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# **PART ONE**

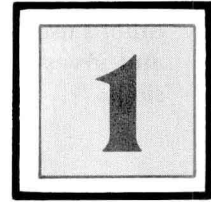
## **Introduction**

### **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.**
- ☐ **Tell in each case the extent of the responsibility of a business owner for the debts of a business organized as a single proprietorship, a partnership, or a corporation.**
- ☐ **Define or explain the words and phrases listed in the chapter Glossary.**



# Accounting, an introduction to its concepts

■ Accounting is a service activity. Its function 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.<sup>1</sup> 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?<sup>2</sup> Likewise, governmental units use accounting information in regulating businesses and collecting taxes, labor

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<sup>1</sup> 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. Copyright (1970) by the American Institute of CPAs.

<sup>2</sup> 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.



unions use it in negotiating working conditions and wage agreements, and investors make wide use of accounting data in investment decisions.

## WHY STUDY ACCOUNTING

Information for use in answering questions like the ones listed is conveyed in accounting reports. If a 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 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. 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. The licensing helps 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 the applicant 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 one 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 expressed the opinion that at least five years of college study are necessary to obtain the body of knowledge needed to be a CPA. For those meeting this standard, it recommends

that no previous work experience should be required.<sup>3</sup> However, it will be several years before all states accept this recommendation. In the meantime, interested students can learn the requirements of any state in which they are interested by writing to its state board of accountancy.

## THE WORK OF AN ACCOUNTANT

Accountants are commonly employed in three main fields: (1) in public accounting, (2) in private accounting, or (3) in government.

### Public accounting

Public accountants are individuals who offer their professional services and those of their employees to the public for a fee, in much the same manner as a lawyer or a consulting engineer.

**Auditing** The principal service offered by a public accountant is auditing. Banks commonly require an *audit* of the financial statements of a company applying for a sizable loan, with the audit being performed by a CPA who is not an employee of the audited concern but an independent professional person working for a fee. Companies whose securities are offered for sale to the public generally must also have such an audit before the securities may be sold. Thereafter additional audits must be made periodically if the securities are to continue being traded.

The purpose of an audit is to lend credibility to a company's financial statements. In making the audit, the auditor carefully examines the company's statements and the accounting records from which they were prepared. In the examination, the auditor makes sure the statements fairly reflect the company's financial position and operating results and were prepared in accordance with generally accepted accounting principles from records kept in accordance with such principles. Banks, investors, and others rely on the information in a company's financial statements in making loans, granting credit, and in buying and selling securities. They depend on the auditor to verify the dependability of the information the statements contain.

**Management advisory services** In addition to auditing, accountants commonly offer *management advisory services*. An accountant gains from an audit an intimate knowledge of the audited company's accounting procedures and its financial position. He or she is thus in an excellent position to offer constructive suggestions for improving the procedures and strengthening the position. Clients expect these suggestions as a useful audit by-product. They also commonly engage

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<sup>3</sup> *Report of the Committee on Education and Experience Requirements for CPAs* (New York: AICPA, 1969), p. 11. Copyright (1969) by the American Institute of CPAs.

certified public accountants to conduct additional investigations for the purpose of determining ways in which their operations may be improved. Such investigations and the suggestions growing from them are known as management advisory services.

Management advisory services include the design, installation, and improvement of a client's general accounting system and any related information system it may have for determining and controlling costs. They also include the application of machine methods to these systems, plus advice in financial planning, budgeting, forecasting, and inventory control. In fact, they include all phases of information systems and related matters.

**Tax services** In this day of increasing complexity in income and other tax laws and continued high tax rates, few important business decisions are made without consideration being given to their tax effect. A certified public accountant, through training and experience, is well qualified to render important service in this area. The service includes not only the preparation and filing of tax returns but also advice as to how transactions may be completed so as to incur the smallest tax.

## Private accounting

When an accountant is employed by a single enterprise, he or she is said to be in private accounting. A small business may employ only one accountant or it may depend upon the services of a public accountant and employ none. A large business, on the other hand, may have more than a hundred employees in its accounting department. They commonly work under the supervision of a chief accounting officer, commonly called the *controller*, who is often a CPA. The title, controller, results from the fact that one of the chief uses of accounting data is to control the operations of a business.

The one accountant of the small business and the accounting department of a large concern do a variety of work, including general accounting, cost accounting, budgeting, and internal auditing.

**General accounting** *General accounting* has to do primarily with recording transactions and preparing financial and other reports for the use of management, owners, creditors, and governmental agencies. The private accountant may design or help the public accountant design the system used in recording the transactions. He or she will also supervise the clerical or data processing staff in recording the transactions and preparing the reports.

**Cost accounting** The phase of accounting that has to do with collecting, determining, and controlling costs, particularly costs of producing a given product or service, is called *cost accounting*. A knowledge of costs and controlling costs is vital to good management. Therefore, a large company may have a number of accountants engaged in this activity.

**Budgeting** Planning business activities before they occur is called *budgeting*. The objective of budgeting is to provide management with an intelligent plan for future operations. Then after the budget plan has been put into effect, it provides summaries and reports that can be used to compare actual accomplishments with the plan. Many large companies have a number of people who devote all their time to this phase of accounting.

**Internal auditing** In addition to an annual audit by a firm of certified public accountants, many companies maintain a staff of internal auditors. The internal auditors constantly check the records prepared and maintained in each department or company branch. It is their responsibility to make sure that established accounting procedures and management directives are being followed throughout the company.

## Governmental accounting

Furnishing governmental services is a vast and complicated operation in which accounting is just as indispensable as in business. Elected and appointed officials must rely on data accumulated by means of accounting if they are to complete effectively their administrative duties. Accountants are responsible for the accumulation of these data. Accountants also check and audit the millions of income, payroll, and sales tax returns that accompany the tax payments upon which governmental units depend. And finally, federal and state agencies, such as the Interstate Commerce Commission, Securities and Exchange Commission, and so on, use accountants in many capacities in their regulation of business.

## ACCOUNTING AND BOOKKEEPING

Many people confuse *accounting* and *bookkeeping* and look upon them as one and the same. In effect they identify the whole with one of its parts. Actually, bookkeeping is only part of accounting, the record-making part. To keep books is to record transactions, and a bookkeeper is one who records transactions. The work is often routine and primarily clerical in nature. The work of an accountant goes far beyond this, as a rereading of the previous section will show.

## ACCOUNTING STATEMENTS

Accounting statements are the end product of the accounting process, but a good place to begin the study of accounting. They are used to convey a concise picture of the profitability and financial position of a business. The two most important are the income statement and the balance sheet.

## The income statement

A company's *income statement* (see Illustration 1-1) is perhaps more important than its balance sheet. It shows whether or not the business achieved or failed to achieve its primary objective—earning a “profit” or net income. A *net income* is earned when revenues exceed expenses, but a *net loss* is incurred if the expenses exceed the revenues. An income statement is prepared by listing the revenues earned during the period, listing the expenses incurred in earning the revenues, and subtracting the expenses from the revenues to determine if a net income or a net loss was incurred.

<b>Coast Realty</b>		
Income Statement for Year Ended December 31, 19—		
<u>Revenues:</u>		
Commissions earned .....	\$31,450	
Property management fees .....	<u>1,200</u>	
Total revenues .....		\$32,650
<u>Operating expenses:</u>		
Salaries expense .....	\$ 7,800	
Rent expense .....	2,400	
Utilities expense .....	315	
Telephone expense .....	560	
Advertising expense .....	<u>2,310</u>	
Total operating expenses ....		<u>13,385</u>
Net income .....		<u><u>\$19,265</u></u>

**Illustration 1-1**

*Revenues* are inflows of cash or other properties received in exchange for goods or services provided to customers. Rents, dividends, and interest earned are also revenues. Coast Realty of Illustration 1-1 had revenue inflows from services which totaled \$32,650.

*Expenses* are goods and services consumed in operating a business or other economic unit. Coast Realty consumed the services of its employees (salaries expense), the services of a telephone company, and so on.

The heading of an income statement tells the name of the business for which it is prepared and the time period covered by the statement. Both bits of information are important. However, the time covered is extremely significant, since the items on the statement must be interpreted in relation to the period of time. For example, the item “Commissions earned, \$31,450” on the income statement of Illustration 1-1 has little significance until it is known that the amount represents one year’s commissions and not the commissions of a week or a month.

## The balance sheet

The purpose of a *balance sheet* is to show the financial position of a business on a specific date. It is often called a *position statement*. Financial position is shown by listing the *assets* of the business, its *liabilities* or debts, and the *equity of the owner or owners*. The name of the business and the date are given in the balance sheet heading. It is understood that the item amounts shown are as of the close of business on that date.

Before a business manager, investor, or other person can make effective judgments based on balance sheet information, he or she must gain several concepts and understandings. To illustrate, assume that on August 3, Joan Ball began a new business, called World Travel Agency. During the day she completed these transactions in the name of the business:

- Aug. 3 Invested \$18,000 of her personal savings in the business.
- 3 Paid \$15,000 of the agency's cash for a small office building and the land on which it was built (cost of the building, \$10,000, and cost of the land, \$5,000).
- 3 Purchased on *credit* from Office Equipment Company office equipment costing \$2,000. (Purchased on credit means purchased with a promise to pay at a later date.)

A balance sheet reflecting the effects of these transactions appears in Illustration 1-2. It shows that after completing the transactions the agency has four assets, a \$2,000 debt, and that its owner has an \$18,000 equity in the business.

World Travel Agency			
Balance Sheet, August 3, 19—			
<i>Assets</i>		<i>Liabilities</i>	
Cash .....	\$ 3,000	Accounts payable .....	\$ 2,000
Office equipment .....	2,000		
Building .....	10,000		
Land .....	5,000		
		<i>Owner's Equity</i>	
		Joan Ball, capital .....	18,000
Total assets .....	<u>\$20,000</u>	Total equities .....	<u>\$20,000</u>

**Illustration 1-2**

Observe that the two sides of the balance sheet are equal. This is where it gets its name. Its two sides must always be equal because one side shows the resources of the business and the other shows who supplied the resources. For example, World Travel Agency has \$20,000

of resources (assets) of which \$18,000 were supplied by its owner and \$2,000 by its creditors. (*Creditors* are individuals and organizations to whom the business owes debts.)

## ASSETS, LIABILITIES, AND OWNER'S EQUITY

The assets of a business are, in general, the properties or economic resources owned by the business. They include cash, amounts owed to the business by its customers for goods and services sold to them on credit (called *accounts receivable*), merchandise held for sale by the business, supplies, equipment, buildings, and land. Assets may also include such intangible rights as those granted by a patent or copyright.

The liabilities of a business are its debts. They include amounts owed to creditors for goods and services bought on credit (called *accounts payable*), salaries and wages owed employees, taxes payable, notes payable, and mortgages payable.

When a business is owned by one person, the owner's interest or equity in the assets of the business is shown on a balance sheet by listing the person's name, followed by the word "capital," and then the amount of the equity. The use of the word "capital" comes from the idea that the owner has furnished the business with resources or "capital" equal to the amount of the equity.

Liabilities are also sometimes called *equities*. An equity is a right, claim, or interest; and a liability represents a claim or right to be paid. The law recognizes this right. If a business fails to pay its creditors, the law gives the creditors the right to force the sale of the assets of the business to secure money to meet creditor claims. Furthermore, if the assets are sold, the creditors are paid first, with any remainder going to the business owner. Obviously, then, by law creditor claims take precedence over those of a business owner.

Since creditor claims take precedence over those of an owner, an owner's equity in a business is always a residual amount. Creditors recognize this. When they examine the balance sheet of a business, they are always interested in the share of its assets furnished by creditors and the share furnished by its owner or owners. The creditors recognize that if the business must be liquidated and its assets sold, the shrinkage in converting the assets into cash must exceed the equity of the owner or owners before the creditors will lose.

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

An understanding of financial statement information requires a knowledge of the generally accepted accounting principles that govern the accumulation and presentation of the data appearing on such statements. A common definition of the word "principle" is: "A broad general law or rule adopted or professed as a guide to action; a settled



ground or basis of conduct or practice. . . .” Consequently, generally accepted accounting principles may be described as broad rules adopted by the accounting profession as guides in measuring, recording, and reporting the financial affairs and activities of a business. They consist of a number of concepts, principles, and procedures which are first discussed at the points shown in the following list. They also are referred to again and again throughout this text in order to increase your understanding of the information conveyed by accounting data.

	First introduced	
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2. Continuing-concern concept .....	1	14
3. Stable-dollar concept .....	1	15
4. Time-period concept .....	3	75
<i>Generally accepted principles:</i>		
1. Cost principle .....	1	13
2. Objectivity principle .....	1	14
3. Realization principle .....	1	20
4. Matching principle .....	3	84
5. Full-disclosure principle .....	8	282
6. Materiality principle .....	8	294
7. Consistency principle .....	9	313
8. Conservatism principle .....	9	317
<i>Generally accepted procedures:</i>		
These specify the ways data are processed and reported and are described and discussed throughout the text.		

## SOURCE OF ACCOUNTING PRINCIPLES

Generally accepted accounting principles are not natural laws in the sense of the laws of physics and chemistry. They are man-made rules that depend for their authority upon their general acceptance by the accounting profession. They have evolved from the experience and thinking of members of the accounting profession, aided by such groups as the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the American Accounting Association, and the Securities and Exchange Commission.

The American Institute of Certified Public Accountants (AICPA) has long been influential in describing and defining generally accepted accounting principles. During the years from 1939 to 1959 it published a series of *Accounting Research Bulletins* which were recognized as expressions of generally accepted accounting principles. In 1959 it established an 18-member Accounting Principles Board (APB) composed of practicing accountants, educators, and representatives of industry, and gave the board authority to issue opinions that were to



be regarded by members of the AICPA as authoritative expressions of generally accepted accounting principles. During the years 1962 through 1973 the Board issued 31 such opinions. Added importance was given to these opinions beginning in 1964 when the AICPA ruled that its members must disclose in footnotes to published financial statements of the companies they audit any departure from generally accepted accounting principles as set forth in the *Opinions of the Accounting Principles Board*.

In 1973, after 11 years of activity, the Accounting Principles Board was terminated. Its place was taken by a seven-member Financial Accounting Standards Board (FASB). The seven members serve full time, receive salaries, and must resign from accounting firms and other employment. They must have a knowledge of accounting, finance, and business, but are not required to be CPAs. This differs from the Accounting Principles Board, all members of which were CPAs, who served part time, without pay, and continued their affiliations with accounting firms and other employment. The FASB issues *Statements of Financial Accounting Standards* which like the *Opinions of the Accounting Principles Board* must be considered as authoritative expressions of generally accepted accounting principles. Both the *Statements* and *Opinions* are referred to again and again throughout this text.

The American Accounting Association, an organization with strong academic ties, has also been influential in describing and defining generally accepted accounting principles. It has sponsored a number of research studies and has published many articles dealing with accounting principles. However, its influence has not been as great as the AICPA, since it has no power to impose its views on the accounting profession but must depend upon the prestige of its authors and the logic of their arguments.

The Securities and Exchange Commission (SEC) plays a prominent role in financial reporting. The SEC is an independent quasi-judicial agency of the federal government. It was established to administer the provisions of various securities and exchange acts dealing with the distribution and sale of securities. Such securities, to be sold, must be registered with the SEC. This requires the filing of audited financial statements prepared in accordance with the rules of the SEC. Furthermore, the information contained in the statements must be kept current by filing additional audited annual reports. The SEC does not appraise the registered securities. However, it attempts to safeguard investors by requiring that all material facts affecting the worth of the securities be made public and that no important information be withheld. Its rules carry over into the annual reports of large companies and have contributed to the usefulness of these reports. In a real sense, the SEC should be viewed as the dominant authority in respect to the establishment of accounting principles. However, it has relied on