

# The Executive's Accounting Primer

Second Edition

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Robert L. Dixon

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# **THE EXECUTIVE'S ACCOUNTING PRIMER**

**Second Edition**

**ROBERT L. DIXON**

Professor Emeritus of Accounting  
Graduate School of Business Administration  
University of Michigan

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His nonteaching experience includes public accounting, consulting, and work on the principal committees of the American Accounting Association, American Institute of CPAs, and the National Association of Accountants. He has served as editor of the *Accounting Review*, president of the American Accounting Association, and AICPA Distinguished Visiting Professor. He is the author of two other books and numerous articles in professional publications.

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# Preface

## **For Whom Is This Book?**

This book is designed for the person who has had little or no formal training or experience in accounting, or who had only a course or two some time ago and has forgotten most of it, and whose current or possible future occupation calls for a breadth of understanding of the internal or financial affairs of a business enterprise. This definition would appear to fit the person who now carries executive responsibilities or who believes that an opportunity for promotion to executive levels would be enhanced by some familiarity with the inner workings and concepts of accounting. Another class of people who are prospective users of this book are members of the legal profession who have had scant training in accounting but who undertake to prepare tax returns or, particularly, become involved in litigation which is concerned with such matters as business profit determinations, rates of return, taxes, and financial damages. To those groups we must add several others: financial analysts, stockbrokers, engineers, and, in fact, all who do some investing and want a better understanding of financial statements.

## **What Does It Offer?**

The big problems in gaining an understanding of accounting are, first, getting over the threshold with minimum pain; second, choosing, with a certain amount of discrimination and sophistication, specific areas of the field for study; and, third, examining those areas enough not only to feel at home with them but, more importantly, to develop an ability

to discuss them and other areas with accountants, financial personnel, and lawyers.

In seeking to surmount the threshold, this book starts with the known and proceeds, at a modest pace, into the unknown. The first four chapters are intended to parade the vocabulary and principal accounting reports and to develop a minimum understanding of the debit-credit structure—or, we may call it, “the accounting method.” Then the remaining sixteen chapters apply accounting method to the analysis of certain prominent areas of accounting in the belief that one need not suffer through the whole accounting spectrum to achieve only an understanding rather than a pick-and-shovel knowledge of accounting. The third goal comes from achieving the first two. If you “know” some accounting and have exercised your mind a bit in tussling with some of its favorite problems, you should then be capable of (1) understanding the meaning and significance of the data that come across your path, (2) recognizing your own needs for accounting data as related to the evaluations and decisions you are called upon to make, and (3) formulating quite explicitly your requests to the accounting staff for special reports or accounting schedules. This book is definitely not designed to teach you how to be a bookkeeper or to become a CPA, and it does not undertake to present the ever-evolving views, rules, and regulations of the Securities and Exchange Commission, the Financial Accounting Standards Board, Committees of the American Institute of Certified Public Accountants, or other accounting authorities. However, it should help you very much to understand and communicate with accountants and financial personnel—in short, to be a better manager or executive. It should also help you in your investment decisions.

## How Should You Read It?

For a person to become a qualified professional accountant requires depth of study and accounting experience. This book is fairly short; in fact, a fast reader probably could “read” the entire thing in a day or less. Don’t! A good deal of the book is devoted to topics that the best accountants in the world find troublesome in spite of their years of exposure to accounting. So please be fair with this book; it is intended for *study* rather than bedtime reading. Some chapters are quite short, and you might do a whole chapter in a single sitting; some chapters are quite long, and you certainly should divide them into two or more reading periods. As a rule of thumb, be satisfied to read no more than about eight to ten pages at one time. Study the illustrative examples very

carefully, and, by all means, do the short tests that appear at the end of most chapters.

Certain chapters, especially Chapters 16 through 18, are somewhat specialized and can be read in any order, or skipped entirely if you wish, but you should be sure to include Chapter 19 in your itinerary. When you have finished this book, if you feel interested in pursuing accounting further, you should find little difficulty in reading any of the widely used textbooks leading into advanced accounting, and you should enjoy reading some of the accounting and finance periodicals such as *The Journal of Accountancy*, *The Financial Executive*, and *The Wall Street Journal*, Barrons, Forbes, and Money.

This is my opportunity to express appreciation to Distinguished Professor Donald H. Skadden, who wrote the chapter on federal income tax concepts. It provides an excellent summary of virtually the whole field of income taxes, and it deserves careful study. It deals with the more important concepts that underlie income taxation—without getting bogged down with rates and section numbers. It really constitutes a minicourse on the subject.

Also I wish to express my special thanks to William A. Sabin and M. Joseph Dooher, who were most helpful and instrumental in bringing about the publication of this book by the McGraw-Hill Book Company. At the same time it should be recognized that the author, and not McGraw-Hill Book Company, is fully responsible for all opinions expressed in the book.

*Robert L. Dixon*

# Contents

## ***Preface***

xiii

## **1 The Balance Sheet**

1

- What Is a Balance Sheet?, 1
- The Balance Sheet—What Good Is It?, 1
- Does the Balance Sheet Really Show Financial Position?, 2
- Does the Balance Sheet Actually Show What You Think It Does?, 3
- How Are Assets Valued?, 4
- Why Are Nonmonetary Assets Reported at Cost?, 5
- Balance Sheet Illustrations, 6
- Balance Sheet Categories, 8
- Balance Sheet Relationships, 9
- Balance Sheet Terminology, 10
- Test Problem, 11

## **2 The Income Statement**

13

- What Is the Income Statement's Purpose?, 13
- What Is Net Income?, 14
- What Is Revenue?, 15
- The Accrual Concept, 16
- What Is an Expense?, 17
- Some Other Offsets to Revenue, 18
- What Are Income Taxes?, 19
- Interest and Dividends, 19

Income Statement Illustrated, 20	
Comments on Illustrative Income Statement, 20	
Test Problem, 23	

### **3 The Accounting Structure**

25

Management Decisions, 25	
Business Forms, 26	
The Accounting Journal, 27	
The Accounting Ledger, 27	
The Ledger Account, 28	
Asset and Expense Accounts, 29	
Equity and Revenue Accounts, 31	
The Process of Recording Complete Transactions, 33	
The General Journal, 36	
Comments on Figures 7 and 8, 38	
Closing Entries Revisited, 38	
The Trial Balance, 38	
The Financial Statements, 39	
Conclusion, 39	
Test Problem, 41	

### **4 The Accounting Cycle**

45

Elements of the Accounting Cycle, 45	
What Is Meant by the Accounting Period?, 47	
What and Why Are Adjusting Entries?, 48	
Problem Data, 49	
The Work Sheet, 54	
The Work Sheet—Comments, 54	
Financial Statements, 56	
Are Interim Statements Dependable?, 56	
Conclusion, 57	
Test Problem, 58	

### **5 Working Capital**

62

What Is Working Capital?, 62	
Cash Receipts Transactions, 63	
Cash Disbursement Transactions, 64	
Marketable Securities, 66	
Accounts Receivable, 67	
Inventories, 68	



Prepayments, 70  
 Current Liabilities, 71  
 What Can Your Accountants Do for You?, 72  
 The Budget, 72  
 The Cash Budget, 73  
 Comments on Cash Budget Illustration, 75  
 Control of Receivables, 76  
 Comments on Aging Schedule, 76  
 Test Problem, 78

## **6 The Flow of Funds Statement** 80

What Are Exhibits and Such Things?, 80  
 The Cash Receipts and Disbursements Statement, 81  
 Working-Capital Changes, 83  
 The Funds Statement—Purpose, 84  
 The Funds Statement—Horseback Version, 85  
 How to Milk a Co., 87  
 The Funds Statement—Balance Sheet Version, 88  
 Comments on Balance Sheet Version, 91  
 The Funds Statement—Complete Version, 91  
 Comments on Complete Version, 92  
 Statement of Financial Changes, 93  
 Test Problem, 93

## **7 Inventories** 96

What Are Inventories?, 96  
 Typical Inventory Transactions, 96  
 Inventory Valuation, 100  
 Identified Cost, 101  
 First-in, First-out, 102  
 What Are Inventory Profits and Holding Gains?, 103  
 Last-in, First-out, 105  
 Dollar Value LIFO, 107  
 Average Cost, 107  
 Cost or Market, the Lower, 108  
 Inventory Turnover, 109  
 Inventory Reports for Management, 109  
 Test Problem, 110

## **8 Fixed Assets and Depreciation** 112

Classes of Fixed Assets, 112  
 Initial Valuation of Fixed Assets, 113

Historical Cost Less Depreciation, 115  
Replacement Cost, 115  
Depreciation of Fixed Assets, 117  
What Is Depreciation?, 117  
Depreciation Patterns, 118  
Straight-Line Depreciation, 118  
Wavy-Line Depreciation, 119  
Decreasing-Line Depreciation, 120  
Composite and Group Depreciation, 122  
Typical Depreciation Entries, 123  
Depreciation Fallacies, 124  
Test Problem, 125

## **9 Corporation Accounts**

127

What Is Unique about Corporation Accounting?, 127  
The Issue of Capital Stock with Par Value, 128  
The Issue of Capital Stock with No Par Value, 129  
The Issue of Capital Stock for Property, 129  
Treasury Stock—What, Why, and How?, 130  
Stock Splits—What, Why, and How?, 134  
Stock Rights, 134  
Stock Options, 135  
Stock Warrants, 136  
Convertible Preferred Stock, 137  
Common Stock Equivalents, 138  
Earnings per Share, 138  
Organization Costs, 139  
Test Problem, 140

## **10 Dividends and Reserves**

143

What Is a True Dividend?, 143  
Corporate Investment in Affiliated Company, 145  
Liquidating “Dividends”, 146  
Pseudo (Stock) Dividends, 147  
What Do Accountants Mean by “Reserves”?, 149  
Contra Accounts Used to Be Called Reserves, 149  
Some Liabilities Used to Be Called Reserves, 150  
Retained Earnings May Be Reserved, 151  
Deferred Credits When in Doubt, 151  
Test Problems, 153

<b>11 Long-Term Debt</b>	<b>156</b>
Why Go in Debt?, 156	
Installment Purchases, 158	
Leases and Sale-and-Leaseback Transactions, 159	
Long-Term Notes, 162	
Mortgage Loans, 162	
Mortgage and Debenture Bonds, 162	
Convertible Bonds, 167	
Bonds with Warrants Attached, 168	
Test Problem, 169	
 <b>12 Basic Cost Accounting</b>	 <b>171</b>
What Is Cost Accounting?, 171	
What Are the Purposes of Cost Accounting?, 171	
Job-Order versus Process Cost Accounting, 172	
Use of Subsidiary Ledgers, 173	
Raw Materials Cost Accounting, 174	
Direct Labor Cost Accounting, 176	
Factory Overhead Cost Accounting—Process Costing, 177	
Factory Overhead Cost Accounting—Job Order, 180	
Process Variations, 183	
Internal Cost Statements, 183	
Test Problem, 184	
 <b>13 Cost Standards</b>	 <b>187</b>
What's a Standard?, 187	
Illustration of Standards—Standard Cost per Unit, 188	
Raw Materials Standards, 188	
Raw Materials Accounting—Standard Costs, 189	
Direct Labor Accounting—Standard Costs, 192	
Factory Overhead Accounting—Standard Costs, 193	
Standard Cost Applications, 196	
Test Problem, 196	
 <b>14 Internal Management Accounting</b>	 <b>199</b>
The Concept of Management Accounting, 199	
Responsibility Accounting, 200	
Standard Costing, 200	
Direct Costing, 201	

Differential Costs and Related Decisions, 202  
Should We Make It or Buy It?, 204  
Decisions to Acquire Plant Assets, 206  
Miscellaneous Topics, 210  
Test Problem, 210

## **15 Federal Income Tax Concepts**

212

### **Taxpayers and Tax Returns, 213**

Individuals, 214  
Partnerships, 215  
Corporations, 216  
Subchapter S Corporations, 216  
Multiple Corporations, 217  
Special Corporate Taxes, 217

### **Accounting Periods and Methods, 218**

Tax Year, 218  
Cash Method, 219  
Accrual Method, 219  
Hybrid Method, 220  
Change of Accounting Method, 220

### **Income, 220**

Inclusions, 220  
Exclusions, 221

### **Deductions, 223**

### **Property Transactions, 225**

Investment Tax Credit, 225  
Depreciation and Amortization, 227  
Disposition of Property, 228  
Net Capital Gain, 231  
Net Capital Loss, 232

### **Credits Against Tax, 232**

### **Available to Corporations and Individuals, 232**

### **Rate Structure, 233**

Maximum Tax on Earned Income (Individuals Only), 234  
Income Averaging (Individuals Only), 234  
Minimum Tax (Both Individuals and Corporations), 235

### **Tax Shelters, 235**

### **Summary, 237**

### **Test Problems, 237**

## **16 Consolidated Statements**

239

What Is a Consolidated Statement?, 239  
Why Isn't a Consolidated Statement a Combined Statement?, 240

Consolidation Buzz Words, 241  
 Elimination Entries, 243  
 Where Are Elimination Entries Recorded?, 247  
 Consolidation of Balance Sheets at Acquisition Date, 248  
 Consolidated Balance Sheets—Sometime Later, 250  
 Consolidation of Income Statements, 252  
 Consolidated Statements—Conclusion, 253  
 Test Problem, 254

## **17 Income Tax Allocation** 257

Why Bother?, 257  
 What Conditions Make Interperiod Allocation Necessary?, 258  
 General Principles of Interperiod Allocation, 258  
 Revenue Recognized before It Is Taxed, 259  
 Expenses Recognized before They Become Tax Deductions, 261  
 Revenue Taxed before It Is Recognized, 262  
 Expenses as Tax Deductions before They Are Recognized, 263  
 Tax Allocation and Permanent Differences, 267  
 Arguments against Tax Allocation, 267  
 Tax Allocation within a Period, 267  
 Test Problem, 268

## **18 Business Combinations** 269

How Business Combinations Are Achieved, 269  
 The Physiology of an Acquisition, 270  
 Impact of Acquisition Transaction on Income, 273  
 The Physiology of a Pooling of Interests, 274  
 Impact of Pooling Transaction on Income, 276  
 Pool versus Purchase Accounting, 278  
 Test Problem, 279

## **19 Recognition of Effects of Inflation** 282

First Let's Set the Scene, 282  
 A Simple Example, 284  
 How Do You Translate Old Dollars into Current Dollars?, 285  
 The Particulars of Translation Technique, 286  
 Common Dollar Reporting—Comparative Data, 289  
 Common Dollar Reporting—Comprehensive Illustration, 290

<b>20 Accounting for Foreign Operations</b>	<b>295</b>
Our Foreign Relations, 295	
Accounts Receivable, 295	
Accounts Payable, 296	
Foreign Branches, 296	
Foreign Subsidiaries, 297	
Accounting for Receivables and Payables, 297	
Foreign Branch Accounting, 299	
Foreign Currency Translation, 302	
Translation and Inflation, 303	
<b>Appendix ONE: Solutions to Tests</b>	<b>305</b>
<b>Appendix TWO: Supplementary Problems</b>	<b>325</b>
<b>Appendix THREE: Supplementary Problem Solutions</b>	<b>355</b>
<b>Index</b>	<b>389</b>

# 1

# The Balance Sheet

## **What Is a Balance Sheet?**

Imagine, first, that you have made a list of everything valuable that you own, and also the estimated dollar value of each thing, and have then added the dollar values to find their total. Second, you have made a list of the people, stores, etc., to whom you presently owe money, and also the amount owing to each party, and have determined the total of those amounts. Third, you have subtracted the smaller of the two totals from the larger to determine the *dollar difference* between the two lists. You now have all of the ingredients for a balance sheet.

Your first list can be labeled “assets”; your second list can be labeled “liabilities”; and the dollar difference can be termed your “net worth.” If you arrange all that information in more or less orderly fashion, you will have a *balance sheet*. In the style customarily used by accountants, your balance sheet might appear as in Figure 1.

## **The Balance Sheet—What Good Is It?**

A balance sheet is what accountants call a *financial statement*. Many accountants will assert that it is the most important of the various kinds of “statements” that they prepare. However, there’s much uncertainty as to just how one arrives at the dollar figures that are assigned to the various assets. This could mean that not only are the individual asset valuations unacceptable to certain users of the statements but so also is the amount that we labeled “net worth” (since it was found by subtracting the liability total from the asset total as listed).

Figure 1

MY NAME Balance Sheet (date)			
Assets		Liabilities	
Cash	\$ 10,000	Owed to stores	\$ 1,200
Stocks and bonds	50,000	Owed to bank	60,000
Clothing	2,500	Total liabilities	\$ 61,200
Furniture	28,000		
House	160,000	Net worth	244,300
Land	40,000		
Miscellaneous	15,000		
	<u>\$305,500</u>		<u>\$305,500</u>

In spite of disagreement on the matter of the dollar valuations (e.g., is our house worth \$160,000 exactly or approximately?) the balance sheet is considered to be a statement of the “financial position” of the enterprise (or of the person or any other “entity” depicted) on the date noted in the heading of the statement. It goes without saying that the dollar measures that are assigned to the various assets must all be “as of” the same date; otherwise, we would have a mishmash and the total would have no meaning.

The balance sheet does not show how the subject—let’s call it the “entity”—reached its displayed position. It also fails to show where the entity is heading (though a series of balance sheets on successive dates can be of help in that connection). Let’s pursue this line of inquiry a bit more.

**Does the Balance Sheet Really Show Financial Position?**

Your own financial position is made up of the valuable possessions, or resources, owned by you, *offset by your debts*. As stated earlier, the *difference* between the dollar measure of your resources and the dollar measure of your debts is what is commonly called your *net worth*. If we apply the same formula to the company with which you are associated, we might, for example, find that the company’s balance sheet shows assets totaling \$1,000,000 and offsetting debts of \$400,000, so that its net worth is \$600,000. Accountants, particularly the teacher crowd, are so impressed by the algebra of this situation that they often refer to “the”



accounting equation as: *Assets minus liabilities equals net worth*, or  $A - L = NW$ .

The balance sheet, basically, consists of a reporting of the dollar amount of assets *on the left-hand side* and all the existing debts *on the right-hand side*; the two sides *are then made equal* by filling in enough on the right-hand side to make them equal! The amount of the filler is the net worth. So if we want to flaunt our mathematical ability a bit, we may point out that, as mentioned above,  $A - L = NW$ . This can just as well be written as  $A = L + NW$ , which is a kind of arithmetic model of the standard balance sheet in which the assets, on the left, equal the sum of the liabilities and net worth, on the right.

So far it would appear that financial position means nothing more than a pair of totals (assets and liabilities) offset to show their difference (net worth). As a matter of fact, this arithmetic pattern constitutes only a minor aspect of any analysis of a company's financial position. The asset total has some meaning; the liability total has some meaning; and the net worth has some (very limited) meaning; but these are *gross* concepts, to say the least. Any analysis of a company's financial position will surely take into account, and with considerably greater interest, the relationships (ratios) that exist between some of the more detailed items within the asset, the liability, and the net worth categories. Financial position, in other words, is not to be construed as a mere difference between the asset and the liability totals. We'll look at that again later.

### **Does the Balance Sheet Actually Show What You Think It Does?**

We have just been commenting, with an apparent degree of confidence, on the service of the balance sheet in revealing a company's financial position. Before we become overly enthusiastic, let's slow down a bit and test our premises.

If the balance sheet does, in truth, show the *current value of all* the assets owned by a company and if it also shows all the company's debts, it would apparently qualify as an accurate statement of financial position—if the asset amount is correct and the liability amount is correct, then their difference, the net worth, must be correct. But now we come to the real hooker. The asset total (as well as many of the details which go to make it up) is *virtually never* equal to the current value of all the assets. If that isn't enough to discourage you, let us add that the *real worth* of a company depends on a great deal more than its list of assets and list of liabilities. You could probably imagine, in this age of leasing