SURVEY OF ACCOUNTING

REVISED EDITION

RICHARD G. SCHROEDER
CHARLES P. ZLATKOVICH

SURVEY OF ACCOUNTING

REVISED EDITION

RICHARD G. SCHROEDER
University of North Carolina—Charlotte

CHARLES P. ZLATKOVICH
University of Texas—El Paso

1998

DAME
PUBLICATIONS, INC.

Cover Design: Amanda S. Austin

Desktop Publishing: Barbara G. Kubricht

Graphic Artist: Amanda S. Austin

Houston, TX 77074
713/995-1000
713/995-9637—FAX
dame.publications@worldnet.att.net

ISBN 0-87393-399-0

Library of Congress Catalog No. 96-71826

Printed in the United States of America

PREFACE

All professionals and business managers require a basic knowledge of accounting. During the past several years, many colleges and universities have attempted to provide nonbusiness majors with an introductory, one-semester course, typically titled Survey of Accounting, that satisfies these students' need to understand the accounting process. However, the supply of texts for these classes is limited, and most of the available texts are watered-down versions of previously published accounting principles texts. Because these texts are not specifically suited to the needs of nonbusiness majors, students often rapidly lose interest in the subject matter. This text is specifically designed to meet the needs of nonbusiness majors.

FOCUS

Because many of the students enrolled in Survey of Accounting courses are or will be self-employed or work in small, unincorporated businesses, this text, in the early chapters, emphasizes accounting for sole proprietorships. Later, accounting for corporations and partnerships is introduced, and finally, some managerial accounting topics most useful to the individuals served by the course are introduced.

The text is divided into four sections. Sections I introduces the accounting cycle as well as accounting for service and merchandising companies. Section II presents the reporting and measurement issues associated with assets, liabilities and equity. Section III reviews special reporting issues including financial statement analysis, international accounting, accounting for changing prices and income taxation. Finally, Section IV presents managerial accounting and introduces such topics as planning and controlling, cost behavior analysis, product costing, budgeting and standard costing.

FEATURES

We have supplied this text with a wealth of pedagogical features to facilitate student learning and retention.

- **Learning Objectives** are outlined at the beginning of the chapter. Later, each learning objective is highlighted prior to the point it is discussed in the chapter.
- The **Practical Insight**, a relevant excerpt from the financial press, piques student interest in the topic at hand.
- **Key Terms** are supplied at the end of each chapter for review purposes.
- A **Demonstration Problem** summarizes the major topics covered in each chapter and illustrates key concepts.
- **Questions** summarize the chapter contents: students who thoroughly understand the issues addressed in the chapter should be able to answer each of the questions.
- **Exercises** review each of the major topics contained in the chapter. Since each exercise covers *only* one topic, the instructor can use the exercises to illustrate chapter topics without confounding the presentation with multiple issues.

- **Problems** review the more complex issues covered in the chapter, frequently addressing more than one issue in a single problem.
- A **Comprehensive Problem** functions as a capstone for the problem material in the chapter. This problem deals with several chapter topics simultaneously, illustrating the interaction of various concepts.
- A **Decision Case** centers on an issue that may be encountered by Survey of Accounting students in their future careers.

In addition to these features, a **Glossary** is contained at the end of the text. With it, students are enabled to easily access definitions of terms which were defined in earlier chapters. Once they have finished the course, the students can use the glossary as a useful reference tool.

Finally, we have incorporated a feature not offered by most Survey of Accounting texts: **Review Cases** *specifically* geared to some of the fields that Survey of Accounting students most commonly enter.

Legal	Review Case 1, summarizing Chapters 1-4 illustrates the accounting cycle for an attorney. The students are asked to assist in developing a suitable system for the practice.
Hotel Management	Review Case 2, summarizing Chapters 5-8, involves some reporting and measurement issues for a hotel and casino under restoration.
Engineering	Review Case 3, summarizing Chapters 9-12, introduces students to an engineering partnership about to decide whether they should accept the terms of a new project.
Health Administration	Review Case 4, summarizing Chapter 13-18, requires management accounting skills to assist a nonprofit health safety organization in their search for appropriate equipment.

We have developed all of these pedagogical features with the needs of Survey of Accounting Students in mind. Further we have strived to create a easy-to-teach format to assist both instructors and students in the educational process.

ACKNOWLEDGMENTS

This project would not have been possible without the help and cooperation of many individuals. A special thanks is due to Tracy Cox who assisted in the development of this text. The production and marketing staff at Dame Publications were particularly helpful. We thank Bill McDowell, Barbara Kubricht, and Amanda Austin.

Richard G. Schroeder
Charles P. Zlatkovich

TABLE OF CONTENTS

PART ONE

THE ACCOUNTING CYCLE

1 FUNDAMENTAL ACCOUNTING CONCEPTS

This chapter begins by defining the function of accounting. Next, some fundamental concepts and the three forms of business organizations are presented. Subsequently, the accounting equation is introduced and the impact of business transactions on the accounting equation, and on three financial statements is illustrated. Finally, the authoritative bodies affecting accounting practice, the role of the accountant in the various sectors of accounting practice, and the role of ethics in accounting are discussed.

At the conclusion of this chapter you should be able to:

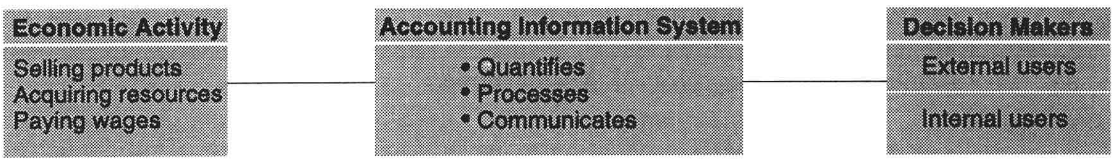
1. Define the function of accounting.
2. Describe three fundamental accounting concepts: business entity, monetary unit, and historical cost.
3. Delineate the three forms of business organization.
4. Explain the accounting equation and its elements.
5. Describe the impact of business transactions on the accounting equation.
6. Identify the functions of three major financial statements.
7. Identify the authoritative bodies influencing accounting practice.
8. Describe the role of accountants employed in the three sectors of the accounting profession.
9. Describe the role of ethics in accounting.

THE FUNCTION OF ACCOUNTING

Learning Objective 1 *Define the function of accounting.*

The economies of the world are characterized by scarce resources. Each country must determine the best use of its scarce resources, and have a process to provide information on the efficiency of the use of its scarce resources. Economic resources are used by businesses to provide goods and services to other businesses and consumers. Accounting provides information about the efficiency of the economic activities of a business that is useful in making decisions. The economic activities of a business include acquiring resources, selling products and services, and paying wages to employees. All information about the economic activities of businesses must be quantified, processed, and communicated by the accounting system in order to be useful. Consequently, accounting can be viewed as a service activity that provides information to decision makers. This process is termed the *accounting decision-making information system* and is illustrated in Exhibit 1-1.

EXHIBIT 1-1 Accounting Decision-Making Information System



As Exhibit 1-1 illustrates, accounting links decision makers with the economic activities of a business. This text is designed to assist future users of accounting information to (1) understand the quantification, processing, and communication of accounting information and (2) make sound business decisions.

The decision makers or users of accounting information are classified as external users and internal users. *External users* include current or potential investors (owners and creditors), employees, taxing authorities, financial analysts, brokers, and labor unions. The use of financial statements by external users to make economic decisions is termed *financial accounting*. The first twelve chapters of this text examine some of the issues relating to financial accounting.

Investors and creditors are the external users with the closest relationships to the business. They make three basic decisions based on accounting information:

Buy A potential investor decides to invest in the business. A creditor decides to extend credit to a business.

Hold A current investor decides to retain an investment in the business.
A creditor decides to continue a credit relationship with the business.

Sell A current investor decides to dispose of an investment in the business.
A creditor decides to discontinue a credit relationship with the business.

Since these decisions are constantly being reviewed by external users, the timely quantification, processing, and communication of information by the accounting decision-making information system is essential.

In making decisions, external users generally rely on the financial statements published by the business. These financial statements (discussed later in the chapter) are the end product of the quantification, processing, and communication process.

Internal users are the managers who work within the business. Internal users make decisions involving the operating, investing and financing activities of a company. The *operating activities* of a company involve the use of resources to produce, distribute and market goods and services. The *investing activities* of a company are the selection and management of the resources that will be used to produce, distribute and market the company's goods and services. These resources include land, buildings, equipment, supplies and employees. The *financing activities* of a company involve decisions about how to obtain the necessary financial resources from investors and creditors necessary to produce, distribute and market the company's goods and services. The use of information to make decisions by internal users is termed *management accounting*.

Internal users are responsible for the daily planning and control of operations. In performing their duties, internal users may require, in addition to the published financial statements, various other reports to be prepared from the company's accounting decision-making information system. The last six chapters of this text examine some management accounting issues, in these chapters we will discuss some of these reports and the information they provide. For example,

- How does a production manager determine the cost of producing the company's product? (Chapter 14)
- How can a financial manager prepare a budget for the next accounting period? (Chapter 16)

ACCOUNTING MEASUREMENT AND CONCEPTS

Learning Objective 2 *Describe the three fundamental accounting concepts: business entity, monetary unit, and historical cost.*

The accounting decision-making information system is designed to provide information to users to help them make business decisions. These decisions can have a significant impact on and may cause the success or failure of a particular business. Consequently, it is necessary to have standards to guide accountants in the quantification, processing, and communication of economic activities. The standards for reporting to external users are termed *generally accepted accounting principles* (GAAP). Generally accepted accounting principles are defined as the methods and procedures used in the preparation of financial statements.

Several broad concepts are related to the selection of the specific principle to use in different situations. Among these concepts are business entity, unit of measure, and historical cost. Knowledge of these and other concepts introduced later in the text will assist in developing an understanding of the accounting process.

Business Entity

Business organizations are frequently referred to as accounting entities or business entities. A business entity is any business organization that exists as an economic unit. In accounting each business entity is considered a basis of accountability; therefore, the economic activities of a business are kept separate from those of its owners. This is termed the business entity concept.

Unit of Measure

Economic activities are measured in terms of money. This is termed the *unit of measure* concept. In accounting it is assumed that the dollar (or other currency) represents a reasonable unit of value that is useful in making economic decisions. Money is the only factor that is common to all economic events; therefore, it is the best measure of economic activity.

Historical Cost

All economic events are recorded in the accounting records at their original cost. This is termed the *historical cost* concept. This amount is said to be an objective measure of value to buyers and sellers because it is the agreed-upon exchange price. The historical cost of most items is retained in the accounting decision-making information system until the items are sold or used by the business.

THE THREE FORMS OF BUSINESS ORGANIZATION

Learning Objective 3 *Delineate the three forms of business organization.*

Three forms of business organization are used in our economy. These are sole proprietorships, partnerships, and corporations. Each of these forms of organization is discussed below. In this text we will begin by discussing accounting for sole proprietorships because it is the least complicated form of accounting. Later in the text we will illustrate accounting for corporations. Partnership accounting is discussed as a separate topic in Chapter 9.

Sole Proprietorships

A *sole proprietorship* is a business that is owned by one person. Under this form of business organization the owner has complete responsibility for the operation of the business. For accounting purposes a sole proprietorship is treated as having an existence separate from that of the owner. However, from a legal standpoint the owner and the business are viewed as one entity. The individual owner of a sole proprietorship manages the business, receives all profits, and suffers all losses. Due to the legal status of sole proprietorships, the owner is personally liable for all obligations incurred by the business. That is, if the business cannot pay its bills, it will be the owner's responsibility to pay all of the creditors with his or her personal funds. Sole proprietorships account for a large majority of businesses in the United States, and include professional practices, such as those of doctors and lawyers; service establishments, such as those of plumbers and carpenters; and small retail stores, such as boutiques.

Partnerships

A *partnership* is similar to a sole proprietorship except that it is owned by two or more people. Partnerships are also treated as separate entities for accounting purposes but are not viewed as legal economic units. A partnership has the advantage of bringing together the talents and economic resources of two or more people. These individuals generally share in the management of the business and in the profits and losses according to a predetermined formula. Because of the legal status of partnerships, **each partner is individually liable for all of the obligations of the business.** The partnership form of business organization is used for professional practices, such as certified public accountants; service establishments, such as realtors; and retail stores, such as restaurants. For example, the public accounting firm of Price Waterhouse is organized as a partnership.

Corporations

A *corporation* **is a business that has both a legal and an accounting existence separate from its owners.** Corporations are organized under the laws of the state in which the company has its home office. The owners of a corporation are termed *stockholders* and do not directly participate in the management of the business. The stockholders elect a board of directors, who in turn hire professional managers to operate the company. The stockholders participate in the profits of a corporation through the receipt of dividends. However, since the corporation is considered a separate legal entity, the stockholders are not personally liable for the corporation's obligations. The separate legal entity status of corporations allows the business to conduct its affairs in its own name. Consequently, a corporation can enter into contracts, buy and sell property, and sue and be sued. Corporations have several advantages over sole proprietorships and partnerships that will be explored in more detail in Chapter 7. Corporations conduct the greatest amount of economic activity in the United States and are especially prevalent in manufacturing activities, such as producing automobiles or electric appliances, and merchandising activities, such as large department stores. Examples of corporations are General Motors and Sears.

THE ACCOUNTING EQUATION

Learning Objective 4 *Explain the accounting equation and its elements.*

The accounting process can be summarized by a single equation referred to as the *accounting equation*. This equation stipulates that an accounting entity's resources are equal to any claims against those resources as follows:

Economic resources = Creditor claims + Owner claims

In accounting, economic resources are termed *assets*, creditor claims against economic resources are referred to as *liabilities*, and owner claims against economic resources are referred to as *owner's equity*. Assets, liabilities, and owner's equity are referred to as the *elements of the accounting equation*. Consequently, the accounting equation expressed in accounting terminology is:

Assets = Liabilities + Owner's equity

Assets

Assets are defined as *probable future economic benefits of a particular entity*. That is, they are economic resources owned by a business that are expected to be of benefit to future operations. Examples of assets are cash, supplies, and equipment. Assets are of value because they can be used or exchanged in the production of goods and services. For example, an individual acquiring an automobile is acquiring an asset.

Liabilities

Liabilities are defined as the *obligations or debts of a business*. Liabilities include accounts payable, salaries payable, or mortgages payable. Purchasing an asset on credit results in the recording of a liability on the company's books. For example, an individual making a credit card purchase is incurring a liability.

Owner's Equity

Owner's equity represents the owner's interest in the business. It is the difference between total assets and total liabilities. That is, assets minus liabilities equals owner's equity. Owner's equity is affected by four types of events: (1) contributions of assets to the business by the owners; contributions of assets increase owner's equity, (2) withdrawals of business assets by the owner; withdrawals of business assets decrease owner's equity, (3) earning *revenue*-assets received from customers from the sale of goods and services are termed revenues; revenues increase owner's equity, and (4) incurring *expenses*-assets or services used in the process of earning revenue are termed expenses; expenses decrease owner's equity. Investments and withdrawals are owner's capital transactions. Revenues and expenses are profitability transactions. If revenues exceed expenses, a company earns a profit for the accounting period. If expenses exceed revenues, the company incurs a loss for the accounting period.

The impact of each of the four events on owner's equity is illustrated in Exhibit 1-2.

Owner's Equity is affected by

1) contributions of assets to the busines by owner: increase O.E.
2) withdrawals of business by owner: decrease O.E.
3) earning revenue-assets received from customers - increase
4) expenses - decrease