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FINANCIAL ACCOUNTING

A Decision-Making Approach



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P R E F A C E

A NEED FOR CHANGE

The focus of the introductory accounting course has remained virtually unchanged for the past four decades. Although many texts now include information from real annual reports so accounting has more meaning for students, most introductory financial texts continue to place heavy emphasis on the mechanics of the accounting cycle. However, nonbusiness students and those who major in areas of business other than accounting rarely use the procedural aspects of accounting taught in many introductory courses, and they quickly forget them. These students ultimately need to be able to use accounting information, but generally will not require the detailed knowledge needed by accountants. Unless students can understand and use accounting information in their decisions, they have received little of value from their accounting courses. Just as important, those who become accounting majors must understand how accounting information ties into decision making.

Representatives of the business and academic community have called for change in the manner in which introductory accounting is taught. The Bedford Committee (American Accounting Association, 1986), the major public accounting firms (1989), and the Accounting Education Change Commission (1992) all have made recommendations for change in accounting education. In its discussion of the introductory course in accounting, the Accounting Education Change Commission stresses the importance of accounting information as a powerful tool in the decision-making process. Those calling for change want decisions and accounting information to be linked so that readers learn to think and analyze rather than to memorize professional standards. Substantive accounting curricular change cannot occur without refocusing and reshaping the content and form of presentation at the introductory level. A change in focus is needed to attract students with integrative skills into the accounting program and to give those who major in other disciplines greater ability to use accounting information in their work and personal lives.

This text was developed to respond to the need for change in accounting education. It focuses on the link between accounting information and decision making, and it emphasizes the strengths and weaknesses of reported accounting information for making different types of business decisions. This first edition follows publication of a preliminary edition that was prepared to satisfy the requests of numerous reviewers

to use the text before the publication of the first edition. By making available a preliminary edition, we were able to build a support network of adopters who have used the text and can share ideas and resources with others attempting their own curricular reform.

OUR APPROACH

This text is intended to provide an evolutionary, rather than a revolutionary, alternative to standard texts. We introduce accounting as a source of information for business decisions. The text encourages active learning by continually focusing on the accounting information and how it can affect decisions. When accounting is taught solely as a means of developing the data needed for financial reporting, we have found that students tend to concentrate too much on its procedural aspects. By including a variety of applications in the text, homework assignments, and class discussion, we have found greater student interest, understanding, and retention.

A DECISION-MAKING APPROACH

From the organization and content of this text, you can see that we have maintained the traditional focus on understanding the elements of the financial statements, but without the traditional concentration on the mechanics of the accounting process. Instead of focusing on the recording of journal entries, we have adopted a decision-making approach that views accounting information within the framework of the decisions made in today's environment. Accounting entries are used in selected situations to illustrate how information is generated, but the emphasis is on understanding the meaning of accounting information so it can be used in making decisions. This decision-making emphasis will benefit students in their other course work in accounting and business and in the workplace after graduation because it provides an improved basis for understanding, interpreting, and using accounting information.

Because most students have not had other coursework in business prior to their first accounting course, this text first provides an introduction to the way in which accounting information is used in business decision making. This is done through a simplified decision model introduced in the first chapter and carried through subsequent chapters. The model requires explicit consideration of (1) the goals to be achieved, (2) the type of information needed to make an informed choice, (3) the identification and evaluation of alternative courses of action, and (4) the selection of a particular course of action. Application of this model is identified throughout the text by a symbol in the margin.

Each of the chapters dealing with the financial statement elements also contains a list of decision questions relevant to investors, creditors, and other decision makers so that students can gain an understanding of the ways in which the subject matter discussed in the chapter can be used in making decisions. The chapters themselves contain a variety of examples from corporate financial statements and the financial press relating to all types of organizations, ranging from global corporations to small businesses, government, and not-for-profit organizations. Hypothetical examples also are used to illustrate basic concepts and primary components of more complex issues.

This decision-making approach has been coupled with the continuation of topical materials traditionally included in an introductory accounting course and with selected

APPLYING THE DECISION MODEL



coverage of the basic recording process. Totally removing all references to procedures and abandoning the journal entry process does not in itself mean progress. We believe students need to understand the types of information captured and how that information is recorded and reported so they can be intelligent users of that information. Thus, we use accounting entries in selected portions of the text to illustrate how financial statement information is generated. For the most part, accounting entries are used in illustrations for additional clarity, and the discussion in the text can stand without the entries for those wishing to bypass them.

AN ACTIVE LEARNING ENVIRONMENT

We believe that students learn well in situations structured so that they are required to go beyond the mechanics of the accounting process. As one means of accomplishing this, we emphasize understanding the need for the financial reporting process, the analysis and management of cash flows, and the development and analysis of the income statement and statement of financial position before presenting any discussion of accounting procedures. We also incorporate “You Decide” situations in each chapter as a means of encouraging students to think beyond the specifics of the materials presented in the chapter and to provide a basis for class discussion of major issues in the chapter.

The end-of-chapter materials are designed to support and reinforce both the decision-making focus of the chapter and the active learning environment. In addition to reinforcing the concepts and procedures presented in the chapter, students are asked to evaluate and use the information in a variety of contexts. For maximum flexibility, the end-of-chapter materials are of considerable breadth and diversity.

ORGANIZATION

The organization of the text provides flexibility in the choice of materials to be covered in a one-semester course. The book is organized as follows:

Basic framework and concepts	Chapters 1–3
Cash flows, income reporting, and financial position	Chapters 4–6
The accounting process	Chapter 7
Financial statement elements	Chapter 8–13
Further consideration of selected topics	Chapters 14–16

We anticipate that most instructors will include Chapters 1–13 in a one-semester course. We discuss and illustrate the analysis and management of cash flows and the use of time value of money concepts early in the text, in Chapter 4. These concepts are discussed in the context of both business and personal decisions. Chapter 7 provides coverage of the accounting process and is a relatively self-contained unit. Chapters 1–13 provide the basics of the accrual accounting model. Chapters 14 and 15 provide coverage of selected topics in somewhat greater depth and are recommended for inclusion as time permits. Chapter 14 provides additional discussion of income reporting issues, including long-term contracts, inventory valuation, discontinued operations,

extraordinary items, and earnings per share. Chapter 15 considers the role of the Securities and Exchange Commission in financial reporting, concepts of aggregated and disaggregated reporting, and ties together a number of aspects of financial statement analysis discussed earlier. Personal financial reporting is discussed in an appendix. The topics in these two chapters are in self-contained sections; thus, instructors can easily choose from among the topics. Chapter 16 provides an overview of the reporting issues related to international companies and can be covered without including Chapters 14 and 15.

KEY FEATURES

Students often wonder—indeed, they may ask outright—why they are studying particular material. They often do not see the relevance of coursework to their chosen careers. Use of the decision-making context consistently addresses this question. Throughout the text, we tie accounting information to specific decision questions. The major features of this text, described below, show how we have implemented this approach in each of the chapters.

- **Decision Model Framework:** A simple, yet direct, decision model framework is introduced in Chapter 1 and carried throughout the remainder of the book. At the beginning of chapters, the decision framework is linked to the topics covered through a series of decision questions.
- **Where This Chapter Fits:** At the beginning of each chapter, the reader is given an explanation of where the materials in the chapter fall in the study of accounting and in the overall decision-making framework.
- **Personal View and Business View:** The Personal View provides a somewhat whimsical link between one or more of the concepts presented in the chapter and how the materials might be useful to students in their personal lives. Often they parallel a decision made in the Business View, which shows the relevance of some portion of the materials contained in the chapter to a decision made by the business entity.
- **You Decide:** These active-learning scenarios challenge students to think about accounting in a different way and form their own conclusions. They present students with a variety of situations that either help students apply the concepts discussed or go beyond the explicit discussion to help students expand their thinking. Most of these thinking exercises do not have a single correct answer, but rather challenge students to be creative in addressing issues or decisions.
- **A Closer Look At:** Many hypothetical examples are spread throughout the text to clarify the discussion and illustrate specific points in greater detail. The use of hypothetical examples permits students to focus on the specific point being discussed without the complications of other factors.
- **In Practice:** Many real-world examples are used to illustrate specific points and emphasize different aspects of the accounting and reporting process. These examples provide evidence of how accounting information is used in the real world and give students practice dealing with accounting presentations that often differ from what one sees in idealized hypothetical presentations. Each example includes

an *Analysis* section that helps students understand what lies beneath reported numbers and ties the example to the concepts discussed in the chapter.

- **Our Video Store:** This hypothetical example is developed in Chapter 1 and used throughout the early chapters to illustrate basic accounting principles and provide students with an intuitive understanding of the need for accounting information. Discussions related to this example are marked with a logo in the margin.
- **Artwork:** Photographs are used to add a real-world flavor to the examples provided, and diagrams are used to illustrate selected concepts so that students who are visual learners can gain a better understanding of those concepts.
- **Real Financial Statements:** The financial statements of Motorola, Inc., are included in an appendix to the text and portions of the financial statements are incorporated in the chapter coverage. A number of in-chapter and end-of-chapter assignments require use of these statements as well. In addition, the financial statements for the City of St. Louis are included and discussed in a more limited context.
- **Appendices:** In addition to the financial statements of Motorola, Inc., and the City of St. Louis, a third appendix provides present value and future value tables. Brief appendices are used at the end of (a) Chapter 4 to cover the preparation of bank reconciliations and to illustrate the impact of taxes on the estimation of cash flows and (b) Chapter 15 to illustrate further the analysis of financial statements through the presentation of comparative data on three companies and to illustrate the nature of personal financial statements. End-of-chapter materials relating to the appendices in Chapters 4 and 15 are marked with “A.”
- **Ethics:** Cases in the chapter assignments provide an opportunity to look at the ethical considerations of decisions in a variety of situations.
- **End-of-Chapter Assignments:** Four separate segments are provided to assist instructors in selecting assignments and determining the focus of the materials covered:
 - a. *Examining the Concepts* is used to review basic definitions, terminology, and concepts and gain an understanding of why and how they are used.
 - b. *Understanding Accounting Information* provides exercises aimed at helping students clearly understand the nature of the accounting information covered in the chapter before they proceed to use the information for decision making.
 - c. *Using Accounting for Decision Making* provides an opportunity to deal with more complex issues and to apply accounting information to decision making.
 - d. *Expanding Your Horizons* provides a variety of case materials, special team projects, and library or computer assignments. Research cases are noted in the margins. All cases are intended to build further understanding of the ways in which financial information is presented by different companies or organizations, and the ways in which this information can be used by individuals, creditors, investors, and others in making decisions.



SUPPLEMENTS

We have worked with contributors to develop a complete set of supplemental materials to assist students and instructors. Following is a description of each of the supplements in this package.

Student study guide. We have developed a comprehensive student study guide that is closely coordinated with the text materials. Each chapter begins with a summary of key concepts and topics. A series of fill-in-the blank, true-false, and multiple choice questions, along with short exercises, help students gain a better understanding of key concepts. These are followed by one or more comprehensive problems that students can use for review.

Instructor's resource guide. Developed by Anita Feller of the University of Illinois and the authors, this guide provides a variety of support mechanisms for the instructor. One important help is in providing a consistent and thorough discussion of points to be considered for each "You Decide" presented in the text. In addition, outlines for the organization of lectures and the presentation of chapter materials are provided. More importantly, suggestions are provided throughout for ways to use the text and to present class materials more effectively. Additional examples for use in class are provided, along with aids to assist in the discussion and evaluation of assignments.

PowerPoint Slide Presentation. A special electronic presentation package has been prepared to facilitate classroom instruction. The package includes both outline materials from the chapters and specific examples of accounting and reporting procedures. Instructors with a full version of PowerPoint can modify the presentations to match their own particular teaching styles.

Solutions Manual. A comprehensive solutions manual prepared by the authors provides solutions to all end-of-chapter assignments. In many cases, the solutions manual goes well beyond the minimum answer needed to respond adequately to the item assigned. Answers include computations and detailed explanations that can assist students in gaining mastery of the materials if the manual is placed in the library or otherwise made available to students. Instructors can prepare transparencies directly from the solutions manual or may choose from the transparency package.

Transparencies. A package of solutions for selected exercises, problems, and cases is available to adopters.

Test bank. A comprehensive set of test items consisting of both conceptual and applied questions has been prepared on a chapter-by-chapter basis and is available in either a hard copy or computerized format. True-false, multiple choice, and fill-in-the blanks questions are provided, along with a series of short problems and cases. Where appropriate, one or more comprehensive problems have been provided.



Nightly Business Report Video. This video contains segments from the highly respected Nightly Business Report that have been selected for their applicability to financial accounting and for their reinforcement of key concepts in the text. Each of the segments is approximately 3–5 minutes long and can be used to introduce topics to the students, enhance lecture material, and provide real-world context for related concepts.

Web site. Recognizing that the World Wide Web is a viable resource for students and instructors, we have developed a web site at www.wiley.com/college.html to provide a variety of additional resources. Because Motorola's financial statements are used extensively in the text, instructors and students may also wish to contact Motorola's web site at <http://www.mot.com> for updates and more information.

PRETESTING AND ACCURACY

The text materials have been thoroughly reviewed, and successive versions have been extensively class tested. Both the text and the solutions manual have been painstakingly checked and rechecked to eliminate any possible errors and areas of confusion. Every effort has been made to provide a text that meets the needs of changing approaches to accounting education, yet is accurate in its details and user-friendly in its presentation.

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Thomas E. King
Valdean C. Lembke
John H. Smith



CHAPTER

1

DECISION MAKING AND INFORMATION

WHERE THIS CHAPTER FITS

Chapter 1 introduces the process of decision making and how information is used for decision making. It explores decision making in the context of a market economy, and it introduces accounting by linking accounting information to the financial decisions that are made in a market economy. Chapters 2 and 3 continue with a discussion of how information is communicated in financial statements, and they explore the basic concepts of accounting. Subsequent chapters address the different areas of financial reporting in relation to specific information needs of decision makers.

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