

CHAPTER 1

Accounting

Information for Decision Making

After studying this chapter, you should be able to:

Learning Objectives

- LO1-1** Discuss accounting as the language of business and the role of accounting information in making economic decisions.
- LO1-2** Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.
- LO1-3** Explain the importance of financial accounting information for external parties—primarily investors and creditors—in terms of the objectives and the characteristics of that information.
- LO1-4** Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.
- LO1-5** Discuss elements of the system of external and internal financial reporting that create integrity in the reported information.
- LO1-6** Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.
- LO1-7** Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.
- LO1-8** Describe various career opportunities in accounting.



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THE WALT DISNEY COMPANY

The Walt Disney Company (Disney) was founded in 1923 by Walt and Roy Disney. Over the last 90 years, Disney has grown to become one of the largest entertainment companies in the world, with revenues and assets well above \$50 billion. Disney operates five business segments: media networks, parks and resorts, studio entertainment, consumer products, and interactive media. Disney has grown over the years both by expanding its existing business, and by successfully acquiring other companies and integrating them into Disney.

Just as individuals need reliable financial information when making investment decisions, it is equally important when one company is considering buying

another. Over the years, Disney has acquired ESPN, Pixar, Marvel, and Lucasfilm, among many other companies. Before making these acquisitions, Disney assessed the target company's profitability by examining its income statement, cash flows reflected in its statement of cash flows, and liquidity and solvency by examining its balance sheet. Although nonfinancial considerations play an important role in deciding whether or not to buy another company, and in deciding on the price to pay, financial considerations are integral in evaluating a company before making an acquisition attempt.

Successful acquisitions have been key to Disney's success in recent years. ESPN is a highly profitable

(continued)

unit, and movies from Pixar, Marvel, and Lucasfilm have been highly successful. Movie success not only contributes to the success of the studio entertainment segment, but often leads to rides and attractions that contribute to the success of the parks and resorts segment. In addition, successful movies and their characters spawn merchandise that contributes to the success of the consumer products segment as well as games that contribute to the success of the interactive segment. Content derived from successful movies often serves as an engine of growth for the entire Disney company. ■

Understanding and using accounting information is an important ingredient of any business undertaking. Terms such as *sales revenue*, *net income*, *cost*, *expense*, *operating margin*, and *cash flow* have clearly defined meanings and are commonly used in business-related communications. Although the precise meaning of these terms may be unfamiliar to you at this point, you must gain a basic understanding of these and other accounting concepts to become an active participant in the business world. Our objective in this book is to provide that basic understanding to those who both use and prepare accounting information.

Information that is provided to external parties who have an interest in a company is sometimes referred to as financial accounting information. Information used internally by management and others is commonly referred to as managerial accounting information. Whereas these two types of information have different purposes and serve different audiences, they have certain attributes in common. For example, both financial and managerial accounting require the use of judgment, and information prepared for either purpose should be subject to the company's system of internal control. Financial accounting concepts are critical in order to understand the financial condition of a business enterprise. Determining a company's net income by subtracting its expenses from its revenue is a particularly important part of financial reporting today. This may appear to be a simple process of keeping accounting records and preparing reports from those records, but a great deal of judgment is required. For example, when should the cost of acquiring a resource that is used for several years be recognized as an expense in the company's financial statements? What information is particularly useful for management, but not appropriate for public distribution because of the potential competitive disadvantage that might result? These are among the many complex issues that a business faces on a day-to-day basis and have a critical impact on the company's responsibility to its owners, creditors, the government, and society in general.

As we begin the study of accounting, keep in mind that business does not exist solely to earn a return for its investors and creditors that supply a company's financial resources. Business also has a responsibility to operate in a socially responsible manner and to balance its desire for financial success within this broader social responsibility. We begin our development of these ideas in this chapter, and continue their emphasis throughout this text.

Accounting Information: A Means to an End

The primary objective of accounting is to provide information that is useful in making good decisions, and as a result of good decisions societal prosperity and welfare is maximized. From the very start, we emphasize that accounting is *not an end*, but rather it is *a means to an end*. The final product of accounting information is the decision that is enhanced by the use of that information, whether the decision is made by owners, management, creditors, governmental regulatory bodies, labor unions, or the many other groups that have an interest in the financial performance of an enterprise.

Because accounting is widely used to describe all types of business activity, it is sometimes referred to as the *language of business*. Costs, prices, sales volume, profits, and return on investment are all accounting measurements. Investors, creditors, managers, and others who have a financial interest in an enterprise need a clear understanding of accounting terms and

Accounting Information: A Means to an End

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concepts if they are to understand and communicate about the enterprise. While our primary orientation in this text is the use of accounting information in business, from time to time we emphasize that accounting information is also used by governmental agencies, nonprofit organizations, and individuals in much the same manner as it is by business organizations.

ACCOUNTING FROM A USER'S PERSPECTIVE

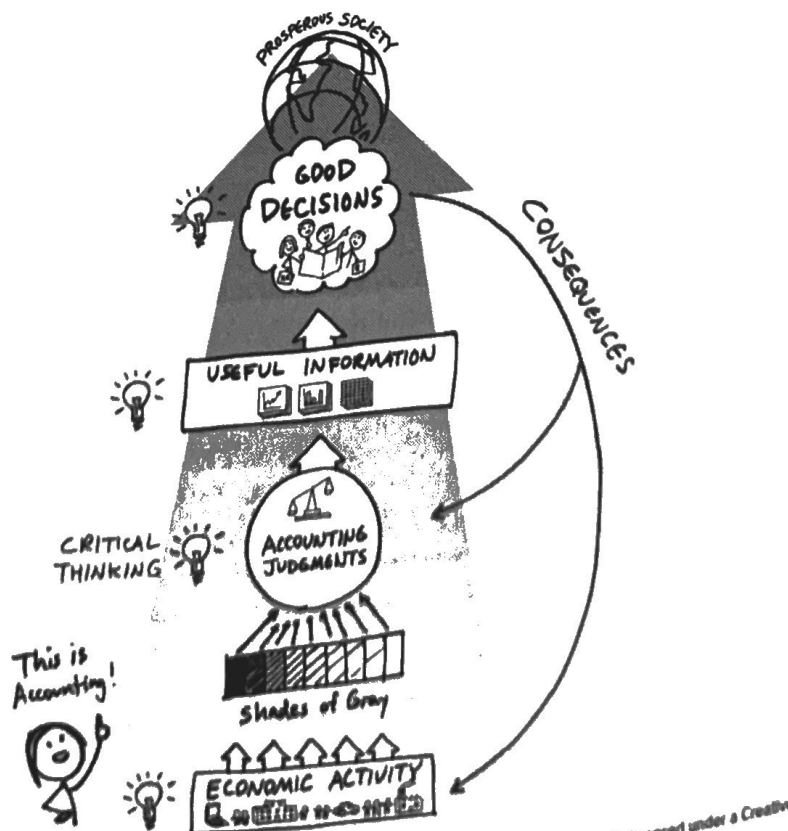
Many people think of accounting as simply a highly technical field with black and white rules, and as a field practiced only by professional accountants. In reality, nearly everyone uses accounting information daily. Accounting information is the means by which we measure and communicate economic events. Whether you manage a business, make investments, or monitor how you receive and use your money, you are working with accounting concepts and accounting information.

Our primary goal in this book is to develop your ability to understand and use accounting information in making economic decisions. To do this, you need to understand the following:

- The nature of economic activities that accounting information describes.
- The assumptions and measurement techniques involved in developing accounting information.
- The information that is most relevant for making various types of decisions.

Exhibit 1-1 illustrates a model developed by the Pathways Commission that describes accounting.¹ Businesses engage in economic activities, and converting these economic activities into useful information sometimes requires significant judgment because business

EXHIBIT 1-1
This is Accounting



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¹ The Pathways Commission was a national initiative from 2010 to 2015 with a goal of making recommendations to engage and retain the strongest possible community of students, academics, practitioners, and other knowledgeable leaders in the practice and study of accounting.

transactions are often complex. Making these judgments requires the accountant to exercise effective critical thinking skills. The ultimate objective of useful information is to facilitate good decisions, and good decisions help bring about a prosperous society.

TYPES OF ACCOUNTING INFORMATION

Just as there are many types of economic decisions, there are also many types of accounting information. The terms *financial accounting*, *management accounting*, and *tax accounting* often are used in describing three types of accounting information that are widely used in the business community.

Financial Accounting **Financial accounting** refers to information describing the financial resources, obligations, and activities of an economic entity (either an organization or an individual). Accountants use the term *financial position* to describe an entity's financial resources and obligations at a point in time and the term *results of operations* to describe its financial activities during the year.

CASE IN POINT

In Sony Corporation's 2015 financial statements to owners, financial position is presented as consisting of ¥15,834 trillion in assets (including cash and cash equivalents, inventories, buildings, and machinery and equipment), with obligations against those assets of ¥12,906 trillion. This leaves ¥2,928 trillion as the owners' interest in those assets. In the same report, results of operations indicate that Sony had a net loss (expenses exceeded revenues) of ¥126 billion for the year ending March 31, 2015.

Financial accounting information is designed primarily to assist investors and creditors in deciding where to place their scarce investment resources. Such decisions are important to society, because they determine which companies and industries will receive the financial resources necessary for growth. When capital, which is a scarce resource, is allocated wisely, the overall prosperity of society is maximized (refer to Exhibit 1-1, the Pathways Model of accounting).

Financial accounting information also is used by managers and in income tax returns. In fact, financial accounting information is used for so many different purposes that it often is called "general-purpose" accounting information.

Management Accounting **Management (or managerial) accounting** involves the development and interpretation of accounting information intended *specifically to assist management* in operating the business. Managers use this information in setting the company's overall goals, evaluating the performance of departments and individuals, deciding whether to introduce a new line of products, and making virtually all types of managerial decisions. A company's managers and employees constantly need information to run and control daily business operations. For example, they need to know the amount of money in the company's bank accounts; the types, quantities, and dollar amounts of merchandise in the company's warehouse; and the amounts owed to specific creditors. Much management accounting information is financial in nature but is organized in a manner relating directly to the decision at hand.

Tax Accounting The preparation of income tax returns is a specialized field within accounting. To a great extent, tax returns are based on financial accounting information. However, the information often is adjusted or reorganized to conform with income tax reporting requirements. We introduce the idea of tax accounting information to contrast it with financial and management accounting information. Although tax information is important for a company's successful operations and is related to financial and management accounting

Accounting Systems

information, it results from a different system and complies with specialized legal requirements that relate to a company's responsibility to pay an appropriate amount of taxes. Laws and regulations governing taxation are often different from those underlying the preparation of financial and management accounting information, so it should not be a surprise that the resulting figures and reports are different. Because the focus of this text is introductory accounting, and because tax accounting is quite complex, we defer coverage of tax accounting subjects to subsequent accounting courses.

Accounting Systems

An **accounting system** consists of the personnel, procedures, technology, and records used by an organization (1) to develop accounting information and (2) to communicate this information to decision makers. The design and capabilities of these systems vary greatly from one organization to another. In small businesses, accounting systems may consist of little more than a cash register, a checkbook, and an annual trip to an income tax preparer. In large businesses, accounting systems include computers, highly trained personnel, and accounting reports that affect the daily operations of every department. But in every case, the basic purpose of the accounting system remains the same: *to meet the organization's needs for information as efficiently as possible.*

Many factors affect the structure of the accounting system within a particular organization. Among the most important are (1) the company's *needs for accounting information* and (2) the *resources available* for operation of the system.

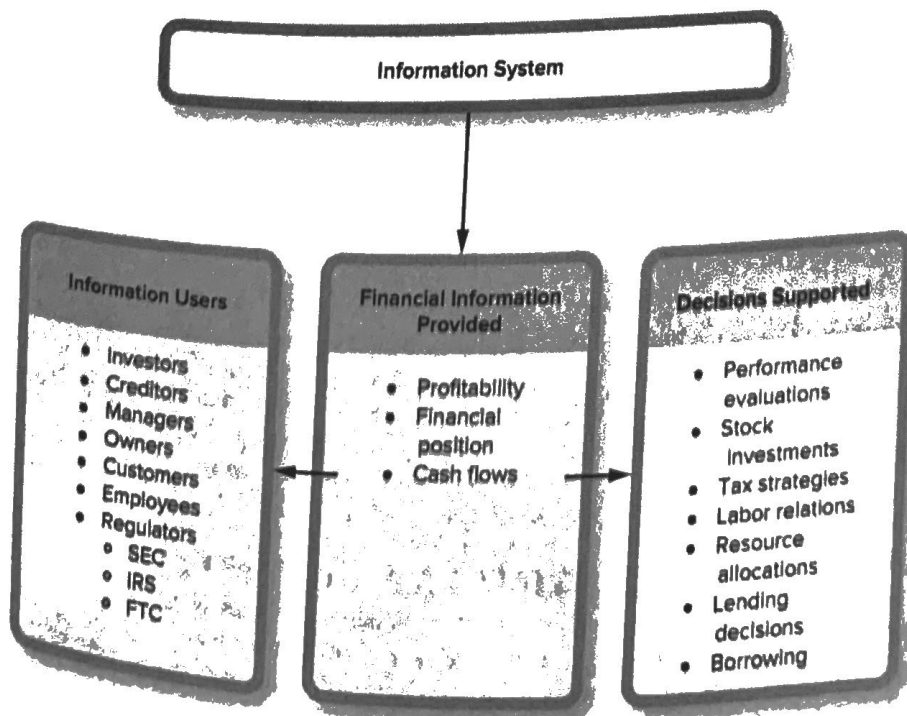
Describing accounting as an information system focuses attention on the information accounting provides, the users of the information, and the support for financial decisions that is provided by the information. These relationships are depicted in Exhibit 1–2. While some of the terms may not be familiar to you at this early point in your study of business and accounting, you will be introduced to them more completely as we proceed through this textbook and as you take other courses in business and accounting. Observe, however, that the information system produces the information presented in the middle of the diagram—financial position, profitability, and cash flows. This information meets the needs of users of the information—investors, creditors, managers, and so on—and supports many kinds of financial decisions such as performance evaluation and resource allocation, among others.

LO1-2

LEARNING OBJECTIVE

Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.

EXHIBIT 1–2
Accounting as an Information System



These relationships are consistent with what we have already learned—namely, that accounting information is intended to be useful for decision-making purposes.

DETERMINING INFORMATION NEEDS

The types of accounting information that a company develops vary with such factors as the size of the organization, whether it is publicly owned, and the information needs of management. The need for some types of accounting information may be prescribed by law. For example, income tax regulations require every business to have an accounting system that can measure the company's taxable income and explain the nature and source of every item in the company's income tax return. Federal securities laws require publicly owned companies to prepare financial statements in conformity with generally accepted accounting principles. These statements must be filed with the Securities and Exchange Commission, distributed to stockholders, and made available to the public.

Other types of accounting information are required as matters of practical necessity. For example, every business needs to know the amounts owed to it by each customer and the amounts owed by the company to each creditor. Although much accounting information clearly is essential to business operations, management still has many choices as to the types and amount of accounting information to be developed. For example, should the accounting system of a department store measure separately the sales of each department and of different types of merchandise? The answer to such questions depends on *how useful* management considers the information to be and the *cost* of developing the information.

THE COST OF PRODUCING ACCOUNTING INFORMATION

Accounting systems must be *cost-effective*—that is, the value of the information produced should exceed the cost of producing it. Management has no choice but to produce the types of accounting reports required by law or contract. In other cases, however, management may use *cost-effectiveness* as a criterion for deciding whether or not to produce certain information.

In recent years, the development and installation of computer-based information systems have increased greatly the types and amount of accounting information that can be produced in a cost-effective manner.

BASIC FUNCTIONS OF AN ACCOUNTING SYSTEM

In developing information about the activities of a business, every accounting system performs the following basic functions:

1. *Interpret and record* the effects of business transactions.
2. *Classify* the effects of similar transactions in a manner that permits determination of the various *totals* and *subtotals* useful to management and used in accounting reports.
3. *Summarize and communicate* the information contained in the system to decision makers.

The differences in accounting systems arise primarily in the manner, frequency, and speed with which these functions are performed.

In our illustrations, we often assume the use of a simple manual accounting system. Such a system is useful in illustrating basic accounting concepts, but it is too slow and cumbersome to meet the needs of most business organizations. In a large business, transactions may occur at a rate of several hundred or several thousand per hour. To keep pace with such a rapid flow of information, these companies must use accounting systems that are largely computer-based. The underlying principles within these systems are generally consistent with the basic manual system we frequently refer to in this text. Understanding manual systems allows users to understand the needs that must be met in a computerized system.

WHO DESIGNS AND INSTALLS ACCOUNTING SYSTEMS?

The design and installation of large accounting systems is a specialized field. It involves not just accounting, but expertise in management, information systems, marketing, and—in many cases—computer programming. Thus accounting systems generally are designed and installed by a team of people with many specialized talents.

Large businesses have a staff of systems analysts, internal auditors, and other professionals who work full-time in designing and improving the accounting system. Medium-size companies often hire a CPA firm to design or update their systems. Small businesses with limited resources often purchase one of the many packaged accounting systems designed for small companies in their line of business. These packaged systems are available through office supply stores, computer stores, and software manufacturers.

COMPONENTS OF INTERNAL CONTROL²

In developing its accounting system, an organization also needs to be concerned with developing a sound system of internal control. **Internal control** is a process designed to provide reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts its operations in an efficient and effective manner. A company's board of directors, its management, and other personnel are charged with developing and monitoring internal control. The five components of internal control, as discussed in *Internal Control—Integrated Framework: 2013* (Committee of Sponsoring Organizations of the Treadway Commission), are the *control environment*, *risk assessment*, *control activities*, *information and communication*, and *monitoring activities*.

An organization's **control environment** is the foundation for all the other elements of internal control, setting the overall tone for the organization. Factors that affect a company's control environment are: (1) the organization's commitment to integrity and ethical values, (2) the independence of the board of directors from management, and the board's oversight of internal control, (3) management assignment, with board oversight, of appropriate levels of authority and responsibility, (4) an organizational commitment to attract, develop, and retain competent individuals, and (5) individuals being held accountable for the performance of their control responsibilities. The control environment is particularly important because fraudulent financial reporting often results from an ineffective control environment.

Risk assessment involves identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives. For example, a company should assess the risks that might prevent it from preparing reliable financial reports and then take steps to minimize those risks. When an entity commits fraud, its risk assessment procedures have likely failed.

Control activities are the policies and procedures that management puts in place to address the risks identified during the risk assessment process. Examples of control activities include approvals, authorizations, verifications, reconciliations, reviews of operating performance, physical safeguarding of assets, and segregation of duties.

Information and communication involves developing information systems to capture and communicate operational, financial, and compliance-related information necessary to run the business. Effective information systems capture both internal and external information. In addition, an effective control system is designed to facilitate the flow of information downstream (from management to employees), upstream (from employees to management), and across the organization. Employees must receive the message that top management views internal control as important, and they must understand their role in the internal control system and the roles of others.

All internal control systems need to be monitored. **Monitoring activities** enable the company to evaluate the effectiveness of its system of internal control over time. Monitoring activities are generally accomplished through ongoing management and supervisory activities, as well as by periodic separate evaluations of the internal control system. Most large organizations have an internal audit function, and the activities of internal audit represent separate evaluations of internal control. In fact, the NYSE requires all listed companies to maintain an internal audit function.

² The information in this section is taken from *Internal Control—Integrated Framework: 2013*. Committee of Sponsoring Organizations of the Treadway Commission, May 2013.

As a result of the large financial frauds at Enron and WorldCom, the U.S. Congress passed, and President George W. Bush signed, the **Sarbanes-Oxley Act (SOX)** of 2002. SOX has been described as the most far-reaching securities law since the 1930s. One of the SOX requirements is that public companies issue a yearly report indicating whether they have an effective system of internal control over financial reporting. In essence, management must indicate whether the entity's internal control system provides reasonable assurance that financial statements will be prepared in accordance with laws and regulations governing financial reporting. In addition for all but the smallest public companies, the company's external auditor must issue its own report as to whether the auditor believes that the company's internal control system is effective. These requirements are contained in Section 404 of SOX; therefore, many businesspeople describe this process as the 404 certification and the audit under Section 404. This certification process has been extremely expensive and time-consuming, and some businesspeople believe that the costs associated with this certification requirement exceed the benefits.

Financial Accounting Information

L01-3

LEARNING OBJECTIVE

Explain the importance of financial accounting information for external parties—primarily investors and creditors—in terms of the objectives and the characteristics of that information.

Financial accounting is an important subject for students who need only an introduction to the field of accounting, as well as for students who will pursue accounting as a major and take many additional accounting courses. Financial accounting provides information about the financial resources, obligations, and activities of an enterprise that is intended for use primarily by external decision makers—investors and creditors.

EXTERNAL USERS OF ACCOUNTING INFORMATION

What do we mean by *external users* and who are they? **External users** of accounting information are individuals and other enterprises that have a current or potential financial interest in the reporting enterprise, but that are not involved in the day-to-day operations of that enterprise. External users of financial information may include the following:

- Owners
- Creditors
- Potential investors
- Labor unions
- Governmental agencies
- Suppliers
- Customers
- Trade associations
- General public

Each of these groups of external decision makers requires unique information to be able to make decisions about the reporting enterprise. For example, customers who purchase from the enterprise need information to allow them to assess the quality of the products they buy and the faithfulness of the enterprise in fulfilling warranty obligations. Governmental agencies such as the Federal Trade Commission may have an interest in whether the enterprise meets certain governmental regulations that apply. The general public may be interested in the extent to which the reporting enterprise is socially responsible (for example, does not pollute the environment).

Providing information that meets the needs of such a large set of diverse users is difficult, if not impossible, in a single set of financial information. Therefore, external financial reporting is primarily used by two groups—investors and creditors. As you will soon see, investors are individuals and other enterprises that own the reporting enterprise. Creditors, on the other hand, are individuals and other enterprises to whom the reporting entity owes money, goods, or services. For example, a commercial bank may have loaned money to the reporting enterprise, or a supplier may have permitted the reporting enterprise to purchase goods and to pay for those goods later. Our assumption is that by meeting the financial information needs of investors and creditors, we provide information that is also useful to many other users of financial information.

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LEARNING OBJECTIVE

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talking about both current investors and creditors and those individuals and other enterprises that may become investors and creditors in the future.

OBJECTIVES OF EXTERNAL FINANCIAL REPORTING

If you had invested in a company, or if you had loaned money to a company, what would be your primary financial interest in the company? You probably would be interested in two things, both of which make up the company's **cash flow prospects**. You would be interested in the return to you at some future date of the amount you had invested or loaned. We refer to this as the **return of investment**. In addition, you would expect the company to pay you something for the use of your funds, either as an owner or a creditor. We refer to this as the **return on investment**. Information that is useful to you in making judgments about the company's ability to provide you with what you expect in terms of the return of your funds as well as a return on your funds while you do not have use of them is what we mean by information about *cash flow prospects*.

Assume that you have a friend who wants to start a business and needs some help getting the money required to rent space and acquire the needed assets to operate the business (for example, delivery truck, display fixtures) and pay employees for their work before the doors open and customers begin paying for the products the company plans to sell. You are in a financially strong position and agree to loan your friend \$100,000. Your intent is not to be a long-term investor or co-owner of the business, but rather to help your friend start his company and at the same time earn a return on the funds you have loaned him. Assume further that you agree to let your friend have the use of your \$100,000 for one year and, if you had not loaned this amount to him, you could have earned an 8 percent return by placing your money in another investment.



YOUR TURN

You as a Creditor

You are a loan officer at a bank that makes small loans to individuals to help finance purchases such as automobiles and appliances. You are considering an application from a young woman who needs to purchase a new car. She is requesting a loan of \$10,000 which, when combined with the trade-in value of her old car, will allow her to meet her needs. What are your expectations with regard to repayment of the loan, and what information would help you decide whether she is a good credit risk for your bank?

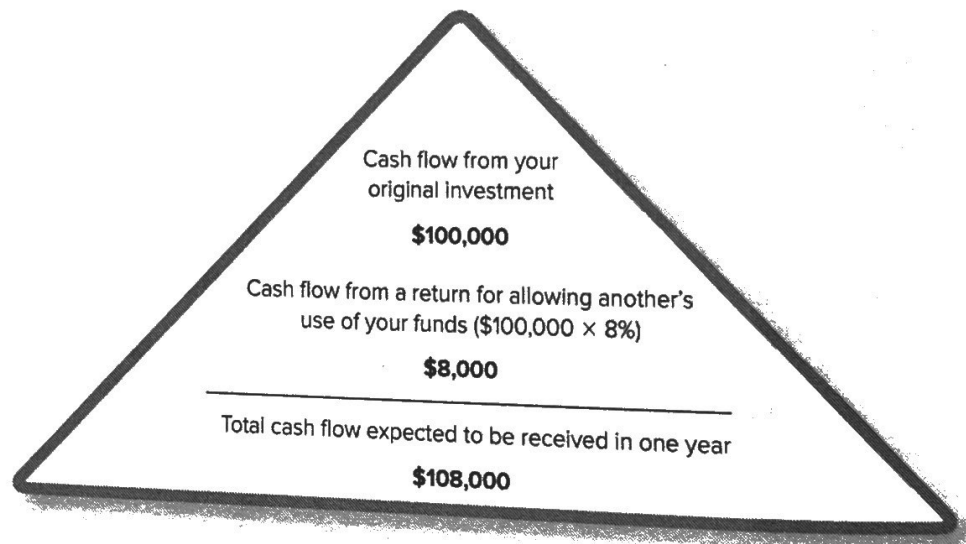
(See our comments in Connect.)

In addition to wanting to help a friend, you are interested in knowing how much risk you are taking with regard to your \$100,000. You expect your friend to pay that \$100,000 back, and to also pay you an additional amount of \$8,000 ($\$100,000 \times 8\%$) for his use of your money. The total return of your investment (\$100,000) back to you one year later, added to the amount you expect to receive for his having used your money for a year (\$8,000), is shown in Exhibit 1-3.

Providing information for you to assess your friend's ability to meet his cash flow commitment to you is essentially what financial reporting is about. You need information to assess the risk you are taking and the prospects that your friend will be able to deliver \$108,000 to you one year from the time you loan him the \$100,000. While this is a relatively simple example, it sets the stage for your understanding of the kinds of information that will help you make this important investment decision.

The accounting profession has identified certain objectives of external financial reporting to guide its efforts to refine and improve the reporting of information to external decision

EXHIBIT 1-3
Investment Analysis



makers. These general objectives are displayed in Exhibit 1-4 and are best understood if studied from the bottom up—from general to specific.³

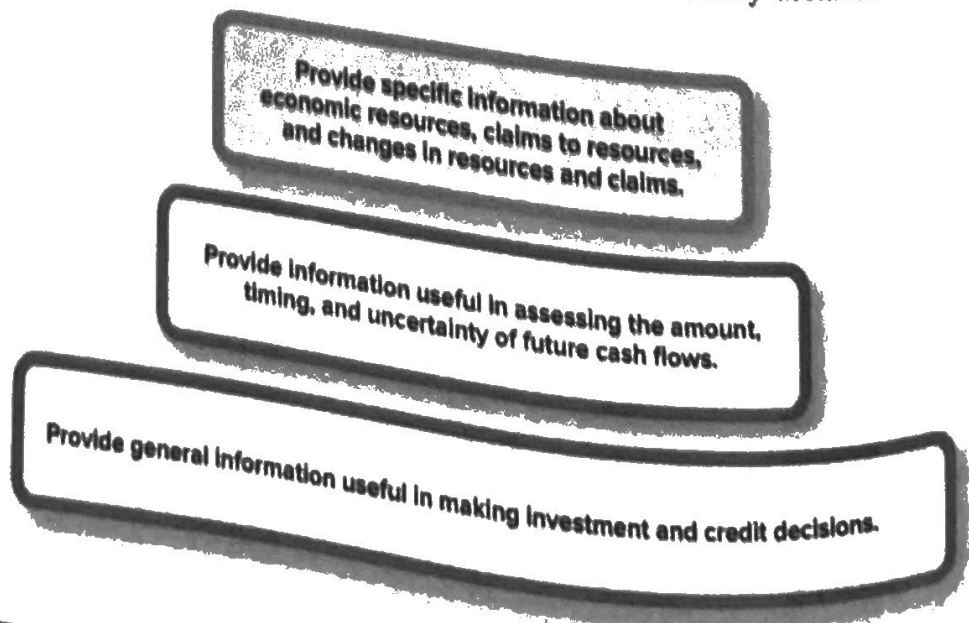
The first objective is the most general and is to provide information that is useful in making investment and credit decisions. As we indicated earlier, investors and creditors are the primary focus of external financial reporting. We believe that, by meeting the information needs of investors and creditors, we provide general information that is also useful to many other important financial statement users.

The second objective, which is more specific than the first, is to provide information that is useful in assessing the amount, timing, and uncertainty of future cash flows. As we discussed earlier, investors and creditors are interested in future cash flows to them, so an important objective of financial reporting is to provide general information that permits that kind of analysis.

The most specific objective of external financial reporting is to provide information about the enterprise's resources, claims to those resources, and how both the resources and claims to resources change over time. An enterprise's resources are often referred to as *assets*, and the primary claims to those resources are the claims of creditors and owners, known as liabilities and owners' equity.

One of the primary ways investors and creditors assess whether an enterprise will be able to make future cash payments is to examine and analyze the enterprise's financial statements. In the general sense of the word, a statement is simply a declaration of something believed to be true. A **financial statement**, therefore, is simply a monetary declaration of what is

EXHIBIT 1-4
Objectives of Financial Reporting: Building from the General to the Specific



³ FASB *Statement of Financial Accounting Concepts No. 1*, "Objectives of Financial Reporting by Business Enterprises" (Norwalk, Conn.: 1978), p. 4.

believed to be true about an enterprise. When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

Financial statements prepared for periods of time shorter than one year (for example, for three months or one month) are referred to as *interim financial statements*. Throughout this text, we use both annual and interim financial statements. As you approach a company's financial statements—either as a user or as a preparer—it is important to establish the time period those statements are intended to cover.

The primary financial statements are the following:

- *Statement of financial position (balance sheet)*. The **balance sheet** is a position statement that shows where the company stands in financial terms at a specific date.
- *Income statement*. The **income statement** is an activity statement that shows details and results of the company's profit-related activities for a period of time (for example, a month, quarter [three months], or year).
- *Statement of cash flows*. The **statement of cash flows** is an activity statement that shows the details of the company's activities involving cash during a period of time.

The names of the three primary financial statements are descriptive of the information you find in each. The **statement of financial position**, or balance sheet, for example, is sometimes described as a snapshot of the business in financial or dollar terms (that is, what the enterprise looks like at a specific date). An income statement is an activity statement that depicts the profitability of an enterprise for a designated period of time. The statement of cash flows is particularly important in understanding an enterprise for purposes of investment and credit decisions. As its name implies, the statement of cash flows depicts the ways cash has changed during a designated period. While the interest of investors and creditors is in cash flows to themselves rather than to the enterprise, information about cash activity of the enterprise is considered to be an important signal to investors and creditors.

At this early stage in your study of accounting, you are not expected to understand these financial statements or how they precisely help you assess the cash flow prospects of a company. The statement of financial position (balance sheet), income statement, and statement of cash flows are introduced more fully to you in the next chapter. Thereafter, you will learn a great deal about how these statements are prepared and how the information contained in them can be used to help you understand the underlying business activities they represent.

CHARACTERISTICS OF EXTERNALLY REPORTED INFORMATION

Financial information that is reported to investors, creditors, and others external to the reporting enterprise has certain qualities that must be understood for the information to have maximum usefulness. Some of these qualities are discussed in the following paragraphs.

Financial Reporting—A Means As we learned in the introduction to this chapter, financial information is a means to an end, not an end in and of itself. The ultimate outcome of providing financial information is to improve the quality of decision making by external parties, and, in so doing, helping to create a prosperous society. Financial statements themselves are simply a means by which that end is achieved.

Financial Reporting versus Financial Statements Financial reporting is broader than financial statements. Stated another way, financial statements are a subset of the total information encompassed by financial reporting. Investors, creditors, and other external users of financial information learn about an enterprise in a variety of ways in addition to its formal financial statements (for example, press releases sent directly to investors and creditors, articles in *The Wall Street Journal*, and more recently, open communications via the Internet). Serious investors, creditors, and other external users take advantage of many sources of information that are available to support their economic decisions about an enterprise.

Historical in Nature Externally reported financial information is generally historical in nature. It looks back in time and reports the results of events and transactions that already have occurred. While historical information is very useful in assessing the future, the information itself is more about the past than it is about the future. However, in recent years, accounting standard setters are requiring greater use of fair values, rather than historical costs, in measuring assets and liabilities.

Inexact and Approximate Measures Externally reported financial information may have a look of great precision, but in fact much of it is based on estimates, judgments, and assumptions that must be made about both the past and the future. For example, assume a company purchases a piece of equipment for use in its business. To account for that asset and to incorporate the impact of it into the company's externally reported financial information, some assumptions must be made about how long it will be used by the company—how many years it will be used, how many machine-hours it will provide, and so on. The fact that a great deal of judgment underlies most accounting information is a limitation that is sometimes misunderstood.

General-Purpose Assumption As we have already mentioned, we assume that, by providing information that meets the needs of investors and creditors, we also meet the information needs of other external parties. We might be able to provide superior information if we were to treat each potential group of external users separately and prepare different information for each group. This approach is impractical, however, and we instead opt for preparing what is referred to as **general-purpose information** that we believe is useful to multiple user groups (that is, "one size fits all").

Usefulness Enhanced via Explanation The accounting profession believes that the value of externally reported financial information is enhanced by including explanations from management. This information is often nonquantitative and helps to interpret the financial numbers that are presented. For this reason, financial information, including financial statements, is accompanied by a number of notes and other explanations that help explain and interpret the numerical information.

Management Accounting Information

Internal decision makers employed by the enterprise, often referred to as management, create and use internal accounting information not only for exclusive use inside the organization but also to share with external decision makers. For example, in order to meet a production schedule, a producer may design an accounting information system for suppliers detailing its production plans. The producer shares this information with its supplier companies so that they can help the producer meet its objectives. Thus, although the creator and distributor of the accounting information is an internal decision maker, the recipient of the information is, in this case, an external decision maker. Other types of accounting information, however, are not made available to external decision makers. Long-range plans, research and development results, capital budget details, and competitive strategies typically are closely guarded corporate secrets.

USERS OF INTERNAL ACCOUNTING INFORMATION

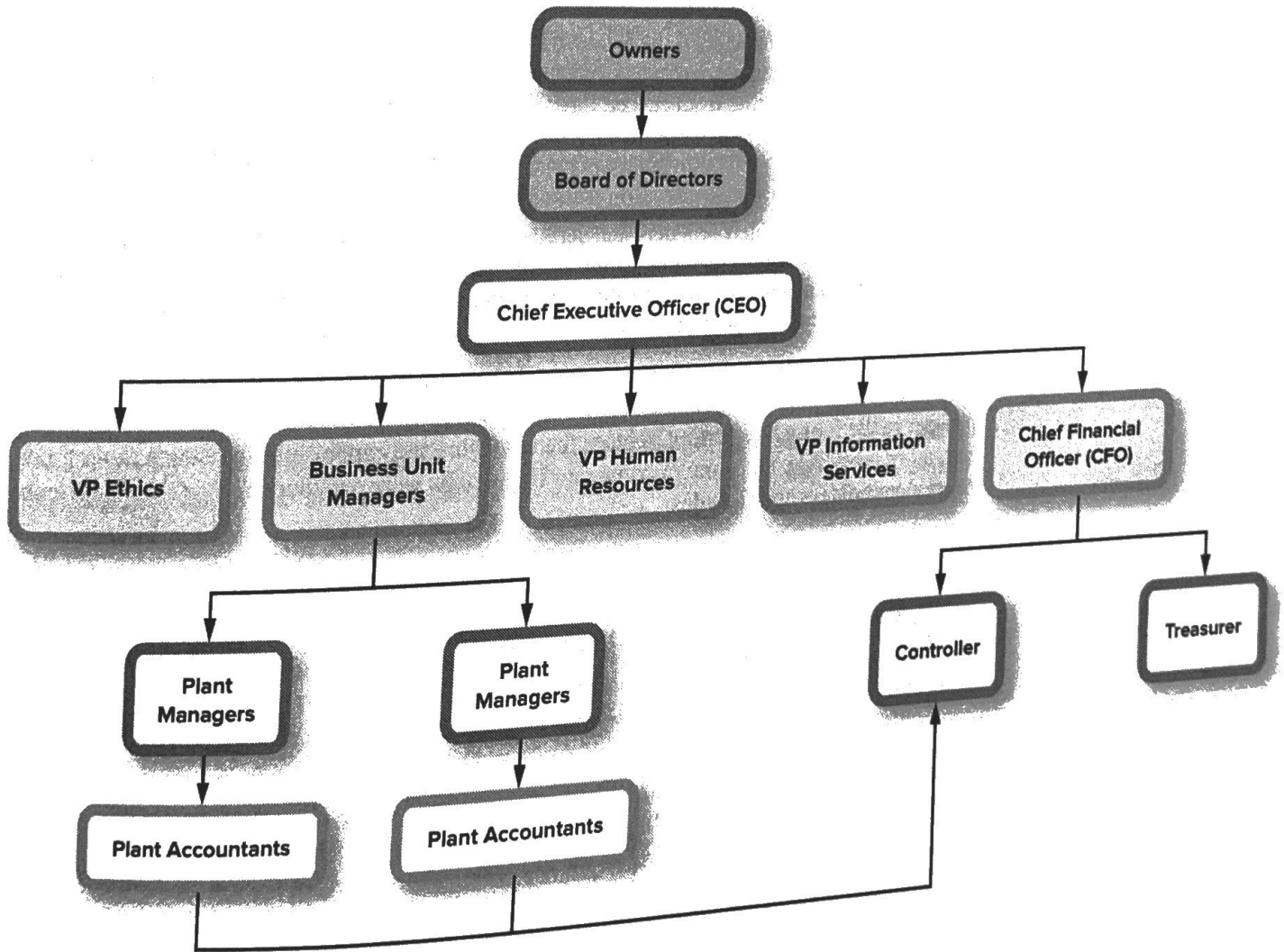
Every employee of the enterprise uses internal accounting information. From basic labor categories to the chief executive officer (CEO), all employees are paid, and their paychecks are generated by the accounting information system. However, the amount of use and, in particular, the involvement in the design of accounting information systems vary considerably. Examples of **internal users** of accounting information systems are as follows:

- Board of directors
- Chief executive officer (CEO)
- Chief financial officer (CFO)
- Vice presidents (information services, human resources, ethics, and so forth)
- Business unit managers
- Plant managers
- Store managers
- Line supervisors

LO1-4

LEARNING OBJECTIVE
Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.

EXHIBIT 1-5 Typical Simple Organization Chart



Employees have different goals and objectives that are designed to help the enterprise achieve its overall strategies and mission. Looking at the typical, simple organization chart in Exhibit 1-5, you can see that the information created and used by various employees will differ widely. All enterprises follow rules about the design of their accounting information systems to ensure the integrity of accounting information and to protect the enterprise's assets. There are no rules, however, about the type of internal reports or the kind of accounting information that can be generated. A snapshot look inside a firm will demonstrate the diversity of accounting information generated and used in the decision-making processes of employees.

Many enterprises use a database warehousing approach for the creation of accounting information systems. This approach, coupled with user-friendly software, allows management and other designated employees access to information to create a variety of accounting reports, including required external financial reports. For example, detailed cost information about a production process is used by the production line supervisor to help control production costs. A process design engineer, when considering the best configuration of equipment and employees, uses the same information to reduce costs or to increase efficiency. Finally, production-related cost information appears in the external financial statements used by investors and creditors.

OBJECTIVES OF MANAGEMENT ACCOUNTING INFORMATION

Each enterprise has implicit and explicit goals and objectives. Many enterprises have a mission statement that describes their goals. These goals can vary widely among enterprises ranging from nonprofit organizations, where goals are aimed at serving specified constituents, to

for-profit organizations, where goals are directed toward maximizing the owners' objectives. For example, the American Cancer Society, a nonprofit organization, has the following mission:

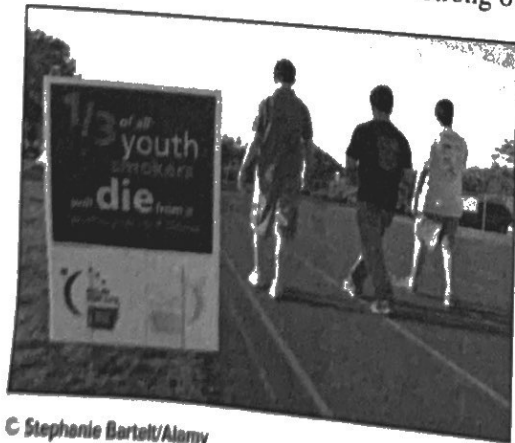
The American Cancer Society is the nationwide, community-based, voluntary health organization dedicated to eliminating cancer as a major health problem by preventing cancer, saving lives, and diminishing suffering from cancer, through research, education, advocacy, and service.⁴

Procter & Gamble (P&G), a for-profit, global producer of consumer products, has the following purpose:

We will provide branded products and services of superior quality and value that improve the lives of the world's consumers, now and for generations to come. As a result, consumers will reward us with leadership sales, profit, and value creation, allowing our people, our shareholders, and the communities in which we live and work to prosper.⁵

Procter & Gamble's annual report to shareholders provides more detail on how the company will achieve its mission. Procter & Gamble's is approximately 180 years old, and to prosper in the future it is putting in place the strategies and capabilities to being a faster growing, more profitable, and simpler company. These steps were explained in P&G's annual letter to its shareholders and includes:

- A more focused business portfolio.
- A commitment to growth and value creation.
- Being more innovative and more productive.
- Better execution and balance.
- Strong ownership and leadership.⁶



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The constituents of these organizations receive external financial information that helps them assess the progress being made in achieving these goals and objectives. In the case of Procter & Gamble, quarterly and annual information is provided to shareholders. The American Cancer Society is required to report its activities and financial condition to regulators. Providing constituents evaluative information is only one objective of accounting systems.

Enterprises design and use their internal accounting information systems to help them achieve their stated goals and missions. Multiple reports, some as part of the normal reporting process and some that are specially constructed and designed, are produced and distributed regularly. To motivate managers to achieve organizational goals, the internal accounting system is also used to evaluate and reward decision-making performance. When the accounting system compares the plan or budget to the actual outcomes for a period, it creates a signal about the performance of the employee responsible for that part of the budget. In many enterprises management creates a reward system linked to performance as measured by the accounting system.

Thus the objectives of accounting systems begin at the most general level with the objectives and mission of the enterprise. These general organizational goals create a need for information. The enterprise gathers historical and future information from both inside the enterprise and external sources. This information is used by the decision makers who have authority over the firm's resources and who will be evaluated and rewarded based on their decision outcomes.

CHARACTERISTICS OF MANAGEMENT ACCOUNTING INFORMATION

The accounting information created and used by management is intended primarily for planning and control decisions. Because the goal of creating and using management accounting information differs from the reasons for producing externally reported financial information, its characteristics are different.

⁴ www.cancer.org/aboutus/whowecare/acmissionstatements.

⁵ <http://us.pg.com/who-we-are/our-approach/purpose-values-principles>.

⁶ Procter & Gamble, 2014 Annual Report, Letter to Shareholders.

Both the processes used to create financial accounting reports and the structure of those reports significantly impact management strategy. For example, because external financial reporting standards require companies to include pension-related obligations on their financial statements, management monitors those obligations closely. These pension-related obligations impact labor negotiations and labor-related corporate strategies.

Another example is that the processes necessary to create required external financial reports have historically determined the type of accounting information available inside of companies for internal decision making. Most plants within companies are organized as profit centers where plant-related financial statements mirror those necessary for external reporting purposes.

As you read the chapters of this book, we will remind you about how financial reporting has an impact on and is impacted by management strategies. The following paragraphs identify internal accounting information characteristics.

Importance of Timeliness In order to plan for and control ongoing business processes, accounting information needs to be timely. The competitive environment faced by many enterprises demands immediate access to information. Enterprises are responding to this demand by creating computerized databases that link to external forecasts of industry associations, to their suppliers and buyers, and to their constituents. Time lines for the development and launch of new products and services are becoming shorter and shorter, making quick access to information a priority.

In addition to needing timely information for planning purposes, enterprises are constantly monitoring and controlling ongoing activities. If a process or activity goes out of control, the enterprise can incur significant costs. For example, recalls of products can be very expensive for a company. If the company can monitor processes and prevent low-quality or defective products from reaching its customers, it can experience significant savings.

Identity of Decision Maker Information that is produced to monitor and control processes needs to be provided to those who have decision-making authority to correct problems. Reporting scrap and rework information to line workers without providing them the responsibility for fixing the process is counterproductive. However, a self-directed work team that has been assigned decision-making responsibility over equipment and work-related activities can have a significant impact on rework and scrap if team members control the process causing the problems.

Oriented toward the Future Although some accounting information, like financial accounting information, is historical in nature, the purpose in creating and generating it is to affect the future. The objective is to motivate management to make future decisions that are in the best interest of the enterprise, consistent with its goals, objectives, and mission.

Measures of Efficiency and Effectiveness Accounting information measures the efficiency and effectiveness of resource usage. By comparing the enterprise's resource inputs and outputs with measures of competitors' effectiveness and efficiency, an assessment can be made of how effective management is in achieving the organization's mission. The accounting system uses money as a common unit to achieve these types of comparisons.

Management Accounting Information—A Means As with financial accounting information, management accounting information is a means to an end, not an end in and of itself. The ultimate objective is to design and use an accounting system that helps management achieve the goals and objectives of the enterprise.

Integrity of Accounting Information

What enables investors and creditors to rely on financial accounting information without fear that the management of the reporting enterprise has altered the information to make the company's performance look better than it actually was? How can management be sure that internally generated information is free from bias that might favor one outcome over another? The