6TH EDITION

Financial Accounting

An Integrated Approach

Ken Trotman
Elizabeth Carson
Michael Gibbins

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Financial accounting: an integrated approach
6th Edition
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Preface

One question I have been frequently asked since writing the first edition of this book is: why write an introductory accounting textbook?

First, I have been involved in teaching introductory financial accounting for over 35 years. I enjoy trying to get across the introductory concepts. Second, I have been surprised at the differences between how introductory accounting is taught in most undergraduate programs and how it is taught in MBA courses in the United States and Australia. Thirty years ago there were good reasons for the differences, as most of our first-year undergraduate students were accounting majors. This is not the case today. Third, when I ask attendees at executive education programs what their accounting background is, many respond that they did first-year accounting 10-plus years ago but found it boring!

With this in mind, I tried to add to an undergraduate book some of the features that MBAs and executives seem to enjoy. We don't want our students returning in 10 years and suggesting our courses are boring! Talking about companies and relating the material to annual reports and newspaper articles helps students to get interested.

With all of the above in mind, we set about incorporating the following in the book. First, we have tried to make clear to students the importance of accounting information by frequent reference to current material. Second, as companies are the most common business organisations in Australia today, we start by writing about companies, rather than spending many introductory chapters concentrating on sole traders. Third, to keep this book's material interesting and relevant, we have made frequent references to the content of annual reports. Students learn about real companies and can follow their performance in the newspapers or the share market if they wish. Fourth, we believe that the depth of technical knowledge in this book will challenge both accounting and non-accounting majors.

The first edition of this textbook was adapted from the second edition of the best-selling Canadian introductory financial accounting textbook of the same name written by Michael Gibbins. In the Australian edition, we have added eight chapters as well as reorienting the material towards the Australian context. Our sixth edition incorporates a new Chapter 8 on receivables. Previously the receivables material was part of the early chapters on accrual accounting (particularly Chapter 5). By moving it to Chapter 8 we have made Chapter 5 more manageable; it also allowed us to address receivables in more detail, including the use of subsidiary ledgers. In addition, sustainability reporting has been moved to Chapter 17 and linked with integrated reporting. These sustainability reports have become very common and are increasingly important.

The most attractive features of the fifth edition have been retained: an easy-to-read style with a wealth of extracts from company annual reports, newspapers and magazines, 'How's your understanding?' activity questions throughout each chapter, questions at the end of each chapter relating to real annual reports, as well as a set of cases with questions relating to the Woolworths Limited Annual Report 2014 (appendix at the end of the book).

Students should take advantage of the ancillary material that goes with this book, in particular the CourseMate website, which includes revision quizzes, practice questions, annotated weblinks and much interactive material. Also, the publisher has made available a suite of additional resources for instructors. Students may like to also obtain the accompanying Study Guide, which provides numerous additional questions.

We trust that you will enjoy the book.

Ken Trotman

Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of accounting and help you understand how the theory is applied in the real world.

CHAPTER OPENING FEATURES

The **learning objectives** and **chapter overview** give you a clear sense of what topics each chapter will cover and what you should be able to do after reading the chapter

FEATURES WITHIN CHAPTERS

The three main elements of a balance sheet are assets, liabilities and **shareholders' equity.**

Key terms in bold highlight important accounting terminology. Definitions for these terms can be found at the end of the book in the glossary.

HOW'S YOUR UNDERSTANDING?

How's your understanding activity questions throughout each chapter help you to reinforce your understanding of key concepts as you progress through the text, providing you with the opportunity to reflect and revise important material.

HOW'S YOUR UNDERSTANDING?

Here is a question you should be able to answer, based on what you have just read. If you can't answer it, it would be best to re-read the material.

What are the two main things that financial accounting measures?

Your answer should be: financial performance and financial position.

FOR YOUR INTEREST

For your interest sections present intriguing insights into the accounting profession and bring a unique perspective to the concepts covered in each chapter.

> **FOR YOUR INTEREST**
>
> Below is an observation from an experienced practitioner concerning double entry:
>
> I personally believe that if you can't understand the debits and credits of a client's business, you can't possibly understand where issues in their business or processes can occur. It is fundamental to being a good accountant, auditor or business advisor.
>
> Source: Fiona Campbell, Partner, Audit Services, Ernst & Young

A REAL CASE

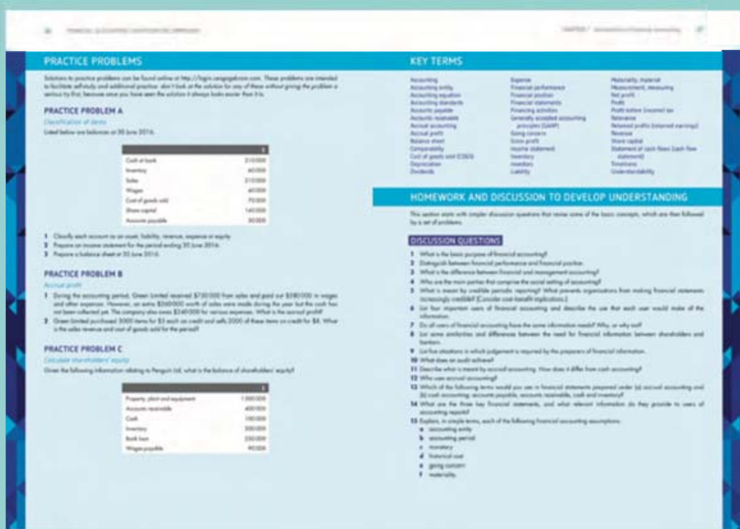
A real case boxes contain real-world examples of accounting scenarios that help you put the theory into practice.

> **A REAL CASE**
>
> Mike, a junior auditor, was assigned to do a surprise count of the cash on hand at a local clothing shop. The cash counted was short compared with what was expected, based on the auditors' projections of cash from sales and bank deposit records. Mike was accused by the shop's accounting clerk of stealing the cash himself while counting it, and he had to call the police and insist that they search him and so demonstrate that he had not stolen it.
>
> It turned out that the accounting clerk had been stealing cash and covering up the thefts by changing the sales records: a classic case of poor internal control through lack of segregation of duties, because the clerk

END-OF-CHAPTER FEATURES

At the end of each chapter you'll find several tools to help you to review, practice and extend your knowledge of the key learning outcomes.

- Practice problems give you the opportunity to test your knowledge and consolidate your learning.
- A list of key terms from the chapter have been provided to help with your revision.
- The homework and discussion to develop understanding section provides you with discussion questions, problems, and cases to help you with your revision.



Guide to the online resources

FOR THE INSTRUCTOR

Cengage Learning is pleased to provide you with a selection of resources that will help you prepare your lectures and assessments. These teaching tools are accessible via http://login.cengage.com.

SOLUTIONS MANUAL

The Solutions manual provides solutions to the discussion questions, the end-of-chapter problems and the case questions.

EXAMVIEW TEST BANK

ExamView helps you to create, customise and deliver tests in minutes for both print and online applications. The Quick Test Wizard and Online test Wizard guide you step-by-step through the test-creation process.

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Use the chapter-by-chapter PowerPoint presentations to enhance your lecture presentations and handouts to reinforce the key principles of your subject.

ARTWORK FROM THE TEXT

Add the digital files of graphs, pictures and flowcharts into your course management system, use them within student handouts or copy them into lecture presentations.

FOR THE STUDENT

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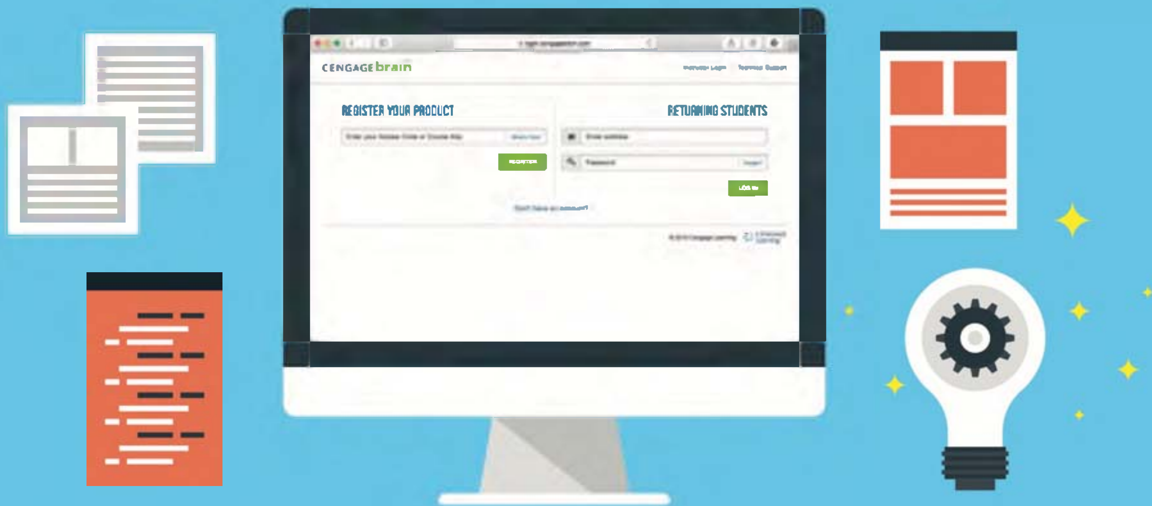

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- Glossary and Flashcards
- and much more!

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ALSO AVAILABLE

Available separately is an introductory Management Accounting eBook that helps you build a fully integrated understanding of financial accounting and management accounting. You can buy the Management Accounting eBook direct from CengageBrain.

About the authors

Ken Trotman is Scientia Professor in the School of Accounting at the University of New South Wales. He has an MCom(Hons) from the University of New South Wales and a PhD from the Australian Graduate School of Management (UNSW). He is a Fellow of both Chartered Accountants Australia and New Zealand and CPA Australia. Ken's major research interests include examining the processing of information by users of accounting reports and auditors, and the factors that affect the quality of their decisions. He has received the following awards from the American Accounting Association: 2001 Outstanding Educator Award by the Audit Section, 2008 Notable Contribution to the Auditing Literature Award, 2009 Notable (Lifetime) Contribution Award in Behavioral Accounting Literature, and 2014 Behavioral Outstanding Doctoral Dissertation Supervisor Award. He received the Outstanding Contribution to the Accounting Research Literature Award by the Accounting Association of Australia and New Zealand (AAANZ) in 1999. His research has resulted in him being made a Fellow of the Academy of Social Sciences in Australia. He is a former president of the AAANZ, a former Coopers & Lybrand visiting research professor and Director of Research for the audit section of the American Accounting Association. He has over 40 years of university teaching experience, much of which has covered introductory accounting. In addition to teaching in the School of Business, UNSW, he has taught at the University of Illinois at Urbana–Champaign, Cornell University and the University of Michigan. He has extensive consulting experience and has conducted many executive training programs in both the private and public sectors. He has published widely in Australian and international research journals and is on the editorial boards of numerous leading international research journals. In 2011 he was inducted into the Australian Accounting Hall of Fame.

Elizabeth Carson is a Professor in financial accounting and auditing at the University of New South Wales. Elizabeth's research interests include economics of global and national audit markets, industry specialisation by auditors and audit reporting. Her PhD investigating global audit firm networks and global industry specialisation by audit firms was awarded the American Accounting Association Auditing Section Outstanding Dissertation Award in 2008. Her work has appeared in leading academic journals including *The Accounting Review*, *Auditing: A Journal of Practice and Theory* and *Accounting and Finance*. Elizabeth teaches at postgraduate level in financial accounting and auditing, as well as supervising research students in the Honours, MPhil and PhD programs. She received the Pearson Education Accounting Lecturer of the Year award for her development of the 'Accounting: A User Perspective' subject in the Masters of Commerce program. Prior to joining academia, she worked with Pricewaterhouse Coopers (PwC) and is qualified as a chartered accountant.

Michael Gibbins is the Winspear Professor of Accounting in the Faculty of Business, University of Alberta. He has a BCom from the University of British Columbia, an MBA from York University and a PhD in accounting and psychology from Cornell University. He obtained his chartered accountancy designation in the Prince George office of what is now Deloitte & Touche. He has held appointments at Queens University School of Business, the Canadian Institute of Chartered Accountants and the University of British Columbia. His research and teaching interests lie in how people make decisions and judgements, and in the way accounting information is used in making important decisions in business and other economic spheres. A particular interest is in the professional judgement of public accountants, managers and other professionals who cope with the pressures and risks of modern business life. He has published widely on judgement, accounting, financial disclosure and educational subjects; is a former editor of the Canadian accounting research journal *Contemporary Accounting Research*; has been on the editorial boards of numerous academic journals; and is active in the Canadian Academic Accounting Association, the American Accounting Association and other professional bodies. He has received a number of education and teaching awards and in 1988 he received the honour of becoming a Fellow of both the Alberta and British Columbia Institutes of Chartered Accountants. Mike is now retired and lives in Edmonton, Canada.

Acknowledgements

The completion of this book was only achieved with the help of many individuals. My greatest thanks go to my former colleague, the late Gordon Howitt. Over 40 years ago Gordon inspired my interest in accounting. He taught me first-year accounting and subsequently as a staff member provided me with guidance and support. Without his help I could not have written this book. During the first edition he encouraged me, regularly checked on progress, continually read drafts, provided many questions, authored the solutions manual and generally offered friendship and support. This support continued with the reviewing of the second edition. For 50 years he made an outstanding contribution to accounting education at the University of New South Wales. I certainly have never met a more dedicated accounting teacher. It has been a privilege to work with him and we all miss his inspiration.

My co-author Mike Gibbins was kind enough to invite me to adapt his original Canadian textbook. Mike has an outstanding reputation as a researcher and I liked his version of the book so much that I decided to take on the task of co-author. My new co-author, Professor Elizabeth Carson, has provided me with many helpful suggestions on previous editions of the book and has helped to reshape many parts of this new edition of the book.

My life has been made much easier with the help of some very capable research assistants. Staff at the University of New South Wales and some other universities have been generous in providing me with material. Michael Pennisi provided material on GST and material on subsidiary ledgers, now in Chapter 8. Athol Carrington and Gordon Howitt provided me with some material in Chapter 5, as well as numerous questions, and Malcolm Miller with some material in Chapter 8. Rosina Mladenovic provided some material for Chapters 8 and 9 as well as numerous comments on the book. Gerry Galley wrote substantial sections of Chapter 11. Noel Harding provided material for Chapter 8. Chapter 17 was largely written by Andrew Trotman with excellent inputs from Tanya Fiedler and Sarah Adams as well as advice from Roger Simnett and Patricia Strong. Kate Morgan has rewritten Chapter 17 for the sixth edition as well as providing material for many chapters. Questions were also provided by Kevin Clarke, Victoria Clout, Claudia Gormily, Dean Hanlon, Noel Harding, Cameron Hooper, Andrew Jackson, Helen Kang, Jeffrey Knapp, Chris Poullaos, Patricia Strong and Per Tronnes. Malcolm Miller and Diane Mayorga have provided advice on technical issues over the years. Other useful comments were provided by present and ex-UNSW staff including Kar Ming Chong, Robert Czernkowski, Neil Fargher, Roger Gibson, Wendy Green, Noel Harding, Andrew Jackson, Amna Khalifa, Janice Loftus, Diane Mayorga, Richard Petty, Baljit Sidhu and Roger Simnett. Over various editions, advice from Stephen Bah (University of Newcastle), Peter Carey (Monash University), Peter Collett (University of Tasmania), Russell Craig, Linda English (University of Sydney), Vic Fatseas (Charles Sturt University), Jack Flanagan, Dean Hanlon (Monash University), Jan Hollingdale (Bond University) and Greg Whittred (University of Auckland) was appreciated. Cengage Learning also arranged for use of some material in Chapter 6 from the US book by I. Solomon, L. Wither, P. Vargo and L. Plunkett.

Ken Trotman

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1

Introduction to financial accounting

ON COMPLETION OF THIS CHAPTER, YOU SHOULD BE ABLE TO:

- describe the basic purpose of financial accounting
- identify the users of accounting information and the decisions they make that require accounting information
- identify the people who are involved in financial accounting
- describe how accrual accounting differs from cash accounting
- calculate accrual profit for an organisation
- explain the basic contents of the three key financial statements and describe the purpose of each statement
- describe the basic principles and assumptions of accounting
- explain why accounting is important.

CHAPTER OVERVIEW

Accounting has been described as the 'language of business'. It provides managers within organisations and those outside the organisation (e.g. investors and creditors) with information about the financial performance and financial position of the business. Regardless of what type of career you pursue, accounting information will have important effects on you.

This chapter introduces you to financial accounting and illustrates some useful accounting concepts and techniques. It outlines a way of thinking about financial accounting that will be important to your career, whether you become an accountant or a user of accounting in business or in other walks of life. You are introduced to the social setting of financial accounting and some of the people involved. Financial accounting is complex and requires sound judgement because it attempts to serve the needs of all these people, not all of whom necessarily see things the same way. You are then introduced to one of the cornerstones of how financial accounting works: accrual accounting, the broad framework within which financial accounting reports are prepared. You are also introduced to the three key financial statements and the basic financial statement assumptions. Examples from the financial press will help convince you of the importance of accounting information.

1.1 Use and preparation of accounting

Use

Financial accounting has value because the information it produces is used in a variety of ways. Users include managers, **investors**, bankers, financial analysts and many others. Such people study **accounting** to learn how to use information effectively and to do their jobs better. For accountants, this information is essential to the services they provide.

Preparation

Accounting is a complex human activity. Accounting information doesn't just happen: it is produced by a large set of people, activities and computers. To be effective users of the information, people need to know something about how and why the information is prepared. Accountants' expertise is all about the how and the why.

The demand for useful information shapes how financial accounting information is prepared; for example, when producing annual or monthly performance reports. How it is prepared shapes its use; for example, in financial analysis and managerial decisions.

FOR YOUR INTEREST

Learning terminology is important. To help you with that, this book has a glossary of terms at the back on page 734. If you're not sure what a term means, look it up right away.

Accounting is a challenging discipline that involves many capabilities: assigning numbers to represent financial phenomena; providing explanations of those numbers; analysing and verifying the information prepared by others; understanding the needs of those who use accounting's reports to make decisions; engaging in oral, written and electronic communication with the many people involved in an organisation's financial activities; and maintaining judgement that is sound, objective and ethical.

Much of the challenge of accounting is in figuring out which numbers to use and deciding what the numbers tell us. Adding and subtracting the numbers is often the easy part. This makes accounting both easier and harder to learn than you might have thought. Accounting is rooted in the financial setting, and has its own vocabulary, so don't expect it all to make perfect sense at the beginning. It will take a while for you to acquire the knowledge that creates an understanding of business and accounting as they really are in our world. This understanding will be based on your knowledge of both concepts and techniques, and of the viewpoints of both accountants and the users of accounting.

The going will not all be easy, but if you give it your best effort, you may be surprised at the high level of sophistication you will reach. Here is one important suggestion. The only way to learn accounting is to do problems. It is vital that you do more than just read the examples. After reading the chapter, come back and do the examples to check your understanding.

1.2 Financial accounting

Accounting is a process of identifying, measuring and communicating economic information to allow informed decisions by the users of that information. Accounting systems are often described as either financial accounting systems (where periodic **financial statements** are provided to external decision-makers, such as investors, creditors and customers) or management accounting systems (including information for planning and performance reports to managers throughout the organisation; that is, internal decision-makers).

Financial accounting measures an enterprise's performance over time and its position (status) at a point in time, and does so in Australian dollars, US dollars, yen, euros or whatever currency is judged relevant to the enterprise. This **measurement** of **financial performance** and **financial position** is done for all sorts of enterprises: large and small businesses, governments from local to national levels, universities, charities, churches, clubs, international associations and many others. The financial statements, which are financial accounting's reports, summarise the measurements of financial performance and financial position in standard ways thought to be useful in evaluating whether the enterprise has done well and is in good shape. These financial statements include notes, which contain many words (sometimes dozens of pages) of explanation and interpretation, in addition to the numbers. The statements report on the economic and financial matters and are largely for the use of people outside the enterprise, such as investors, lenders, club members, regulatory agencies and taxation authorities.

In summary:

- *Financial performance* is the generation of new resources from day-to-day operations over a period of time.
- *Financial position* is the enterprise's set of financial resources and obligations at a point in time.
- *Financial statements* are the reports describing financial performance and position (e.g. the balance sheet and the income statement).
- *Notes* are part of the statements, adding explanations to the numbers.

As we will see throughout this book, financial performance and position are highly related. Good performance is likely to lead to a healthy financial position; if a company has been making profits, it will probably build up resources. On the other hand, a healthy financial position facilitates performance; if you have lots of resources compared to obligations, the company can undertake activities that lead to good performance.

Another branch of accounting, management accounting, is oriented towards helping managers and others inside the enterprise, in contrast to financial accounting's more external focus. While management accounting is not examined in this book, students interested in how financial accounting measures managerial performance will find frequent references to the relationship between managers and financial accounting. In the end, all forms of accounting exist to help people such as managers, investors, bankers, legislators and the public make financial decisions.

HOW'S YOUR UNDERSTANDING?

Here is a question you should be able to answer, based on what you have just read. If you can't answer it, it would be best to re-read the material.

What are the two main things that financial accounting measures?

Your answer should be: financial performance and financial position.

1.3 Who uses financial accounting information?

This book will show you the many ways in which financial accounting has been shaped by the development of business and society. Financial accounting helps:

- stock market investors decide whether to buy, sell or hold shares of companies
- banks and other lenders decide whether or not to lend
- managers run enterprises on behalf of owners, members or citizens (in addition to the help provided by management accounting and other sources of information)
- management by providing basic financial records for the purposes of day-to-day management, control, insurance and fraud prevention
- governments in monitoring the actions of enterprises and in assessing taxes, such as income tax and the goods and services tax (GST).

Whole books can be, and have been, written about each of these functions. Though this book emphasises externally oriented financial accounting for business firms, don't forget that there are many other organisations that use, and are affected by, accounting. When words like 'organisation', 'company' or 'enterprise' are used, the implications often go well beyond business firms.

The centre of our interest in this book – financial accounting for the enterprise – operates within and serves a complex social setting. It seeks to monitor and report on financial events initiated by or happening to the enterprise. Accounting is not a passive force within the social setting: it tells us what is going on, but in so doing it affects our decisions and actions and, therefore, also affects what is going on.

The social setting is composed of many people, including groups, companies, institutions and other parties interested in, or having an influence on, the company's financial accounting. As we will see many times in this book, these parties do not share the same interest in the company's accounting, and may even be in competition or conflict with each other. Most will be in the same country as the company and its management but, increasingly, companies and other enterprises are operating internationally. The other groups interested in, and affecting, the company's financial accounting may be located anywhere on the planet.

Let's consider some possible users of the financial statements of a listed company:

- A company's board of directors manages the company on behalf of its shareholders. One function of the board, which involves the financial statements, is hiring the company's top operating management – especially the chief executive officer (CEO). Suppose you are a member of the board and are preparing for a discussion at the next board meeting. The board evaluates the CEO's performance continuously, which is its responsibility. The financial statements have been provided to the board prior to the meeting, and will be a major contribution to this evaluation.
- A company's shares are listed (i.e. can be bought and sold) on the Australian Stock Exchange (ASX). Suppose you are a financial analyst for an investment dealer and are preparing a report projecting future earnings and making recommendations about whether the company's shares are worth buying, keeping if already held, or instead should be sold. You have the financial statements and will use them to support your report.
- A company has several hundred million dollars in bank borrowings, and lines of credit (pre-authorised borrowing capability) for millions of dollars more. Suppose you are a commercial lending officer for a bank, conducting a regular review of the company's borrowing status. You must consider the quality of the company's financial performance and assets (many of which have been assigned as security on bank loans, and therefore could be seized if the company doesn't pay its loans back on schedule). Financial performance is important because **net profit** generates cash to pay loans, and a good past record suggests that the company is likely to be able to earn profit in the future. You have requested the financial statements to use in your review.
- A company depends on a large number of suppliers to obtain goods and services. Suppose you are the sales manager of a stationery supplier and are considering signing a long-term contract to supply the company. You want to sign the contract because your company needs the business, but you have to be satisfied that your shipments will be paid for. More positively, you hope that if you do a good job, you will have an opportunity to grow with the company. Most of the information you need has been received already, but you have obtained the financial statements and are reviewing them as you make your final decisions about the contract.

In summary, these scenarios indicate the following reasons for using the company's financial statements:

- evaluation of the CEO's performance by a member of the board of directors
- preparation of 'buy', 'sell' or 'hold' recommendations by a financial analyst
- review of the company's borrowing status by a bank lending officer
- development of a supply contract with the company by a stationery supplier's sales manager.

These scenarios have been chosen to add to your insight into the use of financial accounting information. They are not complete. In all cases, the financial statements would be only part of the information used in the decision-making process. Also, there are many other uses for financial statements, some of which might make different demands on the quality of the information from those discussed here.

FOR YOUR INTEREST

Above we noted that financial statements would be only part of the information used by various groups such as investors and management in decision-making. Another important type of information is sustainability reporting. These reports include information on economic, environmental, social and safety performance. For example, they could include information on carbon emissions, energy usage, employee safety, community involvement, etc. We introduce this material in Chapter 17, as many companies now include this information in their annual reports or separate sustainability reports.

1.4 The people involved in financial accounting

The main participants in the art of financial accounting are:

- the information users (the decision-makers)
- the information preparers, who put together the information to facilitate the users' decision-making
- the auditors, who assist the users by enhancing the credibility of the information, providing a professional opinion about the fairness and appropriateness of the information.

Users (decision-makers)

In financial accounting, a user or decision-maker is someone who makes decisions on the basis of the financial statements, on his or her own behalf, or on behalf of a company, bank or other organisation. Ultimately, the nature and contents of financial statements are functions of the demand for decision information from users. If user demand is the fundamental reason for financial statements, understanding the demand is important.

A user's main demand is for the *credible periodic reporting* of an enterprise's financial position and performance:

- *Credible* means that the information in the reports (the financial statements) appears to be sufficiently trustworthy and competently prepared for it to be used to make decisions. There is a cost–benefit issue here: huge amounts of money could be spent trying to make the reports absolutely perfect, but since that money would have to come out of the enterprise's funds, spending it would make its performance and position poorer. Users, such as owners and managers, may not want that to happen, so credibility is a relative condition, not an absolute one. Accounting information has to be worth its cost.
- *Periodic* means that users can expect reports on some regular basis (such as yearly or quarterly). The longer the wait, the more solid is the information. But waiting a long time for information is not desirable: users are willing to accept some imprecision in the information in return for periodic reports with timely, decision-relevant information.

The main groups of users are as follows:

- *Owners* are individual business owners, such as proprietors, partners and other entrepreneurs; individual investors (shareholders) in shares on stock markets who can vote on company affairs; companies that invest in other companies; superannuation funds and other institutions that invest in companies; and people with quasi-ownership interests, such as members of clubs or voters in local councils. In respect of companies, shareholders own portions of the corporation – shares that can be bought and sold – but the corporation is a legal entity existing separately from its shareholder owners. Investors purchase shares in a company with the hope of gaining in two ways: receiving a portion of the company's profit in the form of **dividends**, and being able to sell their shares in the future at a price higher than they paid.
- *Potential owners* are people of the same sort as the owners listed above, who do not at present have funds invested in the enterprise but may be considering making such an investment. Because potential owners often buy shares from present owners – for example, by trading shares on the stock market – rather than investing directly,

there is often a significant difference in outlook between present owners, who may wish to sell their shares for as much as possible, and potential owners, who would like to pay as little as possible.

- *Creditors and potential creditors* are suppliers, banks, bondholders, employees and others who have lent money to the enterprise, who are owed funds in return for supplying something of value, or who are considering taking on such a role. Creditors do not have the legal control of the enterprise that owners have, but they often have a large say in enterprise decisions, especially if the enterprise gets into difficulty. In cases of extreme difficulty, creditors may have the right to take over control of the enterprise from the owners. Sometimes the difference between creditors and owners is hard to discern because it may depend on subtle legalities about who has what rights, and some people may play both roles for a given enterprise. For example, an owner invests money in a business, but in addition may lend the business further money, becoming a creditor as well as an owner. Creditors need to decide whether to supply goods or services to the firm on credit.
- *Managers* are those who run the enterprise on behalf of the owners. They have a great interest in the way accounting reports on their activities and results. They use the information for planning, controlling and organising the activities of the entity. Often managers' salaries and bonuses, and the likelihood of staying in their jobs, are directly affected by the contents of the financial statements. In small businesses in particular, the owner may also be the main manager.
- *Employees and their unions or other associations* are interested in the enterprise's ability to pay wages, maintain employment levels and keep such promises as paying superannuation contributions. Financial information can be used to assess job security.
- *Regulators and other government bodies and agencies* are groups that may use the financial statements as a basis to evaluate whether the enterprise is following various rules and agreements.
- *Financial and market analysts* are people who study companies' performances and prepare reports for others by analysing those companies. Analysts often make recommendations about whether to invest, sell or do neither.
- *Competitors* may use the financial statements to try to understand the enterprise's operations for the purpose of making life more difficult for the enterprise. Sometimes, for example, managers are reluctant to disclose information to shareholders, because competitors can then also obtain it and act to reduce the enterprise's prospects.
- *Accounting researchers* are people – mostly university academics, but also some based in accounting firms and other organisations – who study accounting with the objective of understanding it and contributing to its improvement.
- *Customers* need to consider if the entity is financially sound. This is particularly important when customers are required to pay amounts in advance. It is also important if customers rely on the warranties provided by the entity.
- *Miscellaneous third parties* are various other people who may get access to an enterprise's financial statements and use them in various ways. Once statements have been issued, many people may make use of them. For example, politicians may make judgements about industry efficiency or taxation levels, journalists may write stories about employment practices, and judges may evaluate the enterprise's ability to pay if it loses a lawsuit.

Think about all these users and decisions! It is a great challenge to develop one set of periodic financial statements for an enterprise so that it can be useful for all. Perhaps you will not be surprised to know that there is much controversy about whether financial statements do this well, and whether financial accounting methods serve some users or decisions better than others.

How likely is it that you, the reader, will use accounting information in the future?

If you plan to be an **accountant**, the value of studying financial accounting is clear. It may not be so clear, however, if you have other plans, such as a career in management, marketing, finance, engineering, law, human resources or production. To provide some perspective to those of you not planning an accounting career, and to help you understand the managers you will work with if you do become an accountant or auditor, comments will be made frequently about managers and financial accounting.

Financial accounting is directly relevant to managers because it reports on the managers' performance as decision-makers, caretakers of the enterprise, representatives of the owners, legal officers of the enterprise, and so on. Any manager cannot help but be interested in how her or his performance is being measured and in how that performance is analysed, projected and otherwise evaluated. Managers' bonuses, promotions, dismissals, transfers and other rewards and penalties are often directly based on the numbers and commentaries prepared by accountants. Every manager should have an intimate understanding of how accounting is measuring his or her performance and should be able to conduct a 'reasonableness check' of the information being provided. It is critical for managers to understand the impact of every decision they are making on accounting numbers as these numbers will measure their performance.

Here are a few examples of how non-accounting managers may use accounting information.

Marketing managers need to understand the financial statements of potential customers to determine which customers to focus on and which ones to extend credit to. Purchasing managers need to understand suppliers' financial statements to make sure they have the capacity to supply in the long term. Human resources managers use accounting information in salary negotiations, and information systems designers need to include the accounting information system in their design.

If you are extremely talented and have decided to make your fortune as a sports star or musician, you still need to know about accounting. We suggest that understanding the financial statements of the Sydney Cricket Ground or the Opera House would be of benefit in negotiating with those organisations.

Preparers (decision facilitators)

Two main groups are responsible for the information in the financial statements:

- *Managers* are responsible for running an enterprise, including issuing accounting and other information, and controlling its financial affairs. The fact that managers are also users, and are vitally interested in the results, has created a fundamental conflict of interest for them and has led to the development of the auditing function (see below). Managers are often referred to, as a group, as management.
- *Accountants* have the job of shaping the financial statements by applying the principles of accounting to the enterprise's records, under the direction of management. Many accountants are members of professional societies, such as CPA Australia, Chartered Accountants in Australia and New Zealand, and the Hong Kong Society of Accountants. Accountants and their professional bodies also often have auditing experience and interests, and sometimes auditing roles, but the task of preparing the financial statements is quite different in principle from the task of verifying those statements once they are prepared.

Auditors (credibility enhancers)

Auditors report on the credibility of the enterprise's financial statements, on behalf of owners and others. Auditors have the job of assisting the users by verifying that the financial statements have been prepared fairly, competently and in a manner consistent with accepted **accounting principles**. The auditing role is a very old one, arising because users demanded some assurance that managers' reports on their performance were not self-serving, biased or downright untruthful. This book refers frequently to external auditors, who report on the financial statements on behalf of external users, but there are also internal auditors, who work within the enterprise to support the credibility of information being used by management, and other auditors (such as tax auditors, who verify taxpayers' computation of tax). While external auditors may be asked for advice in preparing the statements, especially for small companies, they must avoid responsibility for the statements because their role is to scrutinise the preparation process. They cannot credibly audit statements they have prepared! (Professional accountants often do prepare financial statements, but in so doing they are not acting as external auditors, and they make this clear in covering letters and footnotes attached to the statements.)

The external auditors are formally appointed by the owners; for example, at the annual shareholders' meeting. But an enterprise's external auditor is not permitted to be an owner or manager of the enterprise. For example, they cannot own shares in the company and they cannot act as a director or manager of the company, even for a small part of the year. This is to ensure that the auditor is financially and ethically independent and can therefore be objective about the enterprise's financial affairs. Independence and objectivity are fundamental ideas that you will encounter frequently in this book.

External auditors may work alone or in partnership with other auditors in accounting firms. Some of these firms are very large, having thousands of partners and tens of thousands of employees, and offices in many cities and countries. Accounting firms offer their clients not only external auditing but also advice on income tax, accounting, computer systems and many other financial and business topics. However, if they conduct the audit there are rules in place about what other services they can provide, as auditors cannot be involved in auditing their own work, or creating any conflict-of-interest problems. Managing this requires considerable professional skill and attention to the ethics and rules of professional conduct. Whether this is being done successfully is a matter of much controversy at present. In Australia, as well as in many overseas countries, there has been additional regulation aimed at improving the independence of auditors. The large accounting firms annually spend many millions of dollars on their independence and quality-control systems.

People and ethics

Ethics, mentioned above, will be raised throughout this book. Ethical issues can arise in just about any area of accounting. Here are some examples, all of them real:

- An enterprise has been sued by a recently fired employee who claims that the dismissed was based on the employee's age, and therefore broke employment laws. The enterprise's general manager denies any impropriety. The enterprise's chief accountant, who personally feels that the former employee's claim is justified, has suggested to the boss that the lawsuit should be mentioned in a note to the financial statements, so that users of the statements will know there is a potential for loss if the former employee wins. The general manager feels that the chief accountant should ignore the lawsuit in preparing the financial statements, to avoid embarrassment and the appearance of admitting guilt. The general manager fears that such an apparent admission could be used against the enterprise in court and so could cause the enterprise to lose the lawsuit. What should the chief accountant do?
- While doing an audit, the external auditor learns that the enterprise may have been cheating one of its customers. The customer, who is unaware of this and quite happy with things, is another client of the auditor. The auditor, who is bound by rules of conduct designed to protect the confidentiality of information gained during the audit, knows that saying anything to anyone could result in major lawsuits. Should the auditor just keep quiet about what was found?
- A third enterprise's general manager is paid a bonus each year, calculated as a percentage of profit. The general manager is considering a proposed change of **depreciation** method that will reduce depreciation **expense** and therefore raise **accrual profit** and increase the general manager's bonus. Should the general manager refuse to implement the accounting change, request that the bonus calculation ignore the change, or just go ahead and enjoy the higher bonus?

These illustrative problems do not have easy answers, so none are offered here. They are dilemmas for the chief accountant, the auditor and the general manager. This book will address ethical issues from time to time, helping you to sharpen your ethical sense along with your accounting knowledge – the two are inseparable.

1.5 Accrual accounting

Financial accounting's task of producing financial statements is a complex one. For even a small business, thousands of events (transactions) have to be recorded and their financial effects evaluated. For large corporations such as BHP Billiton, Lend Lease, Rio Tinto, Woolworths, AMP, Qantas and Westpac, or organisations such as the University of New South Wales, Brisbane City Council or the Red Cross, the number of annual transactions runs into the millions or billions. Frequently, when the time comes to prepare the financial statements, some transactions have not been completed, are in dispute or have an otherwise unclear status. Here are examples in which appropriate figures may be difficult to determine:

- The value of Westpac's overseas loans (i.e. the money actually to be received back from those loans) depends on the health of the borrowing countries' economies, stability in international money-transfer arrangements (often disrupted by wars, politics and natural disasters) and the relative values of various countries' currencies, which, like nickel prices, can change a lot from day to day.
- The value of donations promised to the Red Cross but not yet received depends on how committed donors are to actually producing the cash. This commitment can be affected by unemployment, rising prices for food and other goods the donors need, and other factors beyond the Red Cross's control.
- The amount of profit that should be recognised during the year by Leighton Holdings for the construction of a major bridge that will take two years to complete will depend on future expenses.

To cope with these complexities, financial accounting for most businesses and organisations uses the **accrual accounting** approach. Under an accrual accounting system, the impact of transactions on the financial statements is recognised in the time periods during which **revenues** and expenses occur, rather than when the cash is received or paid. Formal definitions of revenues and expenses can be quite complicated, and are left to Chapter 2. At this stage, we will provide examples of the main types of revenues and expenses.

The main form of revenue is usually the sale of goods or services; for example, the sale of coffee machines for $45 000 or carrying out the installation of a new computer system for $300 000. Other revenues include interest on investments held, dividends received on shares and rent from premises owned by the company.

Expenses include the costs of services and resources consumed in the process of generating revenues. Examples of costs incurred are wages, electricity, travel and rent. An example of resources consumed is depreciation. Organisations depreciate the cost of an asset (such as a motor vehicle or a printing machine) over the useful life of the asset; that is, each year a percentage of the cost of the asset becomes an expense. These assets are helping in generating revenue; therefore, a share of the cost should be treated as an expense in each accounting period during which the asset helps generate revenue.

Why do we depreciate the cost of an asset over its useful life rather than treat the cost of the asset as an expense in the first year? The reason is that the asset is used over many years and helps generate revenue over many periods. This depreciation expense is matched to the revenues earned during the period. Note that estimates need to be made. For example, a printing machine that cost $480 000 would have annual depreciation of $120 000, $96 000 or $80 000, depending on whether its estimated life is four, five or six years; that is, the judgement on the useful life of the machine has an impact on profit each year.

HOW'S YOUR UNDERSTANDING?

List the main revenues and expenses for a coffee cart you see on campus or in the city.

Your answers should be as follows. The main revenue will come from coffee sales. If all sales are cash sales it would be the cash received for the coffees sold. But note that some customers may have an account where all coffees sold to them are recorded and then they pay the whole amount the following month on receipt of an invoice. Note that under accrual accounting it is the delivery of the service (i.e. handing over the cup of coffee) that results in revenue being recognised. Likely expenses include:

- the cost of coffee
- the cost of cups
- wages
- rent of space (e.g. to the university)
- depreciation on the coffee machine.

Accrual accounting versus cash accounting

Before considering these complexities, let's consider the basic differences between cash accounting and accrual accounting.

- *Cash accounting* involves recording revenues and expenses at the time the cash is received or paid. This is reasonably precise, because the accountant knows whether cash has been paid or received and the exact amount is easily determined (from accounting books or bank statements).
- However, often the timing of cash flow is in a different accounting period from the substance of the transaction. Examples include selling **inventory** on credit; when a contractor fixes machinery but will not be paid until a later accounting period; or the use of machinery, which reduces its future useful life. As noted above (but worth repeating), *accrual accounting incorporates these complexities by recording revenues and expenses at the time they occur, not when cash is received.*

To compare cash profit with accrual profit, consider the following:

- A company makes credit sales of $100 000 in June, which will be collected in July. Under an accrual system, $100 000 revenue would be included in June, whereas under a cash system the amount would be recognised in July.
- A contractor carries out repair work for your company in June for $20 000, but the bill will not be paid until July. Under an accrual system, the expense would be recognised in June, but under a cash system it would not be recognised until July.
- Under accrual accounting there will be an allocation of the cost of equipment to expenses over several accounting periods to recognise the consumption of the equipment's future economic value. This is called depreciation. If some new equipment cost $80 000 and has a life of eight years, $10 000 depreciation would be included in expenses each year.

HOW'S YOUR UNDERSTANDING?

In June, a company makes cash sales of $10 000 and credit sales of $20 000 (all to be collected in July). It pays wages of $6000 and owes $1000 for June expenses (to be paid in July).

1. What is profit using cash accounting?
2. What is profit using accrual accounting?

Your answers should be:

1. $10 000 – $6000 = $4000
2. $10 000 + $20 000 – $6000 – $1000 = $23 000.

Using accrual accounting to prepare financial statements

Using the accrual accounting approach in preparing the financial statements, attempts are made to:

- include all the cash receipts and payments that have already happened; for example, cash sale and cash payment for wages
- incorporate future cash receipts and payments that should be expected, based on existing transactions; for example, it is necessary to include the credit sale now, although the cash will not arrive until the next period
- measure the value of incomplete transactions; for example, estimate the likely amount of **accounts receivable** that will not be collected, and treat the amount as an expense of this year
- estimate figures when exact amounts are unknown; for example, estimate the amount of interest due from the bank at year-end, even though the bank does not add the interest to your account for another two months – the amount is interest revenue