been published:

- No. 1 *Objectives of Financial Reporting by Business Enterprises*
- No. 2 *Qualitative Characteristics of Accounting Information*
- No. 3 *Elements of Financial Statements of Business Enterprises*
- No. 4 *Objectives of Financial Reporting by Nonbusiness Organizations*

Additional topics to be added as the conceptual framework effort continues include:

- Accounting Recognition Criteria for Elements of Financial Statements
- Measurement of the Elements of Financial Statements
- Reporting Earnings and Fund Flows
- Financial Reporting by Small and Closely Held Business Enterprises
- Reporting the Performance of Nonbusiness Organizations

To illustrate the nature and interrelatedness of accounting concepts, and to provide an understanding of accounting and some of its problems and potential, a brief introduction to a small number of important accounting concepts follows.

BASIC CONCEPTS

Five basic concepts will be discussed; for most of these, the discussion will include some description of related concepts. The five basic concepts follow, with a parenthetical indication of some of the major subsidiary concepts that are necessary to an understanding of the basic concepts.

1. Financial condition (asset, liability, shareholders' equity)
2. Results of operations (revenue, expenses, losses, net income, matching)
3. Enterprise (corporate entity, consolidated financial statements)
4. Continuity
5. Present fairly (generally accepted accounting principles, consistency, materiality, full disclosure)

Financial Condition. It is easy to misinterpret the term *financial condition* because many people use it in ordinary conversation referring to their own financial condition. When used by accountants, however, it is a technical term and typically refers to a profit-directed business enterprise. As used by accountants, financial condition refers to the impression or conclusions one might draw from a balanced array of a company's assets and the claims against those

assets. In such an array, the assets and the claims against the assets are described in a semistandardized fashion; that is, certain terms and certain classifications are conventionally used. Conventional methods are also used in measuring or evaluating the assets and the claims against those assets. Unless one has an understanding of the classification and measurement conventions applied in presenting such an array, one could easily come to erroneous conclusions about their meaning and significance. Thus, to explain the concept of financial condition properly, one must move on to some explanation of the concept of assets, liabilities, and shareholders' equity, together with the conventional methods of classifying and measuring these items.

Asset. An asset may be defined as anything of use to future operations of the enterprise, the beneficial interest in which runs to the enterprise. FASB Statement of Financial Accounting Concepts No. 3 [1980, par. 19] says that "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Assets may be monetary or nonmonetary, tangible or intangible, owned or not owned. So long as they can make a contribution to future operations of the company and the company has the right to so use them without additional cost in excess of the anticipated amount of that contribution, they constitute assets and are so treated in accounting.

Accountants tend to dichotomize assets basically between current and non-current assets. The technical definition of current assets approved by the Accounting Principles Board of the American Institute of Certified Public Accountants reads as follows [CAP, 1953, chap. 3A]:

For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

Any asset not meeting the terms of this definition is excluded from the current assets classification. Noncurrent assets are typically reported under a variety of headings, such as long-term investments, fixed assets, tangible assets, and other assets. Current assets are set off from noncurrent assets because of their importance in a company's current position. Current position is another concept, subsidiary to the overall notion of financial condition, which has to do with a company's ability to meet its immediate maturing obligations in the ordinary course of business with the assets at hand.

Within the classification of current assets, one typically finds the following:

1. Cash, that is, coin, currency, and bank deposits that are readily available for any purpose the company management chooses
2. Marketable securities intended for conversion into cash within the operating cycle
3. Accounts and notes receivable that will be collected within the normal operating cycle of the business¹

¹"The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle*" [CAP, 1953, chap. 3A].

4. Inventories of raw materials, work in process, and finished goods
5. Any prepaid expense that if not prepaid, would be a drain on other resources within the next operating cycle (infrequently, substantial in amount).

Asset measurement. The general rule for asset measurement is that assets be valued at transaction price, reduced proportionately for observed and/or estimated consumption of use value. As used in the expression “transaction price,” a transaction refers to an arms'-length exchange transaction between independent parties in which the specific company is one of the parties. Typically, such a transaction has a stated price, which provides the basis for recording the asset acquired. If no stated price exists, a price is inferred from such surrounding circumstances as exist. For example, prices in transactions that are equivalent in terms of quantity and timing may be used. If no transaction price either exists or can be inferred from surrounding circumstances with any degree of validity, accountants sometimes measure the asset received in the same terms as the asset given up. Thus, transaction prices constitute the basic date of accounting.

When used in operations, assets are consumed either physically or in terms of their total available service. To reflect this, the amount recorded for the asset is reduced accordingly so that, over its useful life, an asset's recorded valuation declines from the original transaction price to the price expected to be received upon its retirement or to zero, as the case may be.

There are significant exceptions to this general rule for measuring assets. If the anticipated recovery from use or sale of an asset falls below the transaction price, accountants generally write down the carrying value of the asset to the anticipated recovery amount. Note that these are write-downs only. Accountants are loath to write up an asset to a higher anticipated recovery value. This is the most apparent application of the doctrine of conservatism, which is fairly common in accounting. Conservatism holds that, given a situation in which exact measurement is not possible, accountants should err on the side of understatement of assets and overstatement of expenses, rather than vice versa. Obviously, such a doctrine can be misused; for example, it may be employed to continually understate assets. The extent to which such understatement does exist is not easily determinable, although some suspect that it is not uncommon.

This rule of reducing the carrying value of an asset because of an anticipated reduced recovery is typically applied to marketable securities and to inventories, although it may be extended to other assets as well. If marketable equity securities currently held have market value lower than acquisition cost, they are written down to their present market value for financial statement purposes.² The same treatment is applied to inventories, but with an important modification. Inventories are not written down to a lower present realization price but are valued in terms of a rule commonly described as *the lower of cost or market*. In this expression, the term “market” is not the sales market but the replacement market. Thus, inventories are typically valued for financial statement purposes at the lower of cost or replacement market.

The argument offered in support is that unless an inventory will bring to the

²See FASB Statement No. 12 [1975].