ACCOUNTANTS' HANDBOOK

SIXTH EDITION

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ACCOUNTANTS' HANDBOOK

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PREFACE

A decade has passed since the preceding edition of the ACCOUNTANTS' HANDBOOK was published. More authoritative accounting pronouncements were issued in those 10 years than in the entire previous history of American accounting. The explosion in scope and complexity of accounting principles and practice has dominated the preparation of this 6th edition of accounting's oldest and most comprehensive reference.

Some of the changes in the HANDBOOK, caused by this flood of new accounting literature, are readily apparent. Two volumes are now necessary to provide the encyclopedic coverage that has been the hallmark of this HANDBOOK. The 28 sections of the 5th edition have been expanded to 45. These new sections represent both the need to subdivide broad topics and the addition of new materials that reflect the expanding scope of accounting practice. For example, in the 5th edition liabilities were treated in a single section. In this edition there are new, individual sections on pensions, leasing, and accounting for income taxes covering matters formerly included in the liabilities section. In the 5th edition employee compensation required a single section. Now there are three separate sections: payroll, pensions, and executive compensation. New areas of practice are detailed in separate sections on the evaluation of internal control, valuing nonpublic companies, computing per share earnings, cash flow analysis, the Cost Accounting Standards Board, and interim financial statements, and in two sections on international operations.

Not immediately noticeable are some subtle changes in the HANDBOOK. The proliferation of accounting pronouncements, reflecting the increasing complexity of our business system, has made it almost impossible for anyone to be a general expert in accounting. Sections in this edition are signed by the individual authors, most of whom are *specialists* in particular areas. In past editions most of the contributors were university professors, indicative of the former ability of many academics to be expert in broad areas of accounting. In the 6th edition most of the authors are financial executives, partners in accounting firms, and financial analysts whose corporate or practical responsibilities demand that they be specialists.

The authoritative role required of each of these authors has itself evolved with the increasing specialization of modern accounting. It is probable that William A. Paton, the editor of the 2nd and 3rd editions of the ACCOUNTANTS' HANDBOOK, could have written those editions unaided by contributors. While the present editors eschew comparison with Paton, one of the great accountants, we know that we could not have written this 6th edition alone, and we doubt that he could have. The specialized expertise of the individual authors has become the critical element in this edition. The editors have worked closely with the authors, reviewing and critically editing their manuscripts. However, in the final analysis, each section is the work and the opinion of the individual author.

The extremely detailed and complete index, found in earlier editions, has been retained in the 6th edition. Also, specific references have been added at the end of each section to enable readers to explore subjects in greater depth. Previous editions had frequent citations to leading textbooks. References to such general sources have been reduced in this edition and replaced by citations to authoritative accounting pronouncements and, in many instances, the expert opinion of the authors.

The rapid pace of change in accounting has been accompanied by a prolonged "lead time" for the issuance of authoritative pronouncements. Many accounting standards were in process at the same time that these volumes were being written. The materials here reflect FASB, AICPA, and SEC pronouncements issued through late summer of 1980, including FASB Statements No. 35 and 36 on pension accounting and reporting and Statements Nos. 39 and 40 on inflation accounting for specialized assets. The September 1980 revisions to SEC Regulations S-X and S-K have been reflected in the text. Outstanding exposure drafts have also been included. If changes were under consideration, the authors have explained the possible changes and often given their predictions of the outcome.

Despite these changes or, more appropriately, because of them the 6th edition of the ACCOUNTANTS' HANDBOOK continues to strive for the goal of the 1st edition, written 60 years ago, to provide in a single reference source an answer to every reasonable question on accounting and financial reporting that may be asked by accountants, executives, bankers, lawyers, financial analysts, and other users and preparers of accounting information.

For convenience the pronoun "he" has been used in this book to refer nonspecifically to the accountant and the person in business. We are aware that many women are also active in accounting practice and business. We did not intend to exclude them through the traditional choice of pronoun.

Preparation of this 6th edition of the ACCOUNTANTS' HANDBOOK would not have been possible without the assistance of many individuals. Our greatest debt is obviously to the 57 authors of the 45 sections of this edition. As is evident, the authors have positions and expertise that make them unusually qualified to write their sections. However, the responsibilities associated with these positions result in schedules that leave little time for research and writing. In many instances, the editors took unabashed advantage of personal friendships with the authors to cajole these contributions. We deeply appreciate the value and importance of the time we were given.

We must also acknowledge our debt to the editors of and contributors to the five earlier editions of the HANDBOOK. This volume is a complete revision, but it draws heavily on the accumulated knowledge and comprehensive coverage of the earlier editions.

A project of this scope and complexity requires careful organization and thorough coordination. We were greatly aided by Aliza Mayefsky (now associated with Ernst & Whinney) and Karen Coe who handled a mass of details in organizing and controlling the writing of the sections. Janet Pegg continued this effort and also provided research assistance on a range of subjects. Pamela Lawrence, an avowed nonaccountant, read and corrected the galley proofs of the entire volume, expertly compensating for grammatical deficiencies and typographical errors, and coordinated the completion of the project. Louise Schreiber (now associated with Peat, Marwick, Mitchell & Co.) gave us a "fresh examination" of the final manuscript, which resulted in valuable additions and corrections.

We particularly appreciate the outstanding assistance provided by Brian Zell, Manager, Auditing Standards Division of the AICPA, in the preparation of the index.

Patricia McConnell, of Bear, Stearns & Co., wrote Section 7 on analysis of cash flow. Ms. McConnell also provided continuous advice and assistance on the entire project, from the original outline to final corrections for last minute changes in authoritative pronouncements.

To the many other individuals and organizations who have provided valuable suggestions and illustrative materials sincere thanks are extended. Specific acknowledgment is given elsewhere to the many publications referred to in the preparation of this book. In particular, we and the authors appreciate the cooperation of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board for their permission to quote extensively from their publications.

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SECTION 1

INTRODUCTION: NATURE AND ELEMENTS OF ACCOUNTING

THE NATURE OF ACCOUNTING

ACCOUNTING DEFINED. The definition of accounting has undergone a transition from emphasis on what accountants do to emphasis on the purpose of accounting. In 1941 the Committee on Terminology of the American Institute of Certified Public Accountants (Accounting Terminology Bulletin No. 1) stated:

> Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

This definition emphasized the activities of accountants.

The Committee to Prepare a Statement of Basic Accounting Theory of the American Accounting Association ("A Statement of Basic Accounting Theory," p. 1) defined accounting as:

> . . . the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.

This definition broadened the area of accounting and acknowledged the importance of the needs of users of accounting information. It included the entire area of accounting.

In contrast, the Financial Accounting Standards Board has defined its area of concern as **general purpose external financial reporting by business enterprises.** The FASB, in Statement of Financial Accounting Concepts No. 1 (paragraph 7), observed that:

This section is Mr. Carmichael's personal view and not an official position of the AICPA.

> Financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system—that is, information about an enterprise's resources, obligations, earnings, etc.

FUNCTION OF ACCOUNTING. As the more recent definitions of accounting indicate, the meaning of "accounting" cannot be separated from the objective or purpose accounting information is intended to serve. The AAA committee ("A Statement of Basic Accounting Theory," p. 68) notes the following **objective of the accounting function:** "Measurement and communication of data revealing past, present, and prospective socio-economic activities." It also states that the **purpose of the accounting function is** "To improve control methods and decision making at all levels of socio-economic activities."

The AICPA Study Group on the Objectives of Financial Statements ("Objectives of Financial Statements," p. 13) observes that:

> The fundamental function of financial accounting has been unchanged almost from its inception. Its purpose is to provide users of financial statements with information that will help them make decisions.

The FASB expresses a similar concern for the intended use of accounting information (Statement of Financial Accounting Concepts No. 1, paragraph 9).

> Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions—for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.

ACCOUNTING ORGANIZATIONS. A variety of organizations have an interest in the accounting discipline. There are organizations that represent accountants—who may be employed in public accounting practice, private industry, or government—and organizations that represent issuers or users of accounting information. These organizations are identified and explained in Section 3, "Accounting Authorities and Organizations."

FRAMEWORK OF ACCOUNTING. The frequency with which the word "principles" appears in the accounting literature is pointed out by Storey *(The Search for Accounting Principles–Today's Problems in Perspective)*. The term "generally accepted accounting principles" appears in every auditor's report. A number of other words with overlapping, if disputed, meanings are also widely used, such as postulate, standard, procedure, and rule. The AICPA's Special Committee on Research Program set down three basic terms, differentiated as follows (*Journal of Accountancy*, Vol. 106, p. 63):

> **Postulates** are few in number and are the basic assumptions on which **principles** rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear their understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of **rules** or other guides for the application of principles in specific situations. . . .

There has not been nor is there any substantial agreement as to the meaning of "accounting postulates" and "accounting principles." Ross (*The Elusive Art of Accounting*) says of Moonitz' well-known study of basic accounting postulates (ARS No. 1) that "the study can . . . be criticized from the point of view that some of the basic postulates, however, axiomatic they may sound, are difficult and perhaps even impossible to apply in actual practice."

The AAA committee's "A Statement of Basic Accounting Theory" focused on "the entire area of accounting." The committee seldom used the term "principles." Rather, the statement was oriented to accounting standards, which "provide criteria to be used in evaluating potential accounting information."

The AICPA study group ("Objectives of Financial Statements," p. 15) created the terminology that became the basis for the current framework of accounting. It noted:

> To serve users' needs, the accounting process should consist of an interrelated and compatible system of objectives, standards or principles, and practices or procedures. Objectives should identify the goals and purposes of accounting. Standards should follow logically from objectives, and should provide guidelines for the formulation of accounting practices compatible with the desirable goals. All three levels of the system should be linked rationally to the needs of users.

The FASB has adapted this system for its conceptual framework. Exhibit 1 presents the components of this framework and their relationships as follows:

1. *Objectives.* The objectives underlie the other phases of the conceptual framework. The objectives stem largely from the needs of those for whom the information is intended. They provide a focus for financial reporting by business enterprises and identify broadly the kinds of information that are relevant. The objectives focus financial reporting on a particular kind of decision—committing cash or other resources to a business enterprise with the expectation of future compensation or return.
2. *Qualitative characteristics.* Qualitative characteristics are the criteria that the FASB will use in selecting and evaluating financial accounting and reporting policies. Thus they underlie all components of the conceptual framework except objectives, with particular emphasis on issues related to recognition, measurement, and reporting or display.
3. *Elements.* Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items of which financial statements are composed. There are eight elements: assets, liabilities, owner's equity, revenues, expenses, gains, losses, and comprehensive income.
4. *Recognition and measurement.* To be formally incorporated in a particular set of financial statements, an item must not only qualify as an asset, liability, revenue, expense, or other element, but also must meet criteria for recognition and have a relevant attribute (or surrogate for it) that is capable of reasonably reliable measurement or estimate.
5. *Reporting or display.* Display of information provided by financial reporting depends on elements, recognition, and measurement and is closely related to other aspects of display, such as displays of comprehensive income and its

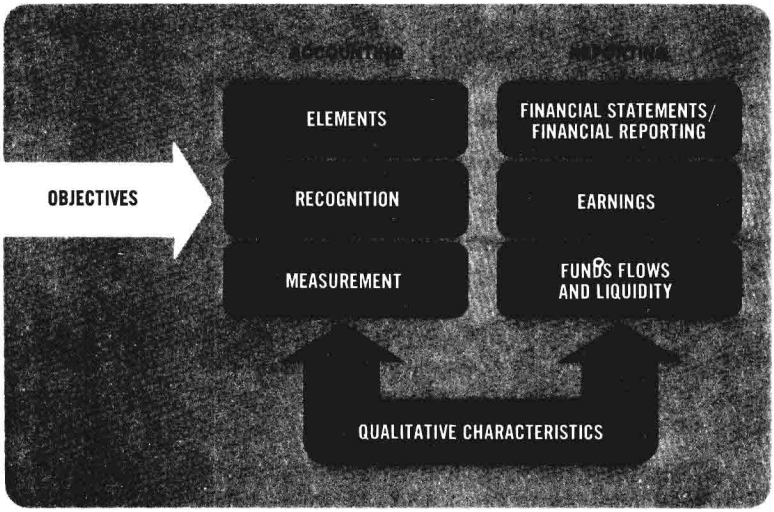

Exhibit 1. The FASB conceptual framework. Source: FASB, "Financial Statements and Other Means of Financial Reporting," p. 30.

components and displays showing funds flows and liquidity information. It concerns what information should be provided, who should provide it, and where it should be displayed. The alternatives are formally incorporated in financial statements, in notes to financial statements, as required supplementary information available on request, and as voluntary information.

The FASB's conceptual framework is discussed further in Section 2, "The Framework of Accounting: Concepts and Principles."

ELEMENTS OF ACCOUNTING

SCOPE OF ACCOUNTING. The AAA committee ("A Statement of Basic Accounting Theory," p. 69) describes the elements of the accounting discipline as consisting of:

1. *Accounting activities.* These represent selected points in the flow of socio-economic activities such as transactions and other identifiable points in the flow of activity accounted for.
2. *Accounting entities.* This includes any organizational unit such as business enterprises, government units, nations, or individuals.
3. *Accounting methods.* This includes such techniques as the computer, statistical analysis, and a variety of other measurement and communication methods.

ACTIVITIES. The activities within the accounting discipline may be broadly categorized into financial accounting, management accounting, social accounting, and tax accounting.