CHAPTER 1

INTRODUCTION: WHY KEEP SCORE?

**Accounting.** You probably already have some conceptions about the subject of accounting. You may view accounting information as merely history, with little relevance for forward-looking management. You may think that accounting data are precise and represent indisputable facts about an operation; or you may feel that, since the accountants themselves often disagree, the results of their labors must represent little more than their individual opinions. You may equate accounting with your checkbook and monthly bank statement; or your savings account passbook; or your paycheck with its stub indicating amounts withheld from pay; or the record of receipts and expenses for your club, charity, or association. You may be accustomed to reading published financial statements of corporations, perhaps in connection with common stock investments you have made or contemplate making. Or, you may feel totally lost when confronted by these published financial statements, replete with large numbers and financial jargon that seem to speak only to the initiated.

**Accountant.** Again, the word may bring a variety of thoughts or images to mind. Your mental image may be of the Victorian clerk working for Ebenezer Scrooge, leaning over his desk, perched atop his tall stool. Alternatively, you may view the modern accountant as commanding a massive computer database with high-speed laser printers spitting forth financial facts at lightning speed.

Each of us is in contact with accounting information nearly every day of our lives. These frequent encounters—many of them baffling and some simply unpleasant—form our opinions on what accounting is and is not, what it can and cannot do for us or to us, and what accountants must be like.
For now, keep an open mind about both accounting and accountants. Those of you who are skeptics now may be persuaded that accounting information, properly analyzed and interpreted, can be of substantial benefit. Those who are now enthusiastic believers in accounting’s value may, after further study, want to temper that enthusiasm. You may conclude that accounting information, like most other information, has its limitations.

**USERS OF THIS BOOK**

This book is addressed to present and future users of accounting information rather than to budding accountants. This user—you—may now be a business, engineering, or liberal arts major in college or graduate school; or a manager (or aspiring manager) in business, industry, government, or in one of the many other types of organizations, both public and private, that dominate our society. For every professional accountant, there are many others of us who need to understand basic accounting concepts because we must interpret accounting reports and make use of financial data both in our personal lives and in our jobs.

Some of you will proceed no further in your study of accounting or financial control than this book; for you, this text should provide both a satisfactory introduction and a conclusion. You will gain an understanding of the fundamental concepts, the framework of accounting, and the managerial uses of accounting information. Importantly, you will also come to appreciate the inherent limitations of accounting techniques and, therefore, of the resulting information.

For those of you who will continue to study accounting, this book provides basic knowledge upon which to build both greater technical skills and greater sophistication in financial analysis. Of course, this book will awaken in a few readers an interest in accounting as a career. If you are one of these, this discovery may come as a surprise, particularly if you were reluctant to crack open this book.

This book is quite unlike traditional accounting books. First, it assumes that you are or will be a manager, not a person preparing for a professional accounting career. Thus, it does not instruct you in bookkeeping. Second, the book seeks to develop within you a healthy skepticism regarding the precision and reliability of accounting data, as well as an appreciation of the benefits of accounting reports. Third, it omits discussion of a number of subjects of interest to professional accountants but of marginal usefulness to managers.

Fourth and most importantly, this book is nontraditional in its organization. It asks you first to consider the need for, and purposes of, financial information before studying a set of dogmatic accounting rules. Accounting can be taught, and often is, by a pedantic presentation of rules and procedures that you are asked to apply to a set of simplified and generally unrealistic exercises. The rules and procedures are slow to sink in if you have little
appreciation of the condition or dilemma that gave rise to them. Moreover, if you don’t wrestle with the dilemmas, you are likely to resist the rules as being unnecessarily arbitrary.

So this book will create in you a need to know by exploring financial data requirements, first in the area of general, or financial, accounting and then later in cost and managerial accounting. This flow is intended to make you aware that there is a need for financial information, that a body of knowledge has developed for compiling this information, and that some quite arbitrary rules and procedures are necessary to permit the accountant to communicate with his or her audiences.

This book’s purpose is to make you a better user of accounting and financial information—gaining all such information that you can, while being mindful of its shortcomings and limitations.

SCOREKEEPING

Accounting is analogous to scorekeeping. Managers in business are interested in the financial score; managers of athletic teams are interested in the game score. Nonmanagement members of the business enterprise, like their athletic counterparts, the players, are also interested in the score. Besides the active participants, a host of other individuals are also interested in the score—in athletics, the fans, the sportswriters, and the concessionaires selling beer and hot dogs; in business, the shareholders, the bankers, the customers, and the government.

We are interested in the score for a variety of reasons, but most importantly because it helps us make better decisions. Managers—whether in business or athletics—change strategies and tactics depending on the score. The score can cause customers, employees, investors, and sports fans to renew or change their allegiances to a company or team.

DEFINITION OF ACCOUNTING

A useful definition of accounting, or financial scorekeeping, must both describe and circumscribe the tasks and responsibilities of accountants. It must tell us both what we can expect from our scorekeeping system and what kinds of information or insights are simply beyond its reasonable scope.

Accounting Is Historical

The score of an athletic contest gives the results of the game thus far, not an estimate of what may take place in the next period, inning, or minute; similarly, accounting information shows only what has gone on in the enterprise up to the date of the reports. Thus, an accountant is a historian.
Of course, history is relevant to the future. Plans for virtually all human endeavors—business, athletics, and international diplomacy, for example—are better formulated after a careful analysis of history. You should recognize, however, that accounting cannot provide a crystal-ball view of the future. Sales forecasts, production plans, and expense budgets—all prospective and all describing what we expect, hope, or plan to occur in the future—are not in the accounting records. On the other hand, the best financial forecasts, plans, and budgets build on solid knowledge of the past as revealed by the historical financial score.

**Accounting Measures and Reports in Monetary Terms**

Much about an enterprise cannot easily or usefully be expressed in monetary terms. These events are not less important than those that can be expressed monetarily, and they are no less relevant to the enterprise’s future. Hiring a respected design engineer may be much more significant for the company than purchasing a new piece of laboratory equipment; however, we have a good deal less trouble valuing laboratory equipment in monetary terms than we do a newly hired engineer. Similarly, obtaining an appointment with the president of a major potential customer company may be more significant than shipping just another order to a present customer, but clearly the first event is more difficult to value in monetary terms (since an appointment is not a sale) than is the second (for which we can value both the sales transaction and the value of the goods shipped).

**Accounting Relates to a Defined Entity**

The entity may be a retail shop, an industrial concern, a church, the city government, the local fire department (a segment of the city government), the senior high school, a parish affiliated with an archdiocese, your family, or just you, an individual. But in each case, the entity must be precisely defined. Then, both the accountant and the user of the accounting information must not confuse that entity with other entities of close association or particular affinity.

For example, when you account for a partnership (say, a law firm), you account for the partnership’s activities and not the personal activities of the partners. The partners probably have other incomes, and they surely have other expenses, but these are not incomes or expenses of the partnership. If the accounting entity is your family, you include the earnings and expenses of all family members, and the result is different than if the accounting entity is you alone. If you are accounting for your parish, you are concerned only with that organization—not the archdiocese and certainly not the worldwide Catholic Church. And you should make sure that you include all activities of this parish, including, for example, the membership committee and the social committee.
For accounting purposes, a large enterprise is frequently broken up into elements, each treated as an accounting entity. For example, normally a single division of a large, multinational industrial enterprise is an accounting entity; the division manager and his or her associates need to know the division’s score separate from the score of the larger enterprise. Of course, the score must also be kept for the overall enterprise, but that can be readily accomplished by combining divisional accounting information.

Accounting Is an Action Process

What verbs define accounting actions? The first verb that comes to mind is record. We speak of accounting records, and therefore the accounting process must record what goes on in the entity. But, before the goings-on can be recorded, they must be observed: what of monetary significance is happening? Once observed, the goings-on must be translated into monetary terms so they can be recorded; they must be measured in monetary units, that is, valued.

Once the goings-on are recorded, however, the accountant’s job is not completed. A sequential log of all that has transpired in a business might satisfy certain legal requirements for records, but it would be so long and unorganized as to be unreadable. Thus, the accountant classifies and then summarizes the data, so that data become information.

To recap, the action verbs in the definition of accounting, listed in the order in which the actions are taken, are observe, measure, record, classify, and summarize.

Now, to what are these actions directed? What kinds of goings-on need to be observed, measured, recorded, classified, and summarized? Surely, transactions to which the entity is a party: for example, making a sale, paying a bill, receiving a check from a customer, lending or borrowing money, paying the payroll, acquiring inventory, buying a machine tool. Can we concentrate solely on transactions between the entity and other, outside entities? Not quite. While such transactions trigger the great majority of accounting entries, we also need to take accounting action to recognize changed conditions internally, changes that have not—at least not yet—involved transactions with outside persons or organizations. Consider these several examples of occurrences or changed conditions:

• A piece of production equipment grows older and, thus, becomes less useful to the company.
• Certain inventory items become obsolete.
• The company’s obligation to pay salaries or taxes arises before the date when they must actually be paid.

Stringing these elements together, then, we arrive at the following definition of accounting:
**Accounting is the process of observing, measuring, recording, classifying, and summarizing the changes occurring in an entity, expressed in monetary terms, and interpreting the resulting information.**

The final clause of this definition—“interpreting the resulting information”—is, of course, not solely the accountant’s task; managers and all others interested in the financial score of the entity also interpret the resulting information. Nevertheless, this final clause is included in the definition to emphasize that part of the accountant’s job is to extract meaning from the recorded history. Indeed, this book places major emphasis on interpretation.

**LIMITATIONS OF ACCOUNTING INFORMATION**

To many people the definition of accounting suggests that the accounting score tells the entity’s full story. Such is most assuredly not the case. Accounting information is limited both in scope (or completeness) and in precision. Too frequently, readers of accounting reports assume they have in hand the truth about the organization’s financial state. Even worse, they believe the reports present the whole truth. Unfortunately, some accountants, perhaps understandably, do little to dispel these erroneous impressions.

The first limitation arises because observing and recording is limited to those activities—transactions or changed conditions—that can be expressed in monetary terms. As mentioned earlier, much of importance cannot be so expressed. Second, we limit our attention to history, not to forecasting the future. Third, we focus on a particular entity, but that entity will be much affected by what goes on outside—for example, in the economy as a whole or within a competing organization.

Finally, the process of observing and measuring inevitably demands estimates, assumptions, and compromises. This situation is aggravated by the fact that the accountant is always working under time constraints, since the usefulness of accounting information is, in part, a function of its timeliness. For example, consider the following dilemmas. How precisely can you value obsolescing inventory? Can you be certain that no one has entered into an agreement that obligates the company without informing the accounting department? Can you be certain that all your customers will pay their bills? Is it not likely that reasonable people will disagree on the precise value to your company of a five-year-old piece of machinery?

In truth, accounting can only estimate the financial state of the enterprise. Don’t expect the accounting documents to reflect all that is important about the enterprise—even its history—or to reflect that history in absolutely indisputable terms. Because accounting reports are often presented in very precise terms—down to the hundredth part of a dollar—they imply a higher level of precision than they deliver. It is possible to be precisely wrong; it is also true that vague accuracy can be highly useful!
AUDIENCES FOR ACCOUNTING INFORMATION

The accountant serves many constituencies; all those people and institutions are interested in an entity’s financial score. Accounting reports address multiple audiences. Who are they, and what do they want to know?

Managers

Managers make the most extensive demands for financial scorekeeping. Charged with the responsibility for both day-to-day operations and long-range direction, managers are concerned with a broad array of issues and questions. They need rapid feedback to determine whether the company is operating according to plan. Are sales and expenses on target? If not, where are they out of line? Managers face a host of marketing decisions. Should a product be added? Should another be deleted? Should a particular order be accepted or declined? What price should the company bid on job X? Should it adjust prices on product line Y? Should it increase or decrease sales promotion expenditures?

In addition to using information to improve operating decisions, managers must also monitor the current financial health of the company. How much cash does the corporation have? How much do customers owe the company? Are they paying on time? How much does the company owe its suppliers? Is it paying them on time? How much inventory does it hold? Does the company have the ability to borrow additional money from the bank?

Furthermore, managers should stay alert to the messages that the company’s financial statements are conveying to the following other audiences interested in the company’s financial score.

Investors

The corporation’s present shareholders are, of course, already investors, but any persons or institutions who might buy shares of the company’s stock are potential investors, and both groups seek financial information. Is the company profitable? Is it sufficiently profitable to sustain or increase the dividend? What are the risks that the company will become bankrupt?

Security analysts and brokers who advise present and potential investors are an important audience. Indeed, the market prices for a company’s securities are determined by the relatively few professional investors and analysts who become thoroughly knowledgeable of the company’s financial score. Thus, this audience is both highly demanding and critically important.

Creditors

When considering a company’s creditors, you probably think first of the bank. In addition, trade suppliers—companies selling on credit to the company—
are also creditors. All creditors are interested in being repaid on time and, in the case of formal loans, being paid interest; but they do not share, as investors do, in the future growth and profits of the company.

The sooner the creditor expects to be repaid—that is, the shorter the maturity of the credit—the greater the creditor’s focus will be on immediate financial position (liquidity) and the less the concern with longer-term prospects. Conversely, if repayment is scheduled for the distant future—that is, if the loan has a long maturity—the lender is increasingly concerned with the company’s long-term prospects, since the long-term lender may not be repaid if the borrower incurs a string of loss years and fails as a viable business.

**Tax Collector**

Various taxes are incurred by the corporation as a function of sales, profits, property owned, payroll, and occasionally other factors as well. In the United States, taxes on profit—income taxes—are exacted by the federal government, certain state governments, and a few municipal governments. Typically, property taxes are collected by the county or municipal government, while sales and payroll taxes are imposed by several levels of government—federal, state, county, and municipal.

Accounting records are used to calculate and subsequently verify tax liabilities. Government tax auditors routinely demand access to accounting records to verify the correctness of the company’s tax payments.

Two preliminary comments regarding taxes are in order. First, in virtually all cases, corporate managers and individual taxpayers should and do strive to minimize current taxes of all kinds. This effort leads both to postponing the payment as long as possible and to taking advantage of every tax law provision to reduce taxes. Note the world of difference between avoiding unnecessary taxes and evading required taxes! Be aware, too, that the exact applicability of a tax law (particularly an income tax law) is often unclear. Thus, a company’s tax liability may not be determinable with certainty. An adversarial relationship between taxpayers (corporate and individual) and tax collectors is almost inevitable.

Second, tax laws must not dictate accounting practice, particularly accounting for profits. Governments enact income tax laws to raise revenue and, in certain instances, to further national economic goals by providing incentives to taxpayers. Thus, the definition of profit in income tax laws is typically at variance to some degree with a definition that is useful to managers and investors. As a result, a company normally has to maintain in its accounting records certain information solely for the purpose of calculating its tax liability.

**Others**

Aside from these primary audiences, many others are interested in the financial score. Customers are interested in the company’s financial viability, par-
particularly if they are dependent on the company as a long-term supplier. Employees have similar interests; a growing, profitable, and financially strong company is an attractive employer. Labor unions, as representatives of the employees, have an avid interest in financial results, particularly just prior to contract negotiations, when the union is formulating demands based at least in part on what it feels the company can afford. Managers at competing companies are also eager readers of published financial statements.

Government regulatory bodies look to the company’s accounting records for information. Companies are, of course, subject to varying amounts of regulation, depending primarily on their lines of business. Public utilities (electric power, natural gas distribution, telephone, and so forth), some transportation companies, and most broadcasting companies (radio and TV) are regulated by both federal and state agencies. All U.S. companies whose securities are actively traded in organized markets (for example, the New York Stock Exchange) are subject to financial reporting requirements stipulated by the federal Securities and Exchange Commission, and both federal and state securities agencies assess the financial information supplied in connection with the sale of newly issued securities. Antitrust legislation constrains the actions (particularly pricing actions) of even relatively small concerns. In their interactions with each of these regulatory bodies, managers rely to a great extent on financial information obtained from accounting records to advance the company’s cause or to defend its position.

DIFFERENT MESSAGES FOR DIFFERENT AUDIENCES

This discussion should convince you that (1) different audiences are interested in quite different types of financial information, and (2) a company may legitimately wish to convey quite different messages to different audiences.

For example, while wanting to report a strong profit picture to shareholders, management seeks to minimize taxes calculated as a percentage of profits. The desired message to creditors may be that the company is in a strong financial position, entitled to more liberal credit terms, just when the desired message to the labor union is that the company cannot afford substantial wage or fringe benefit increases.

This book emphasizes frequently that accountants have considerable latitude in reporting both profit and financial position. Consider again the example of obsolescing inventory. If the accountant is relatively pessimistic about the value of this inventory, both profit and financial position will be reported less glowingly to both shareholders and the income tax collector than if the accountant takes a more optimistic view of its value. Of course, this and similar situations present opportunities for deception or, far worse, fraud. But no matter how honest and objective the accountant attempts to be, judgments are colored by the conscious or unconscious consideration of the message that the resulting financial reports convey to key audiences. After
all, the accountant is subject to the same human frailties and is buffeted by the same human motivations that affect us all!

ACCOUNTING IN THE WORLD OF BUSINESS

The accounting function in business is a service function, not an end in itself. The accounting department does not create sales, fabricate products, or engineer new products. It keeps score and provides information and analyses. Within a business context, accounting is useful to the extent that it assists managers in achieving the company’s objectives. An important (although not necessarily the prime) objective of business is to earn a profit.* The accountant keeps score with respect to that objective.

Most businesses, of course, articulate other objectives to accompany the profit objective. At the risk of provoking arguments about what should be business’s objectives, we can say that managers pay attention to the following:

• Meeting budget
• Maximizing sales or market share
• Providing stimulating work and above-average compensation for employees
• Increasing economic power through sheer size
• Creating or maintaining technical leadership
• Developing enhanced reputation or prestige
• Perpetuating the enterprise for the benefit of employees, the community, the management, or the founding family
• Assuring that present management members retain their jobs

Accounting may not help much in keeping score on certain of these objectives. For example, try quantifying in monetary terms economic power or reputation or prestige. Remember, accounting reports tell only part of the company’s total story.

The fundamental economic decisions that must be made by all economic enterprises involve the efficient allocation of available resources, since resources are inevitably scarce. These scarce productive resources are money, existing productive capacity, and labor, including technical expertise, management expertise, and human muscle. Many analytical techniques, some quite sophisticated and requiring extensive computing power, inform these resource allocation decisions. Much, though not all, of the data utilized in these mathematical models should be available from the accounting records—

* Actual behavior suggests that maximizing profits is not a widespread objective. Rather, managers seem to act as though they want their companies to be adequately (perhaps comfortably) profitable, but not necessarily maximally profitable.
for example, costs and revenues for certain products, for certain departments, or for certain geographic regions. Indeed, designers of accounting systems should have in mind data required by such analytical and planning tools as the following:

- Discounted cash flow analyses of alternative investment opportunities
- Simulation of segments of the company’s operations
- Economic order quantity and other scheduling analyses
- Linear programming of the company’s distribution activities

ACCOUNTING IN NONPROFIT AND GOVERNMENTAL ORGANIZATIONS

The primary focus of this book is on businesses—manufacturers, service organizations, and sales organization—that seek to make a profit. Of course, our society is replete with organizations that are not profit-seeking: government units, educational institutions, charities, certain hospitals, churches and synagogues, clubs, foundations, fraternal and service organizations, political parties, and consumer or farmer cooperatives. The accounting requirements, and therefore accounting systems, of these organizations are somewhat, but not fundamentally, different from those of profit-seeking companies. With different objectives, they require different sorts of data and reports to track progress. Yet all of them take in revenue and incur expenses. The well-managed among them operate on a plan, and the plan involves a budget in monetary terms. Their managers have the same needs as their profit-seeking counterparts to monitor actual financial performance with reference to the budget. Nevertheless, some accounting conventions are different for governmental, educational, or other types of nonprofit organizations.*

USEFUL NONACCOUNTING INFORMATION

While accounting information is limited to what can be stated in monetary terms, nonmonetary measures and records are vitally important to managers of both for-profit and nonprofit organizations. Thus, a caveat: You should seek out insightful nonaccounting measures of both performance and condition to supplement and amplify accounting information.

Consider again the analogy with athletic teams. Sports fans are concerned with other information about the team besides simply the score of the games played and the related statistics on individual team members. They are inter-

*In general, these organizations place a good deal more emphasis on the flow of cash, where profit-seeking businesses place more emphasis on the measurement of profit.
ested in the age and health of the athletes, and the depth of backup personnel for each critical position. They are interested in which athletes perform best under varying climatic, competitive, or time conditions.

Similarly, business managers are interested in such nonmonetary measures as the number of potential new customers contacted, the frequency of late deliveries, employee turnover, employee absenteeism, the market share vis-à-vis competitors, the educational background of technical and managerial personnel, the number of sales calls per salesperson per day, the percentage of contract proposals accepted, the percentage of production capacity utilized, and the quality yield. Indeed, most businesses define a handful of nonmonetary key indicators of performance that they monitor every bit as closely as accounting data. The most significant of these provide early warning signals—that is, foretell operating problems.

**IMPORTANCE OF PERSONAL MOTIVATIONS**

Managing is often defined as the process of planning, supervising, and controlling an organization in pursuit of its objectives. To repeat, this book focuses on accounting’s role in providing data and analyses to assist managers, particularly in their efforts to plan and control.

Bear in mind however, that an organization is a collection of human beings. These people—middle- and lower-level managers, salespersons, scientists and engineers, clerks, machine operators, and everyone else in the organization—have their individual and collective objectives. Every student of human behavior knows that each of us is motivated to satisfy our own needs, whatever they may be. Accounting information may help us to satisfy certain of our needs (for example, you need to demonstrate that your department can operate on budget, and the accounting report verifies that it has), or it can threaten our need satisfaction (say, you committed to lowering overtime costs in your department, and the last accounting report shows no improvement). Inevitably, readers of accounting reports react based on their motivations; those reactions may be constructive to the organization’s overall goals and objectives (for example, you are going to take corrective steps to increase sales of certain products because sales have been below target), or they may be destructive (for example, you will subcontract certain production activities at a sacrifice in total costs rather than incur additional overtime costs, since the high subcontract costs will not be charged to your department and management is on your back about overtime costs). Accounting reports can be used to threaten or coerce mid- and lower-level managers, or they can be used to provide feedback to managers to permit them to do a better job. More about these motivational issues in Chapter 15.

Accountants themselves are, of course, influenced in turn by how managers react to their reports. Too frequently, an adversarial relationship builds up between accounting managers and operating managers. If operating managers
dispute the veracity of the accounting numbers, the accounting department becomes defensive. Operating managers may withhold unfavorable information from the accounting department. Accounting personnel may delight in highlighting areas of poor operating performance. By contrast, a healthy relationship exists when operating managers look to the accounting department for feedback and assistance, and the accounting department readily admits that accounting is not an exact science and that actual results may deviate from plan for perfectly valid reasons.

SUMMARY

Accounting is financial scorekeeping. More comprehensively, accounting is defined as the process of observing, measuring, recording, classifying, and summarizing the changes occurring in an entity, expressed in monetary terms, and interpreting the resulting information.

This book is primarily for managers, those seeking to gain accounting understanding to make them more proficient in using accounting and financial information. It is not intended for those who seek to learn basic bookkeeping skills.

Accounting is not a complete story—or history—of the enterprise. It ignores activities that cannot be measured and expressed in monetary terms. Furthermore, to a significant extent, accounting ignores events or conditions outside of the entity, even though they may importantly affect the future of the enterprise. Remember that nonmonetary, and therefore nonaccounting, measures of a company’s activities and condition also can be both revealing and useful.

While accounting reports serve a myriad of audiences, the primary audience is the managers of the enterprise. Secondary, but very key, audiences include the present and potential investors in the company’s securities, the company’s creditors, and the various governmental taxing authorities. Other interested parties include customers, employees, suppliers, trade unions, government regulatory bodies, and competitors. The informational requirements of these audiences vary widely.

Accounting reports aid managers in tracking the progress toward one or more of the corporate objectives. Furthermore, accounting data are the key inputs for most analytical and planning techniques that assist decisions regarding the optimum allocation of the enterprise’s scarce productive resources.

Accounting techniques for government, education, charity, and other non-profit organizations are not fundamentally different from those for profit-seeking enterprises. However, informational requirements and certain accounting conventions do vary, since these nonprofit organizations pursue objectives different from those of private-sector businesses.
NEW TERMS

**Accounting.** The process of (1) observing, measuring, recording, classifying, and summarizing the changes occurring in an entity, expressed in monetary terms, and (2) interpreting the resulting information.

**Classify.** To categorize within the accounting system similar transactions, occurrences, or conditions.

**Entity.** The organizational unit for which the accounting is being performed.

**Measure.** To value in monetary terms the transaction, occurrence, or condition to be recorded in the entity’s accounting system.

**Monetary terms.** The measure used in valuing all that is to be included in the accounting records.

**Observe.** To determine what transactions, occurrences, or conditions have monetary implications to be recorded in the entity’s accounting system.

**Record.** To evidence in the accounting system those transactions, occurrences, and changed conditions that have been observed and measured (valued).

**Summarize.** To combine and condense data in the accounting system in order to supply meaningful information to the various decision makers within and outside the entity.

EXERCISES

1. What are the five action verbs used to define the process of accounting?
2. Cite three common observable *transactions* that should be measured and recorded in the accounting records.
3. Cite three examples of observable changed *conditions* that should be measured and recorded in the accounting records.
4. Cite three common observable *events* in an industrial company that probably cannot be measured in monetary terms.
5. Name three sets of audiences interested in drawing information from an industrial company’s financial statements.
6. Suggest three examples of nonmonetary (and therefore nonaccounting) data that would be useful to the operating managers in making decisions regarding the manufacture of artificial heart valves for humans.
7. Who are the primary users of accounting data and reports:
   a. Within the organization?
   b. External to the organization?
8. Indicate whether each of the following statements is true or false:
a. Probable future events have no bearing on today’s accounting valuations.
b. Accounting records are only historical.
c. In the United States, income tax laws often define good accounting practices.
d. Most companies provide different financial statements to different audiences.
e. Accounting processes for nonprofit (not-for-profit) entities are, in general, the same as those for profit-seeking companies.

9. Describe the process by which you would go about measuring the value of the following:
   a. An inventory of men’s shirts acquired 15 months ago by a department store
   b. A 10-year-old machine tool used by an automobile manufacturing company to fabricate parts
   c. A three-year-old automobile used by one of the company’s salespersons
   d. A company’s obligation to pay wages during vacation leaves earned by its employees
   e. The obligation to repay a $12,000 loan due in five years with interest payable annually at the rate of 8 percent
   f. A used truck recently purchased
   g. The exchange of a parcel of land owned by the company for a 15-year lease in a newly constructed facility
   h. The acceptance of a five-year interest-bearing note from a customer in settlement for the customer’s past-due account
   i. The signing of a five-year employment agreement with the company’s chief scientist
   j. The acceptance of an order for 120 units of product X requiring delivery at the rate of 10 units per month over the next year
   k. The filing by the company of a lawsuit seeking $200,000 in damages from a supplier that delivered inferior quality material
   l. The return to the company of defective goods previously supplied to the company’s best customer
   m. The bankruptcy of the company’s second largest customer


11. You are a securities analyst for a major stock brokerage firm and have the responsibility for writing a report on the Schuster Corporation. You have just received Schuster’s annual report containing the company’s published financial statements. What specific questions can be answered by
a careful review of these statements? You now have an opportunity to interview the president of the Schuster Corporation for one hour. What are some of the questions you will ask the president? How do these questions differ from those to be answered by the financial statements?

12. You are a shareholder of the Schuster Corporation and have just received the latest annual report of the company, containing financial statements for the previous fiscal year. You have no access to key managers of the company. Where will you look for additional information about the company to decide whether to increase or decrease your share holdings in Schuster? How will you evaluate the reliability of this information?

13. What is meant by the phrase “accounting entity”? Give three examples of related yet separate accounting entities.

14. What different messages regarding its financial condition and profit performance might an industrial company wish to convey to (a) one of its major customers and (b) its shareholders?