

FUNDAMENTAL
ACCOUNTING
PRINCIPLES

Eighth edition

Pyle, White, and Larson

eighth edition

Fundamental accounting principles

1978



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Preface

This Eighth Edition of *Fundamental Accounting Principles*, like previous editions, is designed for use in a first-year accounting course at the college and university level. It describes the fundamental concepts and principles that underlie accounting information, shows how accounting data are accumulated, and initiates the student into the effective use of such data. The balance between financial and managerial topics has been carefully reassessed and apportioned with the intent of serving the educational needs of both students who will make accountancy their career and those who will use accounting information in other areas of specialty or in their personal affairs.

In this revision, we have attempted to make several improvements while retaining the important thrust of previous editions, which was and is presenting a flexible and teachable, yet demanding textual base for introductory accounting. Many sections of the book have been rewritten to provide a more understandable, logical flow of discussion. All of the material has been updated wherever appropriate, and the most recent pronouncements of the various authoritative bodies such as the Financial Accounting Standards Board and the Securities and Exchange Commission have been incorporated. To provide space for an expansion of topical coverage in the area of managerial planning and control, some of the more procedural subjects were condensed. Also, the content of some chapters has been rearranged to gain more instructional efficiency. New chapters have been added on accounting for price-level changes and on flexible budgeting. The previous coverage of fixed budgets has been revised to emphasize the preparation of master budgets for several sequential periods; and the income tax chapter has been revised to reflect the most recent changes in the federal income tax laws. To aid the student, each chapter is begun with a set of measurable objectives designed to focus attention on important

areas of coverage and on expected student performance. A glossary of important terms has also been added at the end of each chapter.

As in previous editions, the instructor's flexibility in topical and homework assignments has been maximized. Almost any chapter after the fifth may be omitted or abbreviated and, if desired, a minimum of time may be devoted to such subjects as special journals and the voucher system. Although we prefer to teach the course by following the chapter sequence as presented, instructors may substantially alter the sequence of chapter assignments without complicating the student's understanding of the materials that follow. For example, Chapters 13 and 14 may be taught in either the first or second of a two-semester course, since the working papers for the problems of these chapters are included in both the first and second semester booklets of working papers.

The supplementary materials accompanying the text are even more extensive than in previous editions. A workbook of study guides, two booklets of working papers, three practice sets, and a list of problem check figures are available to students. Instructors may obtain a series of ten achievement tests, two final examinations, a booklet of supplementary test questions and short-answer problems, comprehensive solutions manuals for the problems of the text, the practice sets, and the tests, and transparency solutions to each problem in the text plus 35 additional teaching transparencies to be used as aids in classroom presentations.

The booklet of supplementary test questions and short-answer problems, which is new with this edition, allows instructors added flexibility in designing quizzes and examinations that fit their own philosophy and teaching emphasis. The questions and problems are grouped by chapter for ease in preparing pop quizzes.

Three alternate sets of achievement tests and final examinations are available, with each final exam structured into 50 multiple-choice questions and problems that may be graded either electronically or manually. To insure that the examination questions are more than five-answer guessing games, the mistakes students commonly make are anticipated and the resulting wrong answers are provided among the answer choices.

Many adopters of the previous edition and other individuals have contributed to changes in this revision through their criticisms and suggestions. We are indebted to all of them. Special appreciation is due to Russell Andersen, Peat Marwick Mitchell & Co.; Phyllis Barker, Indiana State University; Hugo J. Dallas, El Camino College; Sherman Dearth, William A. Holt, Jeff Hooper, and Lee C. Wilson, Mesa Community College; Al A. Evans, Southwest Missouri State University; Louis H. Gilles, University of South Carolina; Blanca M. Gonzalez, Miami Dade Community College; Carl E. High, New York City Community College; Michael D. Kinsman, University of California, Irvine; Ralph P. Knost, University of Cincinnati; Jack Kramer,

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January 1978

WILLIAM W. PYLE
KERMIT D. LARSON

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PART

1

Introduction

1

Accounting, an introduction
to its concepts

After studying Chapter 1, you should be able to:

- Tell the function of accounting and the nature and purpose of the information it provides.
- List the main fields of accounting and tell the kinds of work carried on in each field.
- List the accounting concepts and principles introduced and tell the effect of each on accounting records and statements.
- Describe the purpose of a balance sheet and of an income statement and tell the kinds of information presented in each.
- Recognize and be able to indicate the effects of transactions on the elements of an accounting equation.
- Prepare simple financial statements.
- Define or explain the words and phrases listed in the chapter Glossary.

chapter 1

Accounting, an introduction to its concepts

Accounting is a service activity the function of which is to provide quantitative information about economic entities. The information is primarily financial in nature and is intended to be useful in making economic decisions.¹ If the entity for which the information is provided is a business, for example, the information is used by its management in answering questions such as: What are the resources of the business? What debts does it owe? Does it have earnings? Are expenses too large in relation to sales? Is too little or too much merchandise being kept? Are amounts owed by customers being collected rapidly? Will the business be able to meet its own debts as they mature? Should the plant be expanded? Should a new product be introduced? Should selling prices be increased?

In addition, grantors of credit such as banks, wholesale houses, and manufacturers use accounting information in answering such questions as: Are the customer's earning prospects good? What is his debt-paying ability? Has he paid his debts promptly in the past? Should he be granted additional credit?² Likewise, governmental units use accounting information in regulating businesses and collecting taxes; labor unions use it in negotiating working conditions and wage agreements; and investors make wide use of accounting data in investment decisions.

¹ Accounting Principles Board, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *APB Statement No. 4* (New York: AICPA, October 1970), par. 9.

² Obviously, women as well as men are customers—and students and accountants. In this discussion as in others not referring to a specific person, the pronouns *he*, *his*, and *him* are used in their generic sense and should be understood to include both men and women.

Why study accounting

Information for use in answering questions like the ones listed is conveyed in accounting reports. If a business owner, manager, banker, lawyer, engineer, or other person is to use these reports effectively, he or she must have some understanding of how their data were gathered and the figures put together. He or she must appreciate the limitations of the data and the extent to which portions are based on estimates rather than precise measurements, and he or she must understand accounting terms and concepts. Needless to say, these understandings are gained in a study of accounting.

Another reason to study accounting is to make it one's lifework—to become a professional accountant. A career in accounting can be very interesting and highly rewarding.

Accountancy as a profession

Over the past half century accountancy as a profession has attained a stature comparable with that of law or medicine. All states license *certified public accountants* or CPAs just as they license doctors and lawyers, and for the same reason—to help ensure a high standard of professional service. Only individuals who have passed a rigorous examination of their accounting and related knowledge, met other education and experience requirements, and have received a license may designate themselves as certified public accountants.

The requirements for the CPA certificate or license vary with the states. In general an applicant must be a citizen, 21 years of age, of unquestioned moral character, and a college graduate with a major concentration in accounting. Also he or she must pass a rigorous three-day examination in accounting theory, accounting practice, auditing, and business law. The three-day examination is uniform in all states and is given on the same days in all states. It is prepared by the American Institute of Certified Public Accountants (AICPA) which is the national professional organization of CPAs. In addition to the examination, many states require an applicant to have two or more years of work experience in the office of a CPA or the equivalent before the certificate is granted. However, some states do not require the work experience and some states permit the applicant to substitute one or more years of experience for the college level education requirement. On this score the AICPA's Committee on Education and Experience Requirements for CPAs has expressed the opinion that at least five years of college study are necessary to obtain the body of knowledge needed to be a CPA; and for those meeting this standard, no previous work experience should be required.³ However, it will be several years before all states accept this recommendation. In the meantime the interested student can learn the requirements of any state in which he is interested by writing to its state board of accountancy.

³ *Report of the Committee on Education and Experience Requirements for CPAs* (New York, 1969), p. 11.