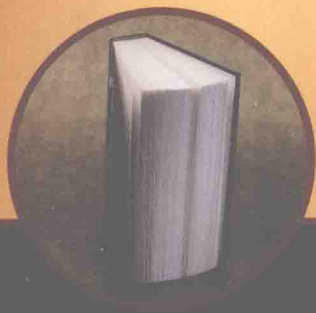


**Financial and  
Managerial Accounting**  
*A Bridge to Decision Making*

Robert W. Ingram  
Bruce A. Baldwin  
Thomas L. Albright  
John W. Hill



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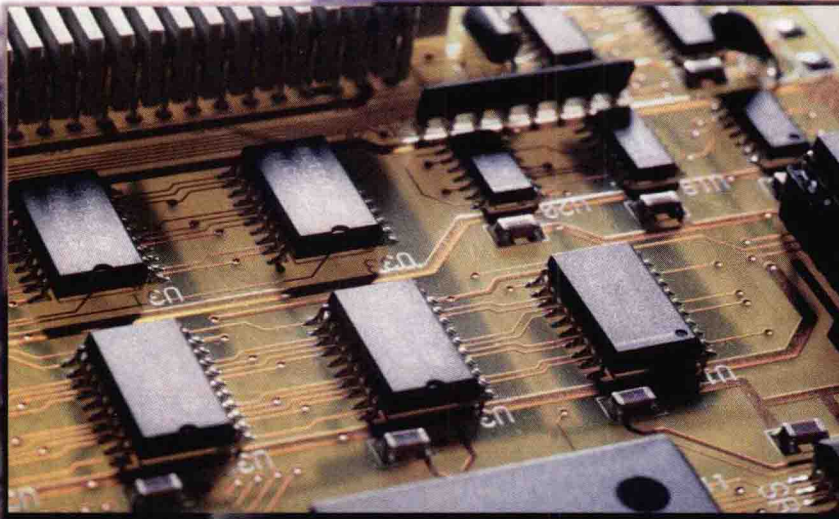
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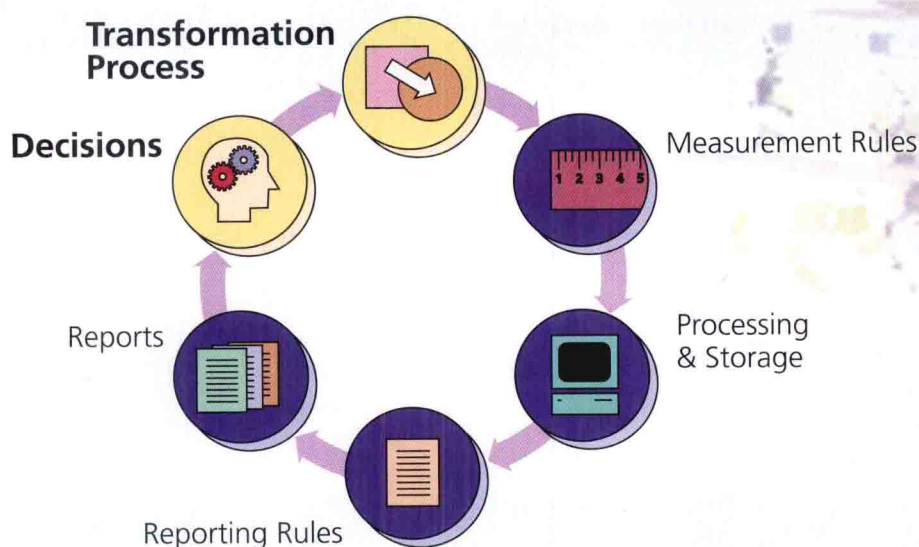
# Section 1

The Accounting Information System



# Accounting and Organizations

# 1



## Overview

This book introduces basic concepts of accounting. It will help you understand why accounting information is important, how accounting information is produced, and how you can use this information in making decisions about organizations. Accounting describes economic events that occur in organizations. Therefore, to understand accounting, you need to understand organizations. This chapter will introduce the purposes of organizations, how they achieve their purposes, the types of decisions made in organizations, and the role of accounting information in making these decisions. **Once you have completed this chapter, you should understand that accounting is a system that produces information for making decisions about organizations.**

*Major topics covered in this chapter include:*

- An illustration of the accounting process
- The purposes and functions of organizations
- Decisions made in organizations
- The role of accounting in making decisions about organizations



## Objectives

Once you have completed this chapter, you should be able to:

1. Identify the purpose of accounting.
2. Explain why accounting is an information system.
3. Compare major types of organizations and explain their purpose.
4. Explain why owners invest in businesses.
5. Explain why accounting information is useful to investors.
6. Identify financing activities and the types of decisions they require.
7. Identify investing activities and the types of decisions they require.
8. Identify operating activities and the types of decisions they require.
9. Describe the steps in an organization's transformation process.
10. Define accounting.



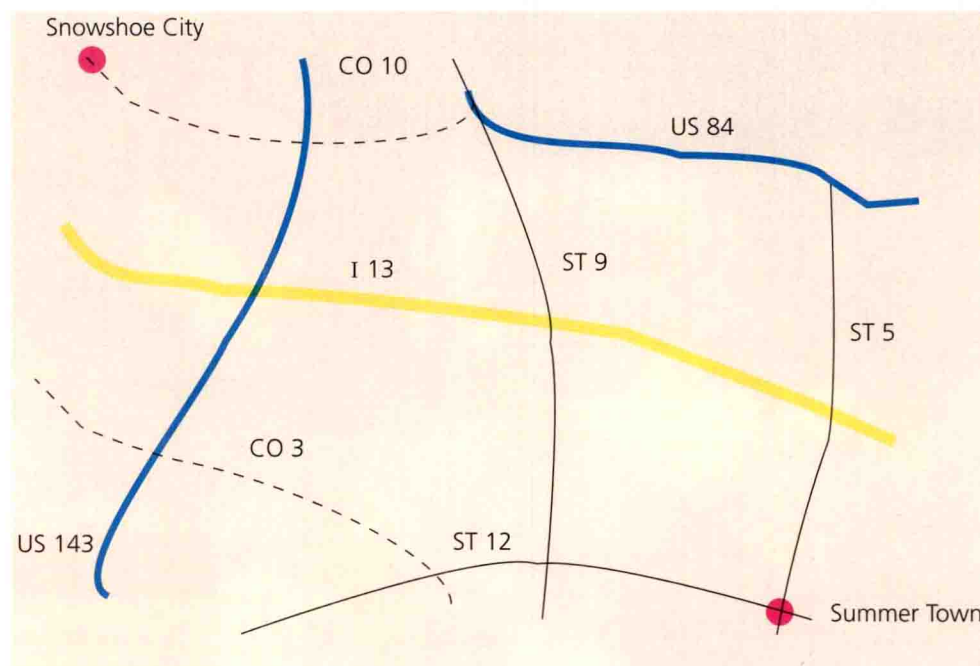
## INFORMATION FOR DECISIONS



All of us make decisions, and we use information to help us make our decisions. **Information includes facts, ideas, and concepts that help us understand the world.** The proper use of good information usually results in better decisions. To use information, we must be able to interpret it and understand its limitations. Poor information or the improper use of information often leads to poor decisions.

As an example, assume that you wish to drive from Summer Town to Snowshoe City. The drive will take several hours and require several turns on unfamiliar secondary roads. Therefore, you use a map to provide information to help guide you along the way (Exhibit 1).

**Exhibit 1** Map from Summer Town to Snowshoe City



Why is the map useful? The map can help you plan your trip. You have selected a primary goal: Arrive at Snowshoe City. You may have other goals as well, such as getting there as quickly as possible. Or, perhaps you wish to stop at various points along the way. The map provides information about alternative routes so that you can select the one that is shortest, fastest, or most scenic. Using the map along the way helps you make decisions about where to turn or stop. It helps you determine how far you have traveled and how far you have left to go. It helps you decide whether you are on the right road or where you made a wrong turn. It helps you decide where you are, how you got there, and where you are going.

Accounting provides information to help in making decisions about organizations. This information is like an organizational map. **Accounting information helps decision makers determine where they are, where they have been, and where they are going.** Rather than measuring distances in miles or kilometers, accounting measures an organization's activities by the dollar amounts associated with these activities. Thus, the primary measurement unit for accounting information is dollars in the United States or the local currency for other countries.

To illustrate, suppose you decide, as a summer job, to start a business at the beach selling sunglasses, hats, and suntan products. You will operate out of a small stand, appropriately named The Beach Shack, which you can rent from a nearby hotel that

owns the beach property. Important questions you might ask include: Is this a good business opportunity? How much money should you expect to make? Are you making as much money as you expected?

Consider the primary components of your business. What will you need to start and run a business? You will need merchandise to sell. Therefore, you will have to purchase this merchandise from suppliers. You will need a place to operate your business and someone to sell the merchandise. You will need money to pay for your merchandise, the rent for your stand, wages, and any miscellaneous costs such as a business license and advertising.

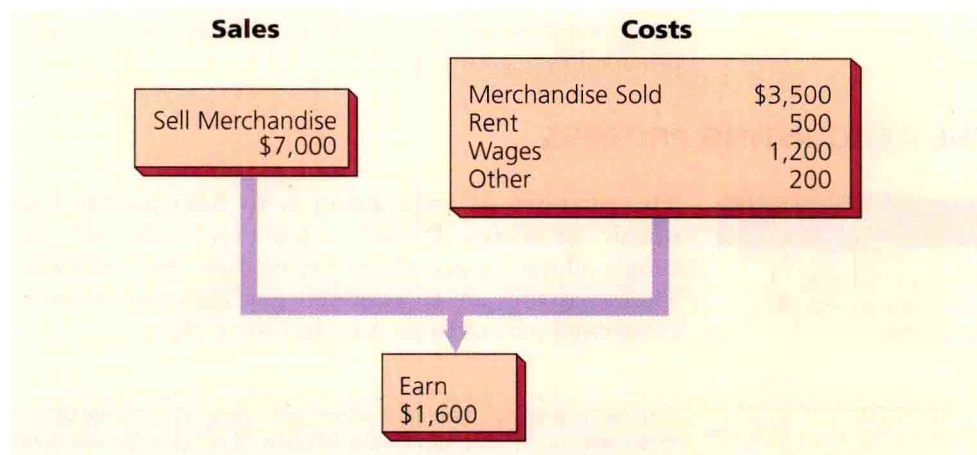
As an initial step in deciding whether to start the business, you might consider how much you can expect to sell. You discuss the venture with some other business operators and determine that a small stand such as yours usually will sell about \$7,000 of merchandise each month for June, July, and August.

Next, you might consider how much money you will need to operate your business. Assume you determine that the merchandise that you can sell for \$7,000 will cost you \$3,500. Also, you decide that you will need some part-time helpers to keep the stand open ten hours a day, seven days a week. Therefore, you determine that your costs each month will be:

Merchandise to sell	\$3,500
Rent for stand	500
Wages	1,200
Miscellaneous	<u>200</u>
Total	<u>\$5,400</u>

Also, you might consider how much you expect to make from the business. As shown in Exhibit 2, if you expect to sell \$7,000 of merchandise and your costs will be \$5,400, you should expect to make \$1,600 of profit from the business each month, or \$4,800 ( $3 \times \$1,600$ ) for the summer. Profit is the amount left over after the cost of doing business is subtracted from the amount sold.

**Exhibit 2** Expected Earnings from The Beach Shack



You should consider whether this appears to be a good business for you. Suppose you have \$5,000 to invest in the business to purchase an initial stock of merchandise and to pay rent, a portion of June's wages, and miscellaneous costs. Would investing your money in the business be a good idea?

If you earn \$4,800 from your investment, you will earn a rate of return on your investment (profit  $\div$  amount invested) of  $\$4,800 \div \$5,000 = 96\%$  for the summer. You will receive \$4,800 of income in addition to the \$5,000 you invested. (The



\$5,000 you invested will be returned in August along with the profit for the month. You will get your \$5,000 back in August because you do not have to purchase merchandise, pay rent, or pay wages for September.) At the end of the summer you would have \$9,800. This is a much higher return than you could expect from investing the \$5,000 in a savings account. On the other hand, you are also investing much of your time in the business. You plan to work 50 hours each week. If you don't start the business, you could work at some other job. For example, you might work at a fast-food restaurant that pays \$5 an hour. If you worked 50 hours a week at the restaurant, you could earn \$3,000 ( $\$5 \times 50 \text{ hours} \times 12 \text{ weeks}$ ) for the summer. In addition, you would not be risking your \$5,000 investment and could earn some interest from savings.

The information about costs and earnings cannot make your decision for you. You must consider whether you want to work on the beach instead of in a restaurant, how certain you are about the amount you can earn from your business, and how much risk you are willing to take. Investing in a business is always risky. **Risk is uncertainty about an outcome**, such as the amount of profit you will earn. Suppose the summer turns out to be unusually cold and wet. If you sell less than you expect, your earnings also will be less. You could even lose money. Are you willing to take the risk? Accounting can help with these decisions by providing information about what you should expect. You have to evaluate the information and make a decision.

Accounting is a way of looking at a business. It measures the activities of a business by the dollars it receives and spends. It helps decision makers determine where they started: For example, you will start by investing \$5,000. It helps determine where you should end up: You expect to earn \$4,800 from your investment. It helps determine whether your expectations are being met: For example, suppose you sold \$6,000 of merchandise during June instead of the \$7,000 you expected to sell. Like a map, accounting can help you determine that you are not where you want to be. It can help you determine what went wrong and, in some cases, what you might change to get back on the proper route.

Accounting provides a model of a business by measuring the business activities in dollar amounts. Underlying this model is an information system. This system provides a process for obtaining facts that can be converted into useful information. Understanding the system and its processes will help you understand the information provided by accounting.

## THE ACCOUNTING PROCESS



**Objective 1**  
Identify the purpose of accounting.

**The purpose of accounting is to help people make decisions about economic activities.** Economic activities involve the allocation of scarce resources. People allocate scarce resources any time they exchange money, goods, or services. These activities are so common that almost every person in our society uses the accounting process to assist in decision making.

### Learning Note

The terms *money* and *cash* often are used interchangeably. In everyday speech, money refers specifically to paper bills and coins. Cash is a broader term that includes checks, bank accounts, and other resources that are easily converted to money. A general term for money and items easily converted to money is *financial resources*.

## Accounting Records

To illustrate a simple accounting system, we can examine a checking account. Suppose you decide to invest in The Beach Shack. You open a checking account for the business at First Beach Bank and deposit \$5,000 in the account.

With your checks and deposit slips, you have a check register similar to the example in Exhibit 3. The register helps you manage and control your money by keeping track of amounts you deposit or withdraw, the source of the deposits, the recipients of the checks, the dates of these events, and the amount available in your account.

**Exhibit 3** The Beach Shack Check Register

Date	Check Number	Activity	Deposits	Checks	Balance
June 1		Deposit by owner	5,000.00		5,000.00
1	1	Beach Supply Company (merchandise)		3,500.00	1,500.00
1	2	Beach Hotel (rent)		500.00	1,000.00
1	3	Sun City (license)		100.00	900.00
7		Sales receipts	1,500.00		2,400.00
7	4	Wages		300.00	2,100.00
(Other transactions for June are omitted.)					

## Summary Reports

If you wanted to know how much you spent in June for your business and for what purposes, you could summarize the information from the check register to help you understand these activities. For example, you might prepare a summary similar to Exhibit 4.

**Exhibit 4** Summary of Deposits and Payments for June

The Beach Shack Checking Account Summary of Deposits and Payments For June				
Beginning cash balance				\$ 0
<b>Cash deposits:</b>				
Deposit by owner	\$5,000			
Sales receipts	<u>6,800</u>			
Total cash deposited			\$11,800	
<b>Cash payments:</b>				
Merchandise	\$5,200			
Rent	500			
Wages	1,200			
License	<u>100</u>			
Total cash paid			<u>7,000</u>	
Excess of deposits over payments				4,800
Ending cash balance				<u><u>\$4,800</u></u>

Observe that the summary of deposits and payments provides information about cash received and paid in June. For example, you can determine that \$5,200 was paid for merchandise and that \$6,800 was received from customers in June. However, you cannot determine from this information if all of the merchandise purchased in June was sold to customers in June. Also, you cannot determine if customers owe you money for merchandise they bought but have not paid for.

The bank provides you with a statement that reports your checking account activities for the month. The statement lists deposits you made with the bank and



checks you wrote that the bank paid during the month. The bank provides this report so that you can verify the accuracy of the information you have recorded in your check register and the accuracy of the bank’s information about your account. You verify the accuracy by comparing your check register with the bank statement.

Steps in the Accounting Process

**Objective 2**  
Explain why accounting is an information system.

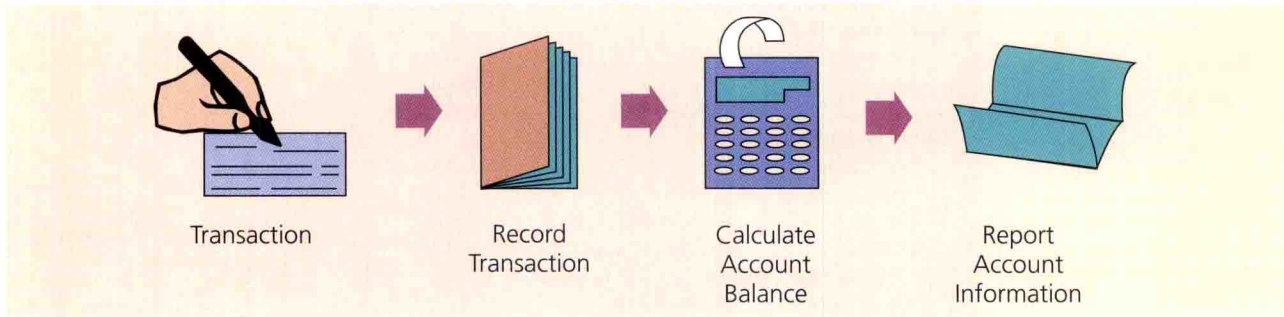
Some of the most important steps in the accounting process occur in this example of a checking account. In a checking account, you are accounting for money held by a bank for your use. The basic information unit in an accounting system is an account. **An account is a record of increases and decreases in the dollar amount associated with a specific resource or activity.** All information you record in your check register involves one account, your cash account with the bank. The register helps you keep track of the increases, decreases, and balance in your checking account.

The information in your check register summarizes the activities of your checking account. You record information in the register when an event occurs that increases or decreases the money in your account. **A transaction is an event that increases or decreases an account balance.** Transactions identify changes in resources and activities that affect resources. For example, when you write a check to pay for merchandise, you exchange money from your checking account for the merchandise. This event is a transaction, and you record it in your check register by noting the amount of the check and the reduction in your cash balance.

The bank maintains an account for each of its customers. Each time a customer deposits money or writes a check, the bank records the transaction in the customer’s account. The account balance is the amount available for use by the customer. The monthly bank statement summarizes the transactions recorded by the bank for the customer’s account.

The activities associated with a checking account provide an example of a typical accounting process. Exhibit 5 illustrates the four basic steps included in the process.

Exhibit 5 The Four Steps of a Typical Accounting Process



Step	Example
1. A transaction occurs.	1. Purchase merchandise.
2. Record the transaction in the proper accounts.	2. Record the payment in the check register.
3. Calculate the account balance.	3. Subtract the check amount from the balance.
4. Summarize and report transactions periodically to serve a specific need.	4. Prepare a summary of checking account activities for the month.