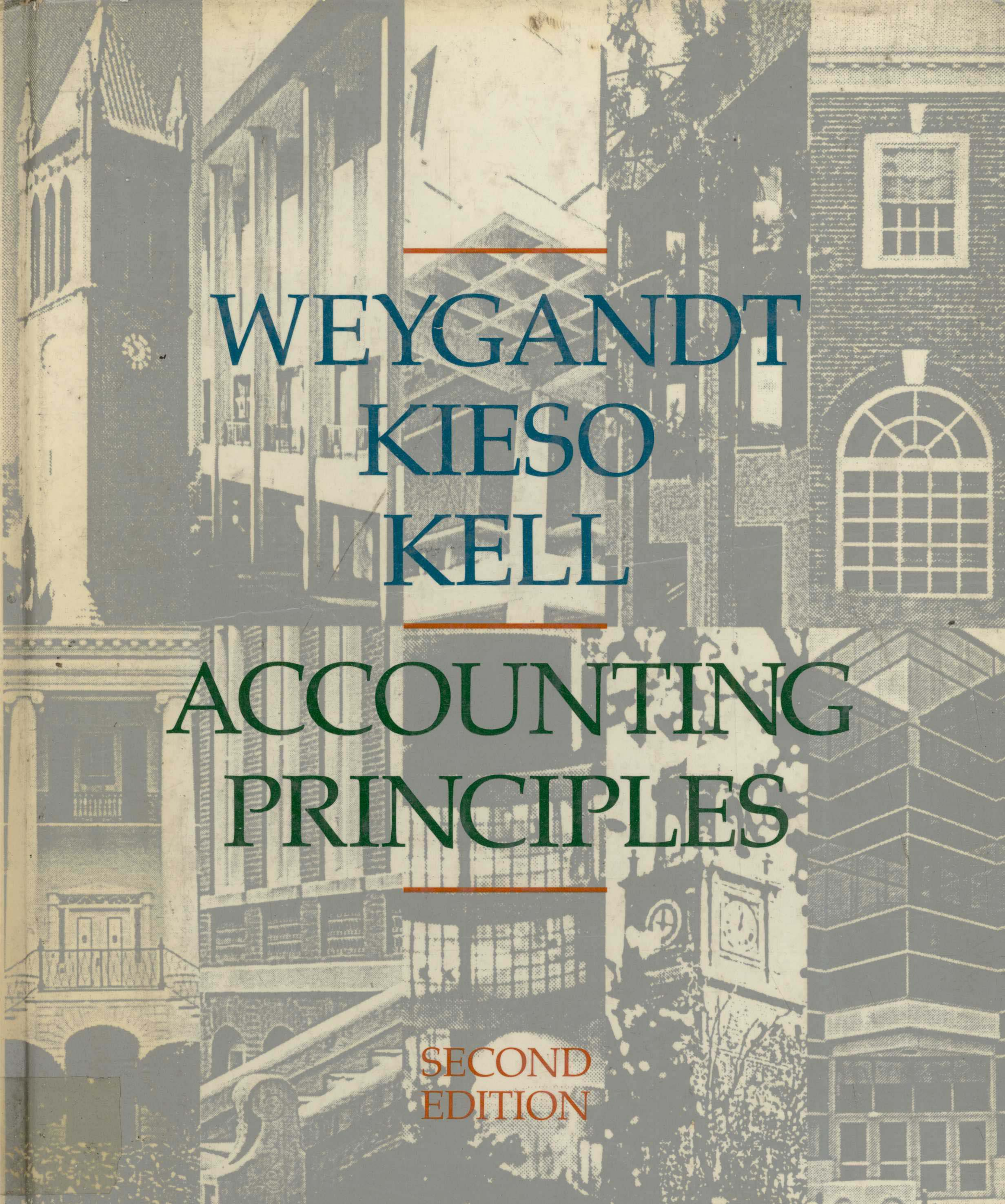

WEYGANDT
KIESO
KELL

ACCOUNTING PRINCIPLES

SECOND EDITION

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Donald E. Kieso, Ph.D., CPA, received his bachelors degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the Peat Marwick Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and the Executive MBA Golden Apple Teaching Award. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, the Board of Governors of the American Accounting Association's Administrators of Accounting Programs Group, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving as a member of the American Assembly of Collegiate Schools of Business Accounting Accreditation and Visitation Committees, the Board of Directors of Aurora University, the chairman of the Arthur Carter Scholarship Committee of the American Accounting Association, and committees of the Illinois CPA Society. In 1988 he received the

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Walter G. Kell, Ph.D., CPA, received his doctorate in accounting from the University of Illinois. He is Professor Emeritus of Accounting at the University of Michigan, where he has served as Chairman of the Department of Accounting. He also has served as the Chairman of the Accounting Department of Syracuse University. He has been an active member of the American Institute of Certified Public Accountants and has served on its Committee on Auditing Procedure (predecessor to the Auditing Standards Board) and Auditing Standards Advisory Council. He is a past president of the American Accounting Association. Professor Kell has been a consulting editor and co-editor of the *Accountant's Handbook* and is the co-author of an auditing textbook. He is a member of the Michigan Association of Certified Public Accountants and has served on its Committee on Accounting and Auditing Procedures and Board of Directors. In 1986 Professor Kell received the Association's Distinguished Service Award because of his significant contributions to the public accounting profession. He recently served as a member and chairman of the CPA Examination Review Board of the National Association of State Boards of Accountancy.

PREFACE

PURPOSE

The second edition of ACCOUNTING PRINCIPLES provides an opportunity to improve on a textbook that set high standards of quality for a first edition. In this edition we have added new material and condensed the coverage of some existing topics because of contemporary developments, reorganized some chapters to enhance the pedagogical effectiveness of the coverage, incorporated numerous real world examples to increase the relevancy of the material, and significantly improved end-of-chapter materials by adding financial reporting problems.

As in the first edition, our objective in writing this textbook is to provide students with a solid conceptual and practical understanding of the discipline of accounting. We have, therefore, attempted to balance our coverage so that the conceptual discussion and procedural presentation are mutually reinforcing. The study of concepts develops an understanding of procedures, and the application of procedures develops an understanding of the concepts. Individuals in business must act as well as think; therefore, we have given a balanced emphasis to the how and to the why.

ACCOUNTING PRINCIPLES was written to be used in the first course in accounting. Designed for both majors and nonmajors, it can be used in a two-semester or a two- or three-quarter-course sequence. Coverage of the complete textbook will provide the student with a solid foundation for the study of additional areas in accounting and business. In addition, knowledge of the principles and procedures contained in this textbook should enable the student to make more informed business judgments and decisions.

GENERAL FEATURES

Accounting is an exciting and dynamic field of study. Unfortunately, the field is often portrayed as one involving only a set of rules or procedures to be followed. We have tried to avoid this approach. One of the main reasons why we decided to write an elementary textbook was to try to improve the pedagogical nature of teaching beginning accounting. In our view, an overemphasis on rules and procedures will only discourage students and leave them without a real understanding of how accounting can be used for making effective financial and business decisions.

To provide a textbook that is current, relevant, and interesting, we have emphasized certain features. These features are: (1) contemporary focus; (2) authoritative and professional content; (3) computer relevancy; (4) real world examples; (5) flexibility in coverage; and (6) increased managerial accounting coverage.

Contemporary Focus

Accounting changes as its environment changes. An up-to-date textbook therefore is a necessity. We continue to meet this important objective in this edition. For example, in Chapter 13, we have significantly reduced the material on inflation accounting because the FASB no longer requires companies to present supplementary price-level adjusted financial information. In its place, we have inserted discussions on ethics and international accounting, subjects now required by the American Assembly of Collegiate Schools of Business.

In the managerial accounting chapters, a significant updating of the material to reflect modern manufacturing accounting has occurred. These include a discussion of Just-in-Time (JIT) processing in Chapter 23 and many real world examples.

Similarly, Chapter 29, Income Taxes and Management Decisions, includes the effects of revenue acts passed by Congress since the first edition of ACCOUNTING PRINCIPLES.

Authoritative and Professional Content

Accounting is a practical discipline. This textbook therefore emphasizes how accounting is currently practiced. The concepts that underlie these practices are carefully explained so that students can understand why a particular rule or procedure is followed. As indicated earlier, textbooks often quote the rule or procedure with little attention to the why. In our view, this approach is inappropriate because it teaches students to memorize rules rather than to understand concepts.

Throughout the textbook we use the professional terminology as developed from the professional pronouncements of the FASB, AICPA, and SEC. Generally accepted accounting principles are discussed and illustrated throughout the textbook, where applicable.

Computer Relevancy

It is important that students have an appreciation of the computer's use in accounting and business. We believe students should acquire this knowledge while learning accounting, not separately from accounting. To achieve this objective we have interspersed throughout the chapters a series of "computer notes" that discuss applications of the computer to accounting in particular and to business in general. These notes will help the students understand and appreciate how this important tool can be used in solving accounting problems. A sample computer note, illustrating the manner in which such notes are highlighted throughout this textbook, is shown below:

In computerized systems, the computer is programmed to flag these normal balance exceptions and to print out error or exception reports. In manual systems, careful visual inspection of the accounts is required to detect normal balance exceptions.

Substantial computer-related materials are also provided as part of the supplementary package of this textbook.

Real-World Vignettes

It is important for students to understand the applicability of accounting principles and techniques to actual business situations. We believe this knowledge is best obtained by presenting real-world examples and situations as an integral part of the study of accounting. Our real-world vignettes may involve a major corporation, a legal or regulatory interpretation, or a contemporary business event, statistic, or practice. A sample of a real-world vignette showing the color and manner in which it is presented in the textbook is illustrated below:

Inventory turnover ratios vary considerably between industries. For example, grocery store chains have a turnover of 10 times and an average selling period of 37 days. In contrast, jewelry stores have an average turnover of 1.3 times and an average selling period of 281 days. Within a company there may be significant differences in inventory turnover among different types of products. Thus, in a grocery store the turnover of perishable items such as produce, meats, and dairy products will be faster than the turnover of soaps and detergents.

Flexibility of Coverage

Our coverage is organized and designed to provide sufficient flexibility so that an instructor does not have to cover every topic in this textbook. Eleven topics have been relegated to an Appendix so the instructor can more readily choose to cover or not to cover them. Material has been placed in an appendix for one or more reasons: (1) the procedure is little used; (2) the approach is highly procedural in nature; or (3) the subject is less essential if time is a constraint. Examples of appendix material are as follows:

Appendix 3–A Alternative Treatment of Prepaid Expenses and Unearned Revenues
This appendix covers the proper accounting for prepaid items when the initial entry is debited or credited to a nominal account.

Appendix 4–A Reversing Entries
It explains the purpose of reversing entries and illustrates how they can facilitate the accounting process.

Appendix 19–A Using a Work Sheet for Preparing the Statement of Cash Flows
This appendix illustrates the use of a work sheet in assembling and classifying data that will appear on the statement of cash flows.

Appendix 21–A Accounting Cycle for a Manufacturing Company
The accounting cycles of a manufacturing and a merchandising company are essentially the same. The differences, however, that exist in the use of a work sheet and in the preparation of closing entries are illustrated in this appendix.

Appendix 23–A Average Costing Method
This appendix supplements the chapter coverage of process cost accounting by explaining the average costing method.

Appendix 24–A Variable Costing
The differences between variable costing and traditional absorption costing of manufactured products is explained in this appendix.

In addition there are five other appendices which can be easily assigned or omitted, depending upon the emphasis to be given.

Increased Managerial Accounting Coverage

This edition continues the extended coverage of managerial accounting. There are nine chapters on managerial accounting. New in this edition are frequent illustrations and explanations of modern manufacturing accounting. Several chapters have also been restructured to improve pedagogical effectiveness. The increased emphasis includes the following changes from the first edition:

1. Expanded discussion of concepts and cost classifications in managerial accounting.
2. Extensive rewriting and expanded material on responsibility accounting.
3. Additional discussion on the average cost method in process costing.

MAJOR CONTENT CHANGES IN THE SECOND EDITION

Most of the changes in this edition have resulted from suggestions by the many users of the first edition and by numerous reviewers. The following major changes in content have been made.

Chapter 6. Accounting Information Systems: Manual and Electronic Data Processing. The material on EDP has been extensively revised, and a mini-practice set has been added to the end-of-chapter materials. The practice set has an estimated working time of four hours.

Chapter 8. This chapter is now entitled Accounting for Receivables. Chapter content is limited primarily to accounts and notes receivable. Special features include the sale of receivables and the accounting for installment notes receivable. Significant by its absence is the discounting of notes receivable which is rarely done in contemporary business.

Chapter 13. Accounting Principles. There are three significant changes in content: (1) a section on Ethics and Accounting Principles has been added as a result of the findings of the Treadway Commission on Fraudulent Financial Reporting, (2) international accounting has been incorporated into the chapter, and (3) inflation accounting has been deemphasized.

Chapter 15. Corporations: Organization and Capital Stock Transactions. The entries for the sale of capital stock on a subscription basis have been eliminated.

Chapter 16. Corporations: Dividends, Retained Earnings, and Income Reporting. This chapter covers the same topics as in the previous edition but the order of coverage has been changed. The topics of dividends and retained earnings are presented first to complete the explanation of the stockholders' equity section in a corporation balance sheet. Attention is then given to income statements for a corporation.

Chapter 18. Investments and Consolidated Financial Statements. This chapter now includes short-term investments (formerly included in Chapter 8) along with previous coverage of long-term investments and consolidated financial statements.

Chapter 21. Managerial Accounting. This is essentially a completely new chapter. It is designed to provide an introduction to managerial accounting and to key management accounting cost concepts. The chapter includes an appendix on the accounting cycle for a manufacturing company.

Chapter 22. Job Order Cost Accounting. The complexity of this first chapter on cost accounting systems has been significantly reduced by limiting the chapter to job order costing.

Chapter 23. Process Cost Accounting. This chapter includes many references to modern manufacturing accounting with real world examples and a discussion of Just-in-Time processing. An appendix has also been added on the use of the average cost method in process cost accounting.

Chapter 24. Cost-Volume-Profit Relationships. Two changes have been made in this chapter: (1) a section has been added on target net income after taxes and (2) variable vs. absorption costing is explained in an appendix to the chapter.

Chapter 25. Budgetary Planning. The material on budgeting in nonmanufacturing companies has been expanded to include a merchandise purchases budget. In addition, there are new exercises and problems on this topic. Zero-based budgeting and program budgeting have been dropped.

Chapter 26. Budgetary Control and Responsibility Accounting. The addition of Responsibility Accounting to the title of this chapter reflects the additional attention given to this important topic. The chapter includes accounting reports on three types of responsibility centers: cost, profit, and investment.

COMPLETE LEARNING PACKAGE

In addition to the general features of the textbook, some other qualitative aspects of the book are: (1) pedagogical features within each chapter; (2) extensive homework material; and (3) complete supplementary package.

Pedagogical Features Within Each Chapter

Study Objectives

As in the first edition, a list of study objectives is presented at the beginning of each chapter. Each objective is subsequently inserted in a marginal note opposite the text material to which it pertains. The summary of study objectives now includes a statement of the objective with the summary material. In addition, the applicable study objective(s) are identified in the textbook for each exercise and problem.

Demonstration Problems

At the start of the problem material, a demonstration problem and solution are provided. Unlike many textbooks that provide only a limited number of demonstration problems, this textbook has a demonstration problem for every chapter, and, in some cases, has two per chapter.

Financial Reporting Problems

New in this edition are financial reporting problems. Each of the financial accounting chapters has a financial reporting problem in addition to a decision case. The problems are designed to familiarize students with the format, content, and uses of published annual reports. Most of the financial reporting problems are based on PepsiCo's 1988 Annual Report as presented in Appendix A at the end of this textbook.

Decision Cases

Each chapter has one or more decision cases at the end of the problem material. The purpose of each decision case is to provide a less structured situation for the students to help them develop their decision-making skills.

Self-Study Questions

Each chapter has self-study questions following the demonstration problem(s). The questions consist of five multiple-choice questions. Answers to the questions are presented in the text at the end of each chapter. The self-study questions provide the student with an opportunity to personally assess his or her understanding of key points of the chapter.

Key Terms Highlighted

Key terms are highlighted in the text in color. Each term is then defined in a Glossary at the end of the chapter. In addition to the definition, the Glossary contains a page reference indicating where the term is discussed in the chapter. All key terms are also identified in the index to the textbook.

Real-World Vignettes

New in this edition are capsule examples or explanations of real world applications of related text material. These real-world vignettes are boxed and colored blue for easy identification. This feature is designed to stimulate student interest and to show how accounting is actually used in the business world.

Computer Notes

A discussion of the use of the computer in an accounting situation is discussed at least once in a chapter and in many chapters, more than once. The computer notes are boxed and colored for easy identification.

Liberal Use of Graphics, Diagrams, and Flow Charts

As often stated, a "picture is worth a thousand words." Throughout the textbook an abundance of graphics, diagrams, and flow charts make optimum use of the four-color format.

Color Coordinated

A new feature in this edition is the use of color as a pedagogical tool. We have used **blue** to designate the study objectives at the beginning of the text, the study objectives in the margins, and the end of chapter Summary of Study Objectives. We also have used **blue** for the Real-World Vignettes. Green is used for the Computer Notes, and rust is used for Key Terms. Rust screens are used for accounting forms, financial statements, internal reports, Solutions to Demonstration Problems. **Grey** screens are used for art displays and Demonstration Problems. As the students use the text they will associate these different aspects of pedagogy and be able to remember them better.

Extensive Homework Material

Because instructors often choose to emphasize different concepts and practices from semester to semester, and because different instructors emphasize different points, we have provided a wide variety of homework material including questions, exercises, problems, and decision cases. In addition, an alternative problem set is included at the end of each chapter that can be used in alternating semesters or quarters if the instructor prefers. It should be noted that the homework material has been extensively checked to ensure accuracy and completeness.

In this edition, the number of exercises has been increased in most chapters. In addition, selected exercises and problems have been identified by a symbolic light bulb to indicate that they are a challenging type of exercise or problem which we refer to as BRAIN TEASERS. Also, as indicated earlier in this preface, the homework materials now include financial reporting problems.

Each chapter contains selected exercises and problems that can be solved by using a computer. The materials are identified by a computer screen located to the left of the exercise or problem. This feature enables students to have hands-on experience in working with the computer in solving accounting exercises and problems.

Supplementary Materials

For the Student

Student Study Guide. This valuable aid for students consists of a chapter review, a demonstration problem with solution, and review questions and exercises (true/false, multiple choice, matching, and short exercises) for each chapter. The Study Guide highlights and summarizes the material in the chapter and helps students measure progress and understanding by immediate feedback. Answers are included, and the incorrect answers to the true/false and multiple choice questions are explained.

Five Manual Practice Sets. College Hills Cycle Shop's, narrative and business paper's versions are practice sets to be used after Chapter 7 of the textbook. Town City Furniture Galleries and Flextone, Inc. are second financial practice sets for use after Chapter 16 of the textbook. Lawn Pro Manufacturing Company is a managerial practice set for use after Chapter 22 of the textbook.

Computerized Practice Set. The computerized version of College Hills Cycle Shop (narrative version) for the IBM-PC includes a workbook, documentation, and a disk. Features of the computerized practice set include automatic posting of student entries to allow the student to concentrate on learning the principles involved. In addition, any journal entries entered in error are easily corrected by the computer; the computer will delete previous wrong postings and automatically correct them to reflect the proper data. The practice set also contains Lotus-type menus, which aid the student in building on previously learned computer skills.

Working Papers I and II. Working Papers I is provided for all problems in Chapters 1–14. These are partially filled in with headings and some preliminary data to save the student's time and act as a learning tool. Working Papers II provides similar information for Chapters 14–29.

Solving Accounting Exercises on the IBM-PC Microcomputer. Selected exercises from the textbook are set up for the students to solve on the computers. When errors are made there is a built-in review process to help students understand the concepts illustrated in the exercise.

Spreadsheet Software for Lotus 1-2-3. The package is keyed to the end-of-chapter problems in the textbook and is for use on the IBM-PC. The package provides the student with a wide selection of end-of-chapter problems and six tutorial problems, as well as a section in the manual that trains the student in Lotus 1-2-3. The package includes ten preprogrammed templates for which the student identifies and enters relevant input data and evaluates the resulting output data; a number of partially completed templates test the student's accounting knowledge and developing computer skills. Finally, a challenging section that requires students to design and create their own spreadsheets is included for students with more advanced computer skills. Eighty problems taken directly from the textbook are covered.

For the Instructor

Annotated Instructor's Edition

For the first time in this edition we have an Annotated Instructor's Edition which overlays supplementary information in green in the margins of the existing student text. This information is designed to assist the instructor with class presentation and consists of the following:

1. **Alternative Terminology**—prepares the students for the variety of terminology they will find in the workplace.

2. **Teaching Help**—provides questions or extra data that help give students a finer focus on the material.
3. **Case in Point**—gives information that will enhance class discussion.
4. **Check Figures**—provides quick answers in the margins next to the end-of-chapter exercises and problems.

Solutions Manual. Complete and accurate solutions to all questions, exercises, problems, and cases in the textbook are included.

Instructor's Manual. A comprehensive resource guide, this manual includes sample syllabi for two-semester and three-quarter use of the textbook, chapter-by-chapter outlines, lecture notes, and time and difficulty charts, including a short description of each problem for instructor assignment purposes.

Examination Book and Microtest. This collection of objective questions and problems for each chapter in the textbook with accompanying answers is also available in software format for IBM-PC and Macintosh and true compatibles. Microtest offers the professor a number of valuable options—the ability to generate a large number of test questions randomly from any chapter; easy question selection (professor can lock in desired question type and chapter number); and text previewing prior to printing. Examinations can be stored on a separate data disk (up to 38 for the IBM-PC and 50 for the Macintosh), and retrieved later for playback. Microtest also has the ability to generate multiple tests simultaneously, and is equipped with disk transfer capability, which enables the user to select questions from any portion of the testbank and from any disk. The machine will locate the questions and print out the test in one run.

Checklist of Key Figures. This is a listing of key figures for students to use to verify problem solutions.

Achievement Tests. These end-of-chapter and end-of-term tests are presented in a format to copy and distribute directly to students.

Test Preparation Service. We provide a form from which the instructor selects the questions from Microtest that he or she wants on an exam, and we send one master exam within 24 hours of receipt of the form. If the instructor prefers, random selection from a number of chapters is possible.

Acetate Transparencies. Acetate transparencies are available for all exercises and problems in the textbook. All are in clear, dark type for good visibility.

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If this textbook helps teachers instill in their students an appreciation and understanding of financial and managerial accounting, if it encourages students to evaluate critically and understand basic accounting, and if it prepares students for more advanced study in business, then we will have attained our objective.

Suggestions and comments from users of ACCOUNTING PRINCIPLES will be appreciated.

Madison, Wisconsin — Jerry J. Weygandt
DeKalb, Illinois — Donald E. Kieso
Ann Arbor, Michigan — Walter G. Kell

University of Wyoming

The University of Wyoming's Old Main building was designed by Denver architect Frederick A. Hale. This Romanesque-styled building is faced with rough-textured sandstone. The exterior of Old Main remains much as it was constructed over 100 years ago.