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A BRIDGE *to* DECISION MAKING, 3E

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# ACCOUNTING

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# ACCOUNTING

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# Preface

## How to Do Well in this Course (For Students Only)

We are going to let you in on some trade secrets instructors seldom tell students. That's why this section is labeled, "For Students Only." If instructors find out we have revealed these secrets, we'll probably get a lot of mail.

Getting good grades is not a matter of luck. That's not the secret. Also, it is no secret that doing assignments (on time), going to class (regularly), getting enough sleep and exercise, eating properly, and studying throughout the semester (instead of just at exam time), will improve your grades. But, this is hard work. So, what you want is a way to get good grades and not work so hard, right? Well, pay attention—the secret is to work smarter! That's not the same as being smarter, which is a matter of luck. Here's how you work smarter.

**Step 1: Determine why this course is important for you.** First, figure out why you're taking this class. What are your goals for the class? Do you care about this course? Do you have a strong motivation to learn about accounting? Perhaps being an accountant comes on your list of career options just below sweeping up at McDonalds. Maybe your goal is to make lots of money. Or, maybe you're just in college to have a good time until you inherit the family fortune. In any case, this course is designed for you. One of the surest ways to have a million dollars is to start with ten million and not know anything about accounting and business management. If you don't inherit wealth, you're not likely to get it without speaking the language of business. Accounting is the language! Maybe you just want to get a good job, but you're pretty sure you don't want to be an accountant. Fine! This course isn't going to make an accountant out of you. It will help you understand some of the "mystical rituals" of accounting that non-accountants often find confusing. Whatever type of management position you have in any organization, you can be pretty sure you're going to have to work with accountants and with accounting information. You should know they can have a major effect on your life. Many organizations use accounting information to evaluate their employees for salary and promotion decisions. You should understand how to interpret this information. You may even learn

accounting isn't what you think. Whether you grow to love or hate accounting, decide what you can get out of this course that will be useful to you.

**Step 2: Find out what your instructor expects of you in the course.** Next, check out your instructor. If you're lucky, your instructor is sensitive, warm, caring, has a good sense of humor, is witty, loves teaching, and wants you to do well in the course. If instead, your instructor is more normal (and less perfect), remember, the instructor is still the instructor. And, as the instructor she has power over your life. So, find out what she expects from you. What are her goals for the course? What does he want you to know or be able to do once you complete the course? Perhaps, he will tell you (good sign), but if not, ask. You should say: "Professor Whatever-Your-Name-Is (it would be wise to use the right name) what's the lowdown on the layout for this course?" This is education jargon for "what are your goals for this course?" This may catch her off guard, so give her a minute or two to think. You may even have to wait until the next class meeting to get your answer. Make sure you and your instructor understand each other's goals. Some accounting instructors expect all their students to become accountants. If you have one of these, make it clear. Tell your instructor: "I don't plan to be no accountant!" (Make sure you add the *ant*, or you may get fast agreement.) Find out what's in this course for you.

**Step 3: Find out how you will be graded.** Now, find out how you will be graded. How does the instructor test? Is he one of the picky types: "What is the third word on the fifth line on page 211?" Or, does he go in for the broader, thought questions: "Explain how accounting was instrumental in negotiating the third treaty of Versailles in 1623." Does he go in for multiple guess, or are short answers his cup of tea? Whatever the method, you need to know what is expected of you and how these expectations translate into grades. Occasionally, you'll find an instructor whose stated expectations don't agree with how he tests and grades. That's why you need to find out about both expectations and grades. If they don't seem to be consistent, you'll have to determine what the instructor really expects.

**Step 4: Emphasize learning what's important.** Figure out what you need to do to accomplish your goals and meet the instructor's expectations. A major lesson you should learn, if you haven't already, is "what you take from a course (and almost anything else) depends on what you bring to it." Your attitude is important. If you decide something is worth learning, you'll probably find a way to learn it. Not because you're supposed to learn it, but because you want to. "Wanting to" is the biggest part of working smarter. Wanting to learn will go a long way toward helping you get a good grade. Unfortunately, it may not be enough unless what you want to learn is also what your instructor wants you to learn. Therefore, you need to make sure you and your instructor are on the same wave length. If you're not, talk it over. Find out why the instructor has a different outlook. You may change your opinion about what's important. Determine how to focus your efforts. Not everything in this book or course is equally important. Focus on what's most important to you and to your instructor.

**Step 5: Communicate with your instructor.** Try to remember your instructor is a person. Even the authors of this book are people. We have wives, children, and pets. Most instructors really want to see you do well, but we need your help. Instructors don't know everything. In particular, we can't read your mind. You need to let your instructor know if you're having problems understanding the material you're expected to learn, figuring out what the instructor expects of you, or figuring out how to prepare for tests and other assignments. Talk with your instructor about problems you're having with the class. Remember, your instructor really is human.

This is your class. You paid for it. OK, maybe it was your parents, or somebody else who put out hard, cold cash for you to take this course. Don't let anybody keep you from getting your money's worth. Working smarter means determining what's important and focusing your attention and efforts on these things. Then, don't be



distracted from your goals. If you run into problems, deal with them. If you don't understand something in class or in the book, ask questions. If you're afraid of asking dumb questions in class, remember: looking dumb in class is better than looking dumb on an exam. If you think you may be missing key points, talk with your instructor. If you want to learn, you can.

That's it. Give it a try. We think you'll find the course more enjoyable and the experience more rewarding. Of course, you might also try doing assignments, going to class, getting enough sleep and exercise, eating properly, and studying throughout the semester. They usually help, even though they are hard work.

Best wishes to you, not only in this course, but throughout life.

Rob Ingram  
Bruce Baldwin

#### A side note:

To aid you in the learning process, basic concepts are indicated by margin icons. The concepts and their respective icons are shown below.

Transformation Process



Control of Accounting Systems



Reporting Rules, Standards



Cash, Cash Flow



Decisions, Decision Making,  
Analysis, Understanding



Time, Accrual Accounting



Organizations, Management,  
Professionals



International



Financial Reports



Stockholders



Accounting Information Systems



Obligations, Valuation, Contracts



Accounting, Processing  
Accounting Information



Effect of Business Activities  
(Risk and Return, Efficiency  
and Effectiveness, Business  
Results)



An Example



One more icon lets you know there's a related Internet hotlink connected to the text's World Wide Web site. Visit our site and follow the directions.

# Preface

## To the Instructor

### **ACCOUNTING, THE TOOL FOR BUSINESS**

Accounting plays many roles. For some people accounting is a career to be pursued. For others it is a set of rules to be followed. But for most, accounting is a source of information to be tapped, a tool for effective decision making. It is for these users of accounting information that we wrote *Financial Accounting: Information for Decisions*. As future managers and investors, students who use this text will benefit by viewing accounting not as a set of technical procedures, but as a way of identifying and understanding business problems and a means for evaluating potential solutions.

The third edition, like preceding editions, emphasizes the analysis and interpretation of accounting information rather than its preparation. Nevertheless, understanding the process by which accounting information is developed is essential to understanding the information itself. Examining transactions provides a convenient means for seeing the connection between business activities and the accounting information that describes them. Accordingly, we explore transactions with a focus on their implications rather than on specific and detailed bookkeeping issues that hold little relevance for non-accountants.

### **CONCEPTS AT THE CORE**

Two primary concepts are essential to understanding and using financial accounting information. The first is the transformation process companies use to create and sell goods and services. It is our belief that students best understand accounting by first understanding how businesses operate. They must understand what a business does before they can understand accounting data that describe it.

The second concept is the necessity of measuring and reporting activities in distinct time periods. Accounting measurement and reporting rules are heavily influenced by timing differences between when events occur that create or use resources



and when cash is received or paid. We believe that both accrual and cash flow measures of the transformation process are important, and understanding one type of measure depends on understanding the other.

## **CONTENT AND ORGANIZATION: BUILDING THE BIGGER PICTURE**

These concepts—transformation and timing—direct the content and organization of *Financial Accounting: Information for Decisions*, 3e. They are introduced and explained in the first several chapters and provide the foundation for the examination of accounting information that comprises the remainder of the text.

The first chapter explains the transformation process and the structure of business organizations that is necessary for this process. Chapter 2 introduces accounting within the context of this transformation process, describing the information needs of the decision makers who operate the business. This chapter introduces the structure and purpose of the accounting system as it is derived from these information needs.

The third chapter introduces timing issues that are essential to accrual accounting and compares accrual and cash flow measures of activities in the transformation process. The fourth chapter describes the accounting cycle as a process of measuring, recording, and reporting accrual and cash flow information. Chapters 5 and 6 examine financial statements as interrelated summaries of business activities that rely on both accrual and cash flow measures. Chapters 3 through 6 prepare students to understand and interpret a wide range of financial statement information as provided by actual corporations. Those aspects of the accounting process necessary for this preparation are covered in depth, using simple, carefully explained examples.

Chapter 7 presents another issue important for understanding the dynamics of business activities over time, the time value of money. This aspect of the time dimension is important for understanding accrual measurement of long-term contractual relationships that occur frequently in business activities.

Chapters 8 through 13 examine accounting for the transformation process in depth. These chapters describe specific measurement and reporting issues that arise in the transformation process. These issues are examined with reference to corporate accounting reports with the goal of understanding and interpreting these reports.

It is relevant to note not only what has been included in these chapters, but what has been omitted. Topics covered in most introductory financial books that have little to do with corporate reporting, such as bank reconciliations, petty cash funds, or payroll accounting, receive little or no attention in this text. Technical measurement issues, such as FIFO and LIFO, are described simply with the goal of understanding the effects of these issues on accounting information rather than emphasizing mathematical procedures for deriving these numbers.

The interpretation and use of accounting information in decision making are integrated into the last six chapters of the book. These tasks are essential to the goal of the text as preparing students to use accounting information. The analysis of financial statement information is treated as an integral part of the accounting process, not as a set of add-on activities. Example issues that managers and investors face in real-world situations illustrate the use of accounting information by decision makers. Students are brought into the decision-making process to view it as a logical sequence connecting business decisions to accounting information. The result of this approach is that students learn to use accounting information to evaluate the strengths and weaknesses of actual companies rather than memorizing lists, ratios, or mathematical procedures.

## **THE THIRD EDITION: IMPROVED FOR STUDENTS**

While this edition retains the conceptual basis and most of the content of earlier editions, it has been improved in several ways:

- More attention is given to the accounting cycle in Chapter 4. Our intention is for students to recognize the major steps in the cycle as an important link between business activities and accounting reports without becoming bogged down in the mechanics of the process. This chapter also presents some of the differences between a manual accounting system and a computerized system.
- Chapter 6 focuses directly on the importance of accrual and cash flow measures. The indirect format of the statement of cash flows is presented as a logical relationship between accrual and cash flow measures of operating activities.
- The chapter describing the accounting profession has been eliminated. The accounting profession is now presented as a sequence of appendices to chapters 1 through 6. This material can be introduced gradually into the course so the accounting profession can be understood within the context of the accounting process. Alternatively, this material can be omitted.
- Chapter 7 presents time value of money concepts using simple examples. Future values are presented first as an introduction to present values. The chapter contains examples of the use of these concepts in accounting measurement, with emphasis on implications, not computations. For example, a car loan is used to illustrate a loan payment schedule.
- Chapters 8 through 13 have been extensively rewritten. A special effort was made to present the material using easy-to-follow examples that emphasize major measurement and reporting issues. Secondary issues that complicate the presentation have been placed in appendices. Instructors can choose which, if any, of these issues to cover without interrupting the primary content.
- The analysis chapters have been simplified by focusing on examples of using accounting information in a decision-making context. These chapters begin with an extended analysis of a hypothetical company in which managers discuss the effects of their decisions on accounting numbers. This on-going scenario places students in the context of decisions that significantly impact businesses.
- The chapters then examine accounting information for actual companies. Accounting reports of Kmart, Wal-Mart, and McDonald's are used to illustrate interpretation and analysis of accounting information. Students are guided through simple computations that provide a basis for understanding the strengths and weaknesses of these companies.
- End of chapter materials have been revised and updated. Additional problems have been added. Problems have been edited carefully to ensure they are understandable to students.
- The vast accounting resources of the Internet are utilized in the third edition, with numerous references to relevant sites, all of which are accessible as links from the Ingram home page: <http://www.swcollege.com/Ingram/html>.

## **PEDAGOGY: DIFFERENT BY DESIGN**

The content, organization, and format of this text differ from those of most financial accounting texts. This is not by accident. The choices we made in creating this text were shaped by several strong beliefs about teaching and learning accounting.

The real world is the best teacher. Consistent attention is paid to what real companies actually do, which often differs from what textbooks describe. Traditional textbook formats and terms often are not found in practice. This reality gap is a disservice to students; we have made great efforts to close it. Examples of actual corporate practices are illustrated throughout the text. The names of actual companies are presented in bold type where these companies are first used.

Never forget the final destination. Many texts become so entrenched in the detailed methods and mechanics of accounting, that students lose sight of the big picture. In contrast, our conceptual basis links business activities to accounting

reports and business decisions. This conceptual basis is a thread running throughout the text that links each chapter to the overall purpose of the book. The last chapter ties back to the first chapter. Accounting is presented as a purposeful and useful decision tool that students can use.

Mind your business. Students need to understand how businesses operate in order to make effective use of accounting information. We emphasize accrual and cash flow relationships because they make clear what businesses do. These relationships can be used to explain past activities and predict or plan for future activities. Students are guided in the use of accounting information rather than being forced to memorize bookkeeping procedures. The conceptual basis and use of accounting information provides a foundation for all students to understand accounting and are as essential for accounting majors as for non-majors.

Practice makes practical. Carefully prepared end-of-chapter materials reinforce chapter objectives, with emphasis on using accounting information to identify, avoid, or correct business problems. This practical approach builds critical thinking and analytical skills which will be essential to the career success of students.

Learning starts with comprehension... Careful explanation using understandable language and simple, straightforward examples makes Financial Accounting: Information for Decisions easier for students to read and understand. All material is related to the underlying conceptual focus of the book so that students can understand why accounting is the way it is. Definitions are provided when terms are first used. Jargon is avoided to the extent possible. Accounting is presented as a logical and essential process for understanding business activities, not as a mystical or arcane set of terms, rules, and procedures.

...And comprehension starts with reading. While it may be self-evident that students can only learn from those texts they actually read, many books seem to ignore this idea. This text was designed explicitly to be read and enjoyed. A full-color, visual format is used to stimulate and hold students' attention. A reader-friendly style, including dialogue, assists with comprehension. Students are encouraged to apply what they are learning to issues with which they are familiar. Photos at the beginning of each chapter help students visualize the business environment. Additional photos in the chapters identify products and company settings for topics and self-study problem materials.

## A TRANSACTION CHOICE

New to this edition we are offering two versions of the text. The key difference between the two is the presentation of the impact of transactions on financial information. In FINANCIAL ACCOUNTING: INFORMATION FOR DECISIONS, the effect is shown through the use of the accounting equation. While we believe that students can gain a clear picture of how company resources and obligations are impacted through the accounting equation approach, we recognize that some instructors believe their students understand transactions better if they are presented in journal entry format. In FINANCIAL ACCOUNTING: A BRIDGE TO DECISION MAKING, transactions are shown as journal entries along with a unique side box that shows students how the transactions affect the balance sheet and the income statement. Both versions continue the same vision: Understanding accounting information is important in decision making. All students will benefit from learning how an accounting information system works and what kinds of activities organizations engage in.

## ANCILLARIES

### For the Student:

*Study Guide:* This guide reinforces and enhances student understanding of the topics covered in the text. It is a thorough, value-adding book that has been prepared by Stephen Senge and George Sanders, both of Western Washington University.

*Annual Report Project and Readings:* This highly popular project by Bruce Baldwin, of Arizona State University West, is tailored to reinforce the concepts presented in the text. Students work with annual reports of real companies to understand, interpret, and analyze the information. The project guides them through this process. Interesting readings from publications like *The Wall Street Journal* along with supporting Questions for Consideration provide additional material for discussion.

*PowerNotes and Forms:* Contained in this book are copies of the key PowerPoint slides with space for note taking. In addition, working paper forms have been included to assist students in preparing selected homework assignments.

*CONTACCT II, Version 3:* Contained in this accounting cycle software package by Dasaratha Rama and K. Raghunandan, both of the University of Massachusetts at Dartmouth, are tutorials, practice assignments, graded homework assignments, and a student instruction booklet. This newly revised software works with the latest version of ToolBook. (A run-time version is provided in the package.) The presentation is livelier and, as with previous versions, allows students to use the package in a lab or at home.

*QuickBooks for Windows (Trial Version):* This commercial accounting software package eliminates the need for debits and credits and allows students to focus on the understanding and interpretation of financial statements.

*BusinessLink Video Workbook:* Enrich student understanding of the BusinessLink video through questions and activities presented in this student workbook. Available 1998.

### For the Instructor:

*Solutions Manual:* Author-prepared and carefully verified solutions to all exercises, problems, and cases are presented in this manual.

*Solution Transparencies:* Where appropriate, solutions to the end-of-chapter assignments have been printed in large type, on easy-to-read acetate transparencies for use in use in classroom presentations.

*Test Bank:* A thorough test bank has been thoughtfully revised by T. Sterling Wetzel, of Oklahoma State University, and carefully verified. It provides testing materials for key points covered in each chapter.

*MicroExam (DOS-based) and Westest (Windows-based):* These two microcomputer versions of the test bank allow for random selection of questions and, if desired, generation of multiple tests. Instructor-created items may be imported in ASCII format for more customized testing.

*Cooperative Learning Techniques and Instructor's Guide:* Contained in this supporting item are chapters explaining cooperative learning techniques for use in the classroom and matrices that suggest application of techniques to specific end-of-chapter items. Philip Cottell, Jr., of Miami University, and Barbara Millis, of the United States Air Force Academy, have prepared this information. In addition, there are outlines of each chapter and teaching notes and descriptions of the exercises, problems, and cases to assist in class preparation.

*Cooperative Learning Workshop Video:* This workshop video presents Philip Cottell, Jr., of Miami University, who explains a number of cooperative learning techniques for use in the teaching of accounting.

*PowerPoint Presentations:* Creatively prepared by Doug Beets of Wake Forest University, these colorful, lively PowerPoint slides present the key topics of each chapter. This product has a built-in PowerPoint viewer program.

*BusinessLink Video:* Six video segments cover key financial accounting topics. Real companies are featured. Available 1998.

*BusinessLink Video Instructor's Manual:* This manual assists instructors in the use of the BusinessLink Video and student workbook. Available 1998.

*Annual Report Project Instructor's Manual:* Prepared by Bruce Baldwin, Arizona State University West, this manual provides guidance in using the Annual Report Project and Readings for Learning Teams and Individuals.

*CONTACCT II Version 3, Manual:* This manual provides solutions to the problems contained in the student software.

*CONTACCT II Version 3, Test Bank:* This ASCII-format 3.5" disk contains problems for testing students using the student software.

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Professor Ingram is a Certified Public Accountant and holds a Ph.D. from Texas Tech University. Prior to joining the faculty at the University of Alabama, he held positions at the University of South Carolina and the University of Iowa, and a visiting appointment at the University of Chicago. His research, which examines financial reporting and accounting education, has been published widely in accounting and business journals. He is the recipient of the National Alumni Association Outstanding Commitment of Teaching Award and the Burlington Northern Foundation Faculty Achievement in Research Award at the University of Alabama. He has also received the Notable Contribution to Literature Award of the Government and Nonprofit Section of the American Accounting Association and the Award for Excellence and Professional Contributions of the Alabama Association for Higher Education in Business.

Professor Ingram is married and has two children. He and his family enjoy sports, travel, reading, music, and art. They live contentedly in Tuscaloosa, Alabama.

## **BRUCE A. BALDWIN**

Bruce A. Baldwin is Professor of Accounting in the School of Management at Arizona State University West. He has held previous faculty appointments at Arizona State University Main, Portland State University, and Linfield College (Oregon). In addition, he has held visiting appointments at the University of Texas-Austin and the University of Alabama-Tuscaloosa. His primary teaching interests involve financial accounting and reporting issues in courses at both the undergraduate and graduate levels. He is known as a challenging and effective teacher and has won several teaching awards.

Professor Baldwin is well-known for his interest in accounting education issues and has special expertise in testing and measurement. He has served as a consultant to a number of national testing organizations and chaired two AICPA task forces that developed employee assessment materials. Currently he is a member of the Certification Advisory Committee of the Arizona State Board of Accountancy. Dr. Baldwin's research articles on accounting policy standards and accounting education have appeared frequently in journals such as the *Accounting Review*, *Journal of Accounting Education*, *Advances in Accounting*, and *Issues in Accounting Education*. He has served as associate editor of the *Journal of Accounting Education* and is currently associate editor of *Accounting Education: An International Journal*.

Professor Baldwin is married and has two children and two grandchildren. He and his wife Connie live busy and sometimes hectic lives in Phoenix, Arizona. At every possible opportunity they escape to the beach at Puerto Penasco, Mexico.



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