CONTEMPORARY ACCOUNTING
A STRATEGIC APPROACH FOR USERS

PHIL HANCOCK
PETER ROBINSON
MIKE BAZLEY

9TH EDITION

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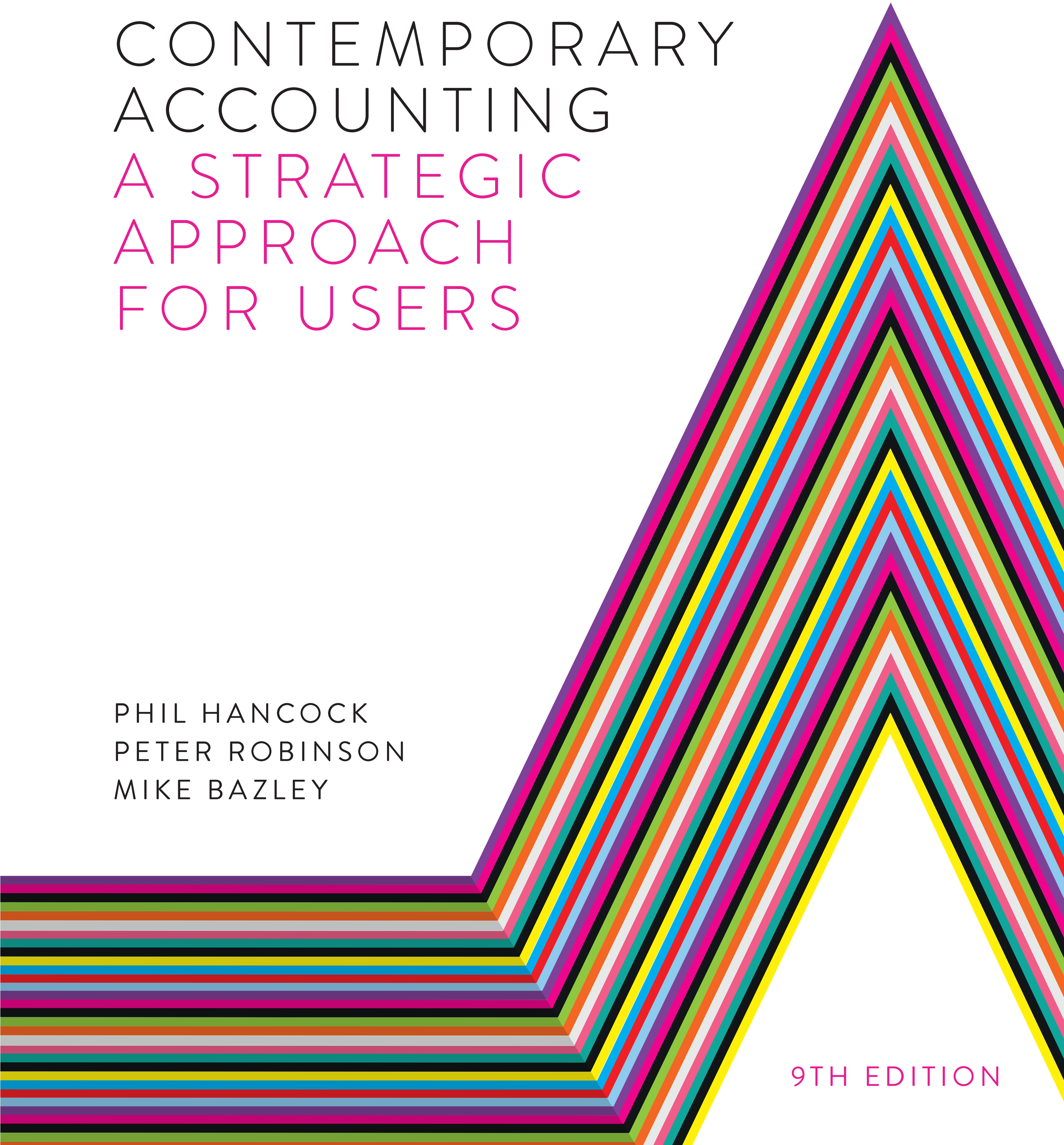

9TH EDITION

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9th Edition
Phil Hancock
Peter Robinson
Mike Bazley

Publishing manager: Dorothy Chiu
Publishing editor: Geoff Howard
Developmental editor: Gregory Hazelwood
Senior project editor: Tanya Simmons
Art direction: Danielle Maccarone
Cover design: Neil Keighley
Text design: Aisling Gallagher
Permissions/Photo researcher: Janet McKeown
Editor: Angela Tannous
Proofreader: Penelope Goodes
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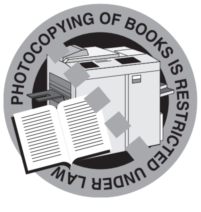

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Cengage Learning Australia
Level 7, 80 Dorcas Street
South Melbourne, Victoria Australia 3205

Cengage Learning New Zealand
Unit 4B Rosedale Office Park
331 Rosedale Road, Albany, North Shore 0632, NZ

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PREFACE

Contemporary Accounting, 9th edition, provides an introduction to accounting for students at universities and other higher education institutions. With the nature and extent of topic coverage, the text meets the needs of students completing a first course in accounting. Thus, the text is well suited to fulfilling the requirements of a one-semester unit in accounting for students enrolled in undergraduate accounting and non-accounting majors or MBA or equivalent post graduate qualifications. The book provides an excellent overview of the accounting function in business for non-accounting majors, and the approach taken to financial accounting provides a solid foundation on which accounting majors can better understand the bookkeeping function. Supplementary materials are available for instructors who want more material on double-entry bookkeeping to support the concepts covered in the book. Where relevant, the implications of different accounting policy choices for managers and other external decision makers are discussed.

The objective of this textbook is to convey an understanding of accounting without introducing unnecessary technical terminology and procedures. Building on basic concepts, it provides a clear understanding of financial statements, their uses and limitations. Accounting terms and concepts are defined in accordance with official pronouncements. Given that Australia has adopted International Financial Reporting Standards (IFRS) for use by all reporting entities in the private and public sectors, the IFRS and relevant pronouncements on the conceptual framework issued by the International Accounting Standards Board (IASB) provide the conceptual basis of *Contemporary Accounting*. Where required, these concepts and regulatory requirements are used to analyse various issues in accounting.

Where appropriate, extracts from annual reports are provided to illustrate contemporary accounting practices. Also included are extracts from the 2013 Woolworths Limited Annual Report. This report appears in Appendix 1 and students are invited to refer to it frequently throughout the text.

Worksheets, based upon the balance sheet equation, are used to introduce accounting techniques and principles such as duality. The in-chapter worked examples and end-of-chapter questions provide students with an understanding of concepts such as assets, liabilities, equity, income, revenues and expenses, and allow them to see how financial statements are prepared. This approach avoids the problems often experienced by students in trying to understand debits and credits.

The text covers financial accounting in Chapters 1 to 11, and these chapters focus on the development of accounting information relevant to the decision-making needs of external users. Chapters 12 to 18 examine the decision-making needs of internal users (i.e. managers) and provide an introduction to core management accounting topics. In each chapter learning objectives and key concepts are identified and highlighted. Review exercises are included and solutions are provided at the end of each chapter. Additional review questions and problems are provided at the end of each chapter. The problems are presented in order of difficulty. The more difficult problems are primarily intended for use in MBA courses (and these are indicated in each chapter) but instructors of undergraduate courses may also find them useful. The ethics case studies are intended for all students and are well suited to in-class group discussions. We recommend that students refer to the comprehensive glossary as they work through the book.

Contemporary Accounting has been presented in a manner that students find easy to read. The response to the first eight editions of this book has been very positive. However, there are major changes in the 9th edition of the book. These changes have been made in response to comments from past and current users of the book, and also in response to changes that have occurred in education, the business world and the accounting profession.

A NEW APPROACH

With the unfortunate passing of Mike Bazley, Peter Robinson has joined with Phil Hancock as an author of *Contemporary Accounting*. On the basis of feedback received and the introduction of a new author, a thorough review of the text has been undertaken. While the main elements of the text, including the conceptual approach and the use of the worksheet, have been retained, the strategic role of accounting information has been given a greater emphasis.

The main changes to each chapter are outlined below:

- Chapter 1 includes the new G4 version of the Global Reporting Initiative and provides an expanded discussion on agency theory and costly contracting.
- Chapter 2 provides the discussion of group or consolidated accounts, which was covered in Chapter 11 in the 8th edition. Some material on the standard setting process has been removed. An example has been added to illustrate the difference between cash and accrual accounting.
- Chapters 3 and 4 are similar to the 8th edition.
- Chapter 5 has been amended so that it now commences with a discussion about business activities and introduces the worksheet to record transactions.
- Chapter 6 presents a more simplified discussion of the statement of changes in equity.
- Chapter 7 is a new chapter on statement of cash flows, following the coverage of the other three financial statements. It includes much of the content on cash flow statements from Chapter 11 of the 8th edition.
- Chapter 8 is a new chapter on accounting for assets. It covers receivables, inventory, property, plant and equipment, and intangible assets. It incorporates the material from chapters 7, 8 and 9 of the 8th edition but in much less detail.
- Chapter 9 is a new chapter on accounting for liabilities. It covers accounts payable, accruals, provisions, taxation and financial liabilities such as hire purchase, leases, bank overdrafts and long-term loans and debentures. It also covers equity as a source of funds.
- Chapter 10 covers financial statement analysis and is similar to Chapter 13 of the 8th edition.
- Chapter 11 reviews how worksheet transactions can be recorded using debits and credits, and is similar to Chapter 13 of the 8th edition.
- Chapter 12 draws upon the material previously covered in Chapter 14 of the 8th edition and introduces management accounting as a source of information used by managers to make resource allocation decisions. New features in Chapter 12 include the use of the value chain concept to illustrate the range of activities undertaken by a firm, and more detailed coverage of Michael Porter's five forces analysis and generic competitive strategies.
- Chapter 13 examines the material on performance measurement covered in Chapter 20 of the 8th edition. This material provides a strategic analysis of performance measurement, including the use of different financial and non-financial performance measures and the use of the balanced scorecard as a comprehensive performance management framework.
- Chapter 14 provides a more integrated and comprehensive examination of costs, including the nature and behaviour of costs, direct and indirect costs, product and period costs, and the allocation of overhead costs using traditional volume and activity-based cost allocation models. It combines material previously covered in Chapters 16 and 17 of the 8th edition.
- Chapter 15 is based on Chapter 19 of the 8th edition, and examines the nature and purpose of budgets with a detailed practical illustration of the development of a master budget. The material on budgets is extended to cover the nature and purpose of projected financial statements.

- With the discussion of cost behaviour now appearing in Chapter 14, Chapter 16 provides a more focused examination of cost-volume-profit analysis, previously covered in Chapter 17 of the 8th edition.
- Chapter 17 incorporates the material previously covered in Chapter 18 of the 8th edition, and examines short-term decision making with and without resource constraints, as well as key management accounting concepts such as sunk, opportunity and relevant costs.
- Chapter 18 examines long-term decision making (i.e. capital investment projects), previously which was covered in Chapter 15 in the 8th edition. The revised chapter provides additional commentary on different types of capital investment decisions, dealing with uncertainty and post-implementation audits.

Additional within textbook resources included are as follows:

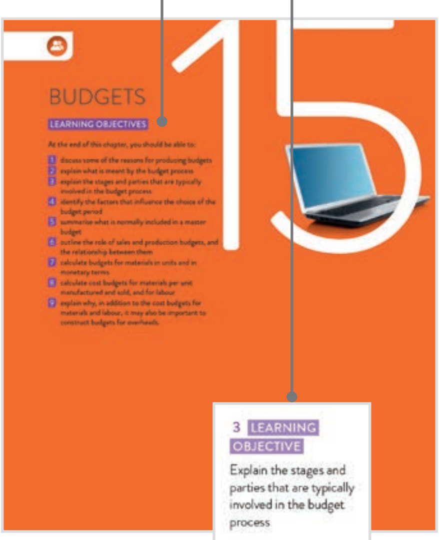
- Appendix 1 provides an extract from the Annual Report of Woolworths Limited for the year ending 30 June 2013. Reference is made to the Woolworths financial report throughout the financial accounting section of the 9th edition, enabling readers to examine the financial report of a real company. Most of the financial accounting chapters include end-of-chapter questions relating to the report. These questions are intended to encourage student interest in reading published financial reports and becoming familiar with the contents.
- Updated Recent newspaper articles are used to illustrate the various topics discussed in many chapters. These articles provide a real-world context for the subject matter discussed, as well as stimulating student interest in accounting as a field of professional practice.

RESOURCES GUIDE

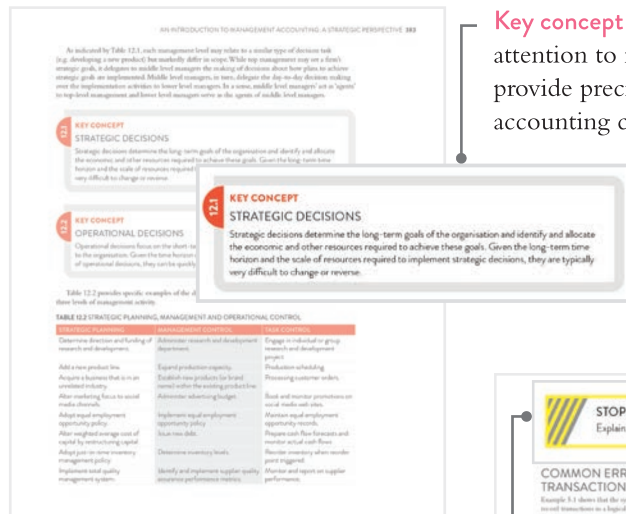
FOR THE STUDENT

As you read this text you will find a number of features in every chapter that enhance your study of accounting, and will enable you to relate these concepts to real-world accounting applications.

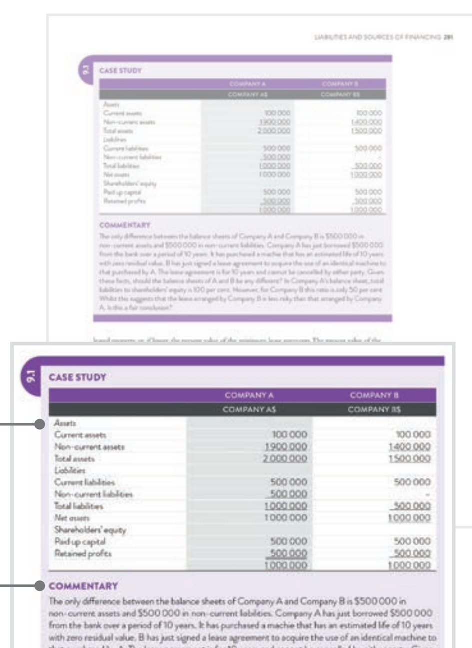
Learning objectives introduce each chapter and give a clear outline of what you will be studying. The learning objectives are also referenced by margin icons to enhance your learning experience.



Key concept boxes bring special attention to important points and provide precise definitions of key accounting concepts.

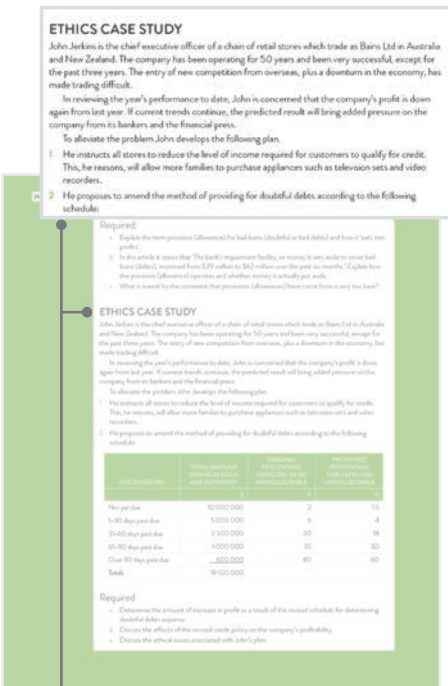


Stop and think exercises progressively reinforce your understanding of key concepts, and provide you with the opportunity to reflect and revise important concepts.



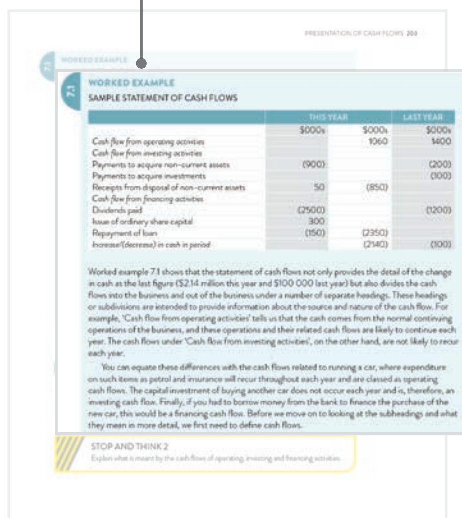
Case studies help you to relate accounting to the real-world business environment.

Each one has a clearly marked Commentary section that outlines the discussion in the case.



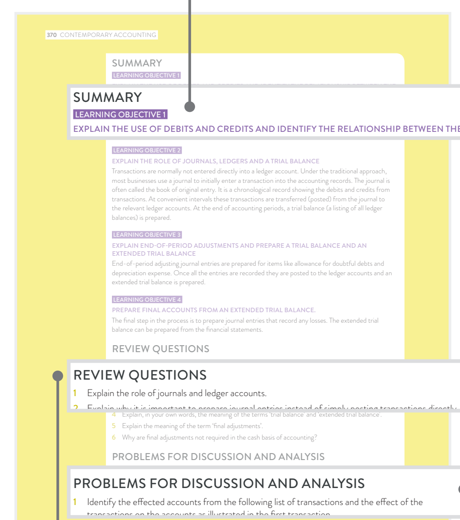
Ethics case studies provide you with real-world examples and dilemmas toyou're your understanding of ethics in accounting.

Worked examples provide you with a step-by-step guide to approaching important concepts.



At the end of the chapter, you will find several learning tools to help you review the chapter's key concepts and extend your learning.

The **summary** reviews the chapter's main points and reflects its learning objectives to consolidate your understanding of key concepts and issues.



Review questions enable you to test your comprehension of the chief aspects of the chapter.

Problems for discussion and analysis are presented in order of difficulty, with more difficult questions labelled as suitable for postgraduate students.

WOOLWORTHS LTD 2013 ANNUAL REPORT

Extracts from the Woolworths Ltd Annual Report 2013 are included in the **appendix**. The margin icon on the left highlights when references to these extracts are made in the financial accounting section of this text so you acquire an appreciation of and become familiar with the financial report of a real company. Questions relating to this report can be found in the end-of-chapter sections.

ETHICS AND CORPORATE SOCIAL RESPONSIBILITY

Throughout the text you will find the **ethics and corporate social responsibility** margin icon to indicate the discussion of issues relating to ethics, and corporate social responsibility.

CENGAGENOW

The ninth edition of Contemporary Accounting has a dedicated CengageNOW study tool that integrates the material in the text with myriad review opportunities. You can test your understanding of chapter concepts, concentrate your revision on your weakest areas and then verify your progress using the latest technology.

For updates and news relating to *Contemporary Accounting*, please go to http://login.cengagebrain.com/.

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Also available from Cengage Learning is Got It Accounting so you can get key accounting concepts locked down. This unique revision model sorts through eight key topics to make sure you really have 'got it' in time to pass your first assessment. Buy it now from https://gotit.net.au for less than the price of a cup of coffee.

FOR THE INSTRUCTOR

Cengage Learning is pleased to provide you with a selection of resources that will help you prepare your lectures. These teaching tools are available on the companion website, accessible via http://login.cengage.com.

SOLUTIONS MANUAL

The solutions manual provides instructors with suggested solutions to all the end-of-chapter questions in the text.

POWERPOINT PRESENTATIONS

Chapter-by-chapter PowerPoint presentations cover the main concepts addressed within the text and can be edited to suit your own requirements. Use these slides for student handouts or to enhance your lecture presentations and to reinforce the key principles of your subject, or for student handouts.

ARTWORK

The digital artwork files of graphs, tables, and exhibits from the book can be used in a variety of media. Add them into your course management system, use them within student handouts or copy them into lecture presentations.

CENGAGENOW

CengageNOW for the ninth edition of *Contemporary Accounting* is a powerful and fully integrated online teaching and learning system that provides you with flexibility and control. This complete digital solution offers a comprehensive set of digital tools to power your course:

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- Personalised study plans, which include a variety of revision tools (animated examples, quizzes, games) for students to use as they master the chapter materials
- Assessment options, which include the full test bank
- Course management tools, including the grade book
- WebCT and Blackboard integration.

EXAMVIEW TEST BANK

ExamView test bank 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. With ExamView's complete word-processing abilities, you can add an unlimited number of new questions to the bank, edit existing questions and build tests of up to 250 questions using up to 12 question types. You can export the files into Blackboard or WebCT, publish tests online or print them in hard copy.

ABOUT THE AUTHORS

Phil Hancock is a Winthrop Professor of Accounting and the Associate Dean of Teaching and Learning for the Business School at the University of Western Australia. Phil has extensive experience in the regulation of corporate financial reporting, management and international accounting in both the educational and private sectors. Phil was Chair of the Accounting Learning Outcomes Working Party, which was responsible for drafting the threshold learning standards for graduates of bachelor and master degrees in accounting in 2010. Phil is a Fellow of CPA Australia and the Institute of Chartered Accountants, and the Accounting and Finance Association of Australia and New Zealand (AFAANZ). In 2013 Phil was awarded the Outstanding Contribution to Accounting and Finance Education by AFFANZ. He is a member of the Western Australian Divisional Council for CPA Australia, and a member of the Financial Reporting panel of the CPA Program. As a teacher, Phil has held senior positions at the University of Western Australia, Edith Cowan University and Murdoch University, where he was an Associate Professor in Accounting before moving to the University of Western Australia.

Peter Robinson has taught at all West Australian universities, spending more than 20 years with each of Curtin University and the University of Western Australia (UWA). Peter has also held teaching appointments with the University of New South Wales (UNSW), the University of Texas at Austin, and the University of South Africa. Peter has taught the breadth of the accounting curriculum at undergraduate and post graduate level with strategic management accounting and public sector financial management being his more recent areas of teaching specialisation.

Peter has also been an active contributor to the development and delivery of study materials used by candidates seeking admission to the Institute of Chartered Accountants in Australia and CPA Australia; to the professional development of managers and senior executives in the for-profit, not-for-profit and public sectors both in Australia and internationally; and has regularly consulted with clients in these sectors upon a wide range of financial and performance management topics. Apart from Peter's undergraduate and post graduate studies in accounting with Curtin, UWA and UNSW, he has a Master of Education (UWA). Over the past five years, Peter has contributed, as reviewer, presenter of professional development material to high school teachers, and as chief examiner in 2011 and 2012, to the development and delivery of Western Australia's Certificate of Education Accounting and Finance course of studies for senior secondary school students in Years 11 and 12. Peter is a Fellow of CPA Australia.

Mike Bazley (1931–2013) was the inspiration behind the first edition of this book, which now enters its 9th edition. The success of this text is a tribute to Mike's perseverance, as many of the publishers he initially approached were not particularly interested in his idea of adapting the UK text *Accounting in Business Context*. However, Thomas Nelson, now Cengage Learning, finally agreed and in 1991 the first edition was published. Sadly Mike Bazley passed away in February 2013. Mike was an excellent teacher and highly regarded by the students he taught, an outstanding work colleague, a valued friend and a true gentleman to all that he met. He is deeply missed by his family and many friends and former colleagues.

Mike Bazley was born in the United Kingdom where, having undertaken national service, he joined a medium-sized company and worked his way to joint managing director. In 1969, Mike migrated to Australia and began his period of employment at the University of Western Australia, which eventually led him to taking up a lectureship in 1977 in UWA's then Department of

Accounting and Finance. He subsequently took up a position with Murdoch University where he was Dean of Studies and Chair of the School of Commerce and Senior Lecturer. In addition to his academic work, he also consulted for the West Australian state government, conducted public seminars and contributed to various academic and professional publications. Mike was a Fellow of CPA Australia. Having retired in 1995, Mike still continued to take great interest in the development of this text. We dedicate the 9th edition of this text to Mike in recognition of his prior contributions over the past 20-plus years and the very substantial and positive influence that he had on its development.

ACKNOWLEDGEMENTS

We wish to express our appreciation and gratitude to the following people who have contributed in some way to the development of this book: Professor Alan Davison for his support and encouragement; Professor Christine Jubb for helpful suggestions on the content of the 6th edition; the reviewers, who provided useful suggestions for the 9th edition; Colette Larsen and Lesley Murrish, for the unenviable task of typing many drafts of the very first edition of the book; and to Pam Bazley and Jenny Hancock for their patience, and for proofreading early versions of the first edition.

We also acknowledge our debt to Aidan Berry and Robin Jarvis, the authors of *Accounting in Business Context* published in the UK. This book was originally based on the British text, although the two books are now significantly different. Responsibility for the opinions expressed and for any errors in this book is entirely our own.

Phil Hancock
Business School
University of Western Australia

Peter Robinson
Michael Bazley

Cengage Learning would also like to thank the following reviewers for their incisive and helpful feedback:

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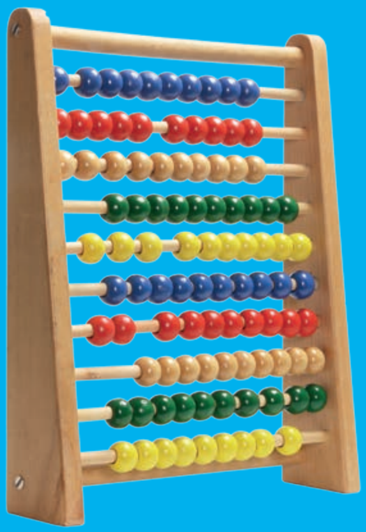
1

INTRODUCTION TO ACCOUNTING



LEARNING OBJECTIVES

At the end of this chapter, you should be able to:

1 explain what is meant by the term 'accounting'
2 explain the difference between management accounting, financial accounting and tax accounting
3 identify the main users of accounting information, and the main purposes for which the information is used
4 identify what is meant by the term 'integrated reporting'
5 identify the Global Reporting Initiative (GRI) and explain, in broad terms, the GRI approach to sustainability reports
6 identify the limitations of accounting information
7 discuss the factors that influence the choice of accounting systems for different types of organisations
8 explain what is meant by the term 'economic consequences' and relate this to the choice of accounting policies
9 identify career opportunities for accountants.

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INTRODUCTION

This chapter discusses the role of **accounting**, its uses and its users. It will also give you an appreciation of the role of accounting within a business organisation and in its dealings with others. We introduce some ideas about the ways accounting helps managers to meet business objectives by, for example, providing the information necessary to make a decision about buying or renting premises. The ways that the size and type of the organisation affect its accounting will be discussed. For example, in a small family restaurant the accounting requirements are much less complex than in a large business such as Woolworths Limited.

Also, while there are many shareholders who rely upon published financial statements for information about the financial performance and position of Woolworths, this is not the case with a small family restaurant. In this chapter we discuss the information required by the internal stakeholders, like managers, and those external to the organisation, like shareholders. The information provided to managers is referred to as management accounting while the information provided to external users is called financial accounting. We discuss the relationships and linkages between management and financial accounting. Another function of accounting worthy of mention is tax accounting, where information is provided to the government for the purpose of levying taxes.

Another factor that both affects and is affected by accounting is the commercial environment. The commercial environment can influence accounting through government legislation such as the adoption of a new corporations act or through the introduction of a goods and services tax (GST). Accounting can also be affected by changes in technology. For instance, developments in information technology have allowed accounting information to be provided more quickly and efficiently, enabling different decisions to be made than might otherwise have been the case. In addition to accounting in the business sector, we also briefly discuss accounting in the public and not-for-profit sectors. Finally, we look at the limitations of accounting information. As with most sources of information, there are imperfections. From this brief résumé we can see that the accounting activity interacts with all levels of business.

Accounts are normally seen as a series of figures. These figures are, in fact, a convenient way of summarising and reporting information that would be indigestible in narrative form. If you were asked to provide a report that gives details of the **value** of everything you own, it would be simpler to use figures to represent the value rather than words. The value of some things (e.g. good health, lead-free petrol or an academic qualification) is difficult to express or analyse in numerical terms, but this has not stopped people assigning a monetary value to them.

In order to understand the role and importance of accounting in the context of business organisations, we need to decide what 'accounting' means. If you were to look up the word 'account' in *Roget's Thesaurus* you would be directed to words such as 'report' and 'narration'. It is also referred to as commercial arithmetic, **double-entry bookkeeping** and so on. These alternatives imply totally different things: a report is something that conveys information for a particular purpose, while commercial arithmetic implies a mechanical exercise following agreed rules or principles.

Besides problems about what accounting can and should document, other issues need to be considered; for example, whether a numerical format is the best format for presenting the information. We also need to consider who the report is for and what its purpose is. For instance, you may give different accounts of your car's condition to a prospective buyer and to a mechanic. In both cases the description could be true, but the prospective buyer may be given general details about the car's performance while the mechanic is told about the car's problems. So we can see that the question of defining accounting has many facets: what you report, how you report, who you are reporting to and for what purpose. We shall look at these issues in more detail later in this chapter. First, let us get a better idea of how accounting is generally understood by examining some definitions from the accounting literature.

WHAT IS ACCOUNTING?

1 LEARNING OBJECTIVE

Explain what is meant by the term 'accounting'

There are a number of definitions of 'accounting' and they have changed over time in response to the changing accounting environment. One definition that has stood the test of time is that given by the American Accounting Association in *A Statement of Basic Accounting Theory* (also known as *ASOBAT*), which defines accounting as:

> the process of identifying, measuring and communicating economic information to permit informed judgement and decisions by users of the information. [1966, page 1]

First, this definition states the purpose of accounting. Second, it states that accounting has a number of components – some technical (such as measuring the data), some analytical (such as identifying the data) and some that require further information (such as the communication of this economic information to users: who are these users and what form does this information take?). Finally, the definition implies that the information has value in the decision-making process. The definition assumes that economics concerns any situation in which a choice must be made involving scarce resources.

Another definition was offered by the American Institute of Certified Public Accountants (AICPA) in the 1973 Trueblood Report (*Objectives of Financial Statements*), which looks to the role of accounting in decision making. The report lists 12 objectives that emphasise this decision-making process. They can be summarised as follows:

- to provide information, through **financial statements**, for the making of economic decisions
- to provide information for predicting, comparing and evaluating the effectiveness of management's use of scarce resources
- to provide information to predict and evaluate the **going concern** of an **entity**
- to provide information on earnings, **cash** flows, profitability and the financial position of the entity.

The usefulness of accounting information for decision making is reinforced by accounting concepts (known as the conceptual framework or the *Framework*), discussed in more detail in Chapter 2.

The conceptual framework gives us a clue to the fact that accounting is closely related to other disciplines (we are recording economic data) and it also gives us some clue as to the uses of accounting information; that is, for reporting on what has happened and as an aid to decision making and control of the business or organisation ('the entity').

A definition from the *Macmillan Dictionary of Accounting* (Parker 1986) states:

> accounting, in broad terms, is the preparation and communication to users of financial and economic information. The information ideally possesses certain qualitative characteristics. Accounting involves the measurement, usually in monetary terms, of transactions and other events pertaining to accounting entities. Accounting information is used for stewardship, control and decision making.

This suggests that accounting information has a key role in the running of a successful organisation.

The use of accounting information for business decision making is also brought out clearly in the definition given by the American Accounting Principles Board in 1970:

> Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. (*APB 4*)

The fact that accounting is described as a service activity reinforces the point made earlier: in order to understand the usefulness of accounting, we need to know who uses it and for what purpose.

1.1

KEY CONCEPT

ACCOUNTING

Important points made in these definitions are that:

- accounting is about **quantitative** information
- the information is likely to be financial in nature
- it should be useful for decision making in the allocation of scarce resources.

2 LEARNING OBJECTIVE

Explain the difference between management accounting, financial accounting and tax accounting

For what purpose is accounting information used?

Accounting information can be used on at least two levels: that of the individual and that of the organisation (or entity). At the individual level, people can use accounting information to help them control the level of their expenditure, to assist in planning future levels of expenditure, to help them raise additional finance (through, for example, mortgages or hire-purchase) and decide the best way to spend their money. So we can see that for the individual, accounting can have three functions: planning, controlling and decision support.

At the level of the entity, accounting is used to control the activities of the organisation, to plan future activities, to assist in raising finance, and to report the activities and success of the entity to interested parties and to the government to determine taxes payable.

An entity also uses accounting in planning, controlling and decision making (which are all internal activities or functions). The major difference between the two levels is that in the case of an entity, accounting also has an external function: providing information to people outside the entity. This external function is usually met through the provision of financial statements or financial reports, and is often referred to as **financial accounting**. The external users require the information that is contained in the financial statements to use in the decision-making process, or to evaluate what management has done with money invested in the business. The financial statements must be prepared in accordance with Generally Accepted Accounting Principles (GAAP). For individuals, the main external users are likely to be banks and the government for tax purposes.

Organisations also must report their activities to the government for the purposes of paying tax. The preparation of the activities of the organisation must be in accordance with the tax rules as specified in the tax legislation. This arm of financial accounting is often called tax accounting, where the objective is to report the activities of the organisation in compliance with the tax rules so that the organisation pays the minimum amount of tax to the government. The tax rules and GAAP rules are not always identical and thus accounting profit differs from taxable income. Hence the reference to 'two sets of books', which does not mean an organisation is engaged in deceit or misrepresenting its state of affairs.

Besides meeting the needs of external users, the system that produces the financial accounting reports and tax returns also meets some of the needs of internal users. One need is to analyse the results of past actions. This requires information on actual outcomes. These can then be evaluated against the projected outcomes, and reasons for differences can be identified so that appropriate actions can be taken. This is only one of a number of needs that managers have. Their other needs are met through different reports that are based upon information provided by the internal **accounting system**.

The internal accounting system, which may be in addition to the system that underpins the external financial reporting system, is often referred to as the **management accounting** function. The major difference between financial accounting and management accounting is that management accounting is primarily directed towards providing information of specific use to managers.

It is important to realise that the financial statements prepared for external users in accordance with GAAP provide a summary of the outcomes of the decisions made by managers. The two types of accounting are therefore interconnected and this can best be demonstrated by the following example. In 1999, Woolworths introduced its *Project Refresh* strategy, which focused on improving business processes and efficiencies throughout its supply chain. The supply chain can be described as movement of a product or raw material (apples) from its original source (fruit grower) to the customer (you). We discuss the supply chain and its management in more detail in Chapter 14. As a result of *Project Refresh*, Woolworths achieved significant reductions in costs of goods by several billion dollars. The very successful strategy, initially tracked and recorded through the management accounting system, was reported to the external users (shareholders) through increased profits in the published financial statements. While we cover financial accounting in Chapters 1 to 11 and management accounting in Chapters 12 to 18, it is important to keep in mind that the two are connected and interdependent.

Financial accounting information, which is often less detailed, has many users apart from managers. This leads us to the question posed below.

Who uses accounting information?

3 **LEARNING OBJECTIVE**

Identify the main users of accounting information, and the main purposes for which the information is used

Whether accounting information relates to the activities of an individual or to a business entity, its users can be placed in two broad categories:

- those inside the entity, such as managers or, in the case of a small business, the owner
- those outside the entity, including banks, analysts, the government, tax authorities, investors, **creditors** and trade unions.

INTERNAL USERS

The major internal user of accounting information is the management of an entity. For a small entity this is likely to be the owner, or a small number of individuals in the case of a partnership. However, many businesses are much larger and are owned by numerous individuals or groups of individuals, as is the case with large entities such as Woolworths, National Australia Bank or Woodside Limited.

Often the major investors themselves are owned by others, as is the case with the major financial institutions. In such a situation, it is extremely unlikely that the actual owners would or could take an active part in the day-to-day running of the entity. Consider the chaos if all the people who bought shares in Woolworths tried to take an active part in the day-to-day running of that business. Instead, these owners or shareholders delegate the authority for the day-to-day running to a group of directors and managers.

These directors and managers are involved in the routine decision-making activities of the entity and their information needs are equivalent to that of the small business owner. These needs are normally met by unpublished reports of various kinds, usually based on information provided through both the financial accounting system and the management accounting system. The exact nature of the reports varies from entity to entity. A department store may require information about the profitability of each of its departments, whereas a factory producing a small number of different products is likely to require information about the profitability of each product.

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The form of each report will also vary according to its purpose. If the purpose of the report is to assist management, it needs to show the past transactions and performance, probably measured against some predetermined standard. For planning purposes, though, a forecast of what is likely to happen in the future is more important.

These different forms of reports and ways of grouping information are normally referred to under the heading of 'management accounting'.

As stated earlier, management accounting is the focus of the second part of this book. At this stage it is worth briefly summarising the different categories of management accounting reports. To do this we need to make some generalisations about the needs of managers and to categorise those needs. In practice, of course, there is a certain amount of overlap between the categories but we need not concern ourselves with this at present. The broad categories that we have referred to in terms of the needs of managers are as follows.

STEWARDSHIP

Stewardship is when managers need to protect the entity's economic resources (normally referred to as **assets**) from, for example, theft, fraud and wastage.

PLANNING

Managers need to plan activities so that finance can be raised, marketing and promotional campaigns set up and production plans made.

CONTROL

Managers need to control the activities of the entity. This includes measures such as setting sales targets, managing human resources, and ensuring that there are sufficient raw materials to meet the demands of production and sufficient goods in stock to satisfy customer demand. It will also include identifying where targets can be set.

DECISION MAKING

Managers need to make specific decisions. For example, should we produce the item ourselves or buy it in? How much will it cost to produce a particular item? How much money will we need in order to run the entity?

Rather than getting deeply involved at this stage, let us first look at the other broad area we identified – the needs of users outside the entity: the external users. We shall be returning to the needs of internal users in more detail in Chapter 12.

STOP AND THINK 1

What are the needs of internal users? Can you identify any other needs of internal users? If so, can you suggest how these would be met?

EXTERNAL USERS

We need to establish who the external users are. The potential users can be divided into three groups, as follows:

- *resource providers*: employees, **lenders** (those who lend money to the entity; for example, bankers), creditors, suppliers (those who supply the entity with goods and services) and, in the case of business entities, investors (that is, shareholders – the owners of the entity)
- *recipients of goods and services*: those who benefit from the provision of goods and services by the reporting entity; that is, customers
- *parties performing a review or oversight function*: government, trade unions and special interest groups acting on behalf of the general public; for example, Greenpeace.

These groups are normally provided with information by means of published financial statements prepared in accordance with GAAP, except for governments which as stated earlier receive information about a organisation's activities based on tax rules. In order to decide to what extent the financial statements meet the needs of the external users and to understand more fully the importance of accounting, we shall briefly discuss the needs of the external users listed above.

OWNERS AND SHAREHOLDERS

In the case of small entities the owners are likely to be actively engaged in the day-to-day operations of the entity. In these small entities, the owners' needs are often met by the management accounting information and reports.

1.2

KEY CONCEPT

FINANCIAL ACCOUNTING

Financial accounting can be thought of as the part of the accounting system that tries to meet the needs of various external user groups. It does this by means of an annual report, which includes a statement of comprehensive income (and possibly an income statement), a statement of financial position (sometimes called a balance sheet), a statement of changes in equity, a statement of cash flows, notes to the financial statements, information required by law and any additional information the entity wishes to supply.

As the entity grows, however, it is likely that the owners will become divorced from its immediate and routine operations. Therefore, the owners will not have access to the management accounting information, which in any case may be too detailed for their requirements. This is the case in organisations listed on a **stock exchange**. (A listed or quoted organisation is one whose shares are traded in an open market where demand and supply govern the price of the share.) It is also the case in a number of other types of entities, such as public sector and not-for-profit entities, where the functions of management are carried out by people on behalf of the major stakeholders/owners.

In all these cases, the owners/major stakeholders need to know:

- whether the entity has done as well as it should have done
- whether the managers have looked after, and made good use of, the resources of the entity.

In order to evaluate whether the entity has done well and whether resources have been adequately used, it is necessary to compare the results of different entities. Information of this type is normally based on past results, and under certain conditions it can be provided by financial statements.

Owners/major stakeholders also need to know how the entity is going to fare in the future. Financial accounting is unlikely to provide this information for a variety of reasons, in particular because it is largely, if not exclusively, based on the past. Past results may be taken into account as one piece of information among many when one is trying to predict the future, but in a changing world it is unlikely that past results will be repeated because conditions will have changed.

Although there are limitations concerning the usefulness of the information in annual reports, they are often the only form of report available to an owner/major stakeholder who is not involved in the day-to-day activities of the business. Such users therefore have to base their decisions on this information, despite its inadequacies. For example, students can study the financial statements of various universities to see how much money they spend on resources such as the library and computing before deciding which university to choose for their courses.

In practice, the shareholder's involvement in this process of making comparisons (in the case of a listed organisation) is likely to be fairly indirect. This is because most of the information contained in the annual report has already been looked at by the owner's professional advisers – accountants, stockbrokers or financial analysts. The investor and owner are likely to base their decision on the professional advice they receive, rather than relying upon their own interpretation of the information. This is not to say that they will rely exclusively on expert information or that they will not use the information provided in the annual reports to assist with their decision. The reality is likely to be a mixture, the balance of which will depend on the degree of financial sophistication of the shareholders or owners. The less sophisticated they are, the more reliance they will have to place on their expert advisers. For example, a shareholder – who is, after all, a part-owner – may seek accounting advice when attempting to understand the accounting information contained in the annual report, to decide whether to sell his or her shares.

LENDERS

People and organisations lend money in order to earn a return on that money. They are, therefore, interested in whether the entity is making sufficient profit to provide them with their return (usually in the form of **interest**). This information is normally provided in the statement of **comprehensive income** or an **income statement**. Lenders are also interested in ensuring that the entity will be able to repay the money it has borrowed; therefore they need to ascertain what resources an entity controls and what it owes. This information is normally provided in the statement of financial position (also called the **balance sheet**).

Research has shown that, in practice, bankers use a mixture of different approaches to arrive at a lending decision. The choice of approach is related to the size of the entity. In the case of smaller entities, the security-based approach predominates. This approach emphasises the availability of economic resources to meet repayments in the event of business failure, and the emphasis is clearly on the statement of financial position or balance sheet. However, with very large businesses the approach towards a lending decision is more likely to be the 'going concern' variety where the emphasis is on the profitability of the entity.

SUPPLIERS OF GOODS

Goods can either be supplied on the basis that they are paid for when they are supplied, or that they will be paid for at some agreed date in the future. In each case the supplier will be interested to know whether the entity is likely to stay in business and whether it is likely to expand or contract. Both these needs relate to the future; therefore, they can never be adequately met by information in the annual report because this relates to the past.

Suppliers of goods who are not paid immediately will be interested in assessing the likelihood of getting paid. This assessment is partially helped by the annual report: the balance sheet shows what resources are controlled by the entity and what is owed, and also gives an indication of the **liquidity** of the controlled resources. However, the balance sheet has limited usefulness for predicting the future. Often the information is many months out of date by the time it is made public, because in most cases it is only published annually.

CUSTOMERS

Like suppliers, customers are interested in an entity's ability to survive and, therefore, carry on supplying them with goods. For example, if you are assembling cars you need to be sure that the suppliers of components are not about to go bankrupt. The importance of this has increased with the introduction of techniques such as **just-in-time management**. (Briefly, this means that inventories of parts at the production centre are kept to a minimum, reducing the cost of storage space and parts. Parts are delivered to the production centre just in time, before the inventories run out.) We discuss inventories in more detail in Chapter 8. The customers in this situation need to see that the entity is profitable, that it has sufficient resources to pay what it owes, and that it is likely to remain in business and supply components efficiently and on time. Some of these information needs are met, at least partially, by the financial statements.

EMPLOYEES

Employees depend on the survival of the entity for their wages and therefore are interested in whether the entity is likely to survive. In the long term, an entity needs to make a profit in order to survive. The statement of comprehensive income or income statement may assist the employee in assessing the future viability of the organisation. The employee may also be interested in ascertaining how well the entity is doing, compared with other similar entities, for the purposes of wage negotiations – although the accounts are only useful for this purpose if certain conditions are met (these are explored later in this book). The accounts can also be used internally for wage negotiations because they provide evidence of the organisation's level of profitability and ability to pay.

THE GOVERNMENT

The government uses accounting information for a number of purposes, the most obvious of which is the levying of taxes. For this purpose it needs to know how much taxable income has been made. The profit an organisation reports to shareholders in its statement of comprehensive income or income statement is based on the application of GAAP, which we will discuss in Chapter 7. However, the profit upon which an organisation is assessed for tax purposes is based on the application of the tax rules and regulations and is the domain of tax accounting. While these rules are often identical to accounting rules, there are instances where they differ. For example, a government may exempt certain income from taxation as an incentive to participants in that industry. This was the case with the gold industry in Australia for many years. Exempt income was not included in gold producers' calculations of their **taxable income**; however, as it was still income, it was included in their income statements for reporting to shareholders. The government also uses accounting information to produce industry statistics for purposes such as regulation.

In certain cases, the government is both owner and customer (e.g. some state energy commissions) or public watchdog (e.g. the Environmental Protection Authority). It can combine any one of these roles with other roles, such as regulatory authority (e.g. Australian Securities and Investments Commission). The government uses accounting information for all these purposes.

THE GENERAL PUBLIC

The general public requires many different types of information about entities in both the public and private sectors. Much of this information is not supplied directly by financial statements. For example, the public might be interested in a organisation's environmental performance, which we expand upon in the next section, or its stance on fair trade issues.

This summary shows that the users of accounting information and the uses to which it can be put are many and varied. It is clear that accounting information has effects both within organisations and in the wider commercial environment in which entities operate and in which we live. It should also be clear that this wider environment can use accounting as a tool for entity control. Before going on to consider in detail the impact of accounting upon the commercial environment and vice versa, we should first consider the limitations of accounting information in order to put its potential impact in context.

STOP AND THINK 2

Who are the main users of accounting information? What are some of the main purposes for which that information is used and which accounting reports are they likely to use?

4 LEARNING OBJECTIVE

Identify what is meant by the term 'integrated reporting'

INTEGRATED REPORTING

Traditionally, organisations, particularly listed organisations, have pursued the maximisation of profit as their major objective. In accounting, reporting on financial performance has been their central focus and is the central focus in this book. However, in the twenty-first century there has been a growing concern about the ability of the world's resources to be able to meet the needs of future generations if not properly managed. The 2007 banking crisis caused a rethinking of the capitalist model and its focus on short-term outcomes. Sustainability and sustainable development are now important issues on the world agenda, but what is meant by the term 'sustainable development'?

The following definition is the one used by Dantes (2005):

> The concept of meeting the needs of the present without compromising the ability of future generations to meet their needs. The terms originally applied to natural resource situations, where the long term was the focus. Today, it applies to many disciplines, including economic development, environment, food production, energy, and social organisation. Basically, sustainability/sustainable development refers to doing something with the long term in mind.
>
> Dantes, 2005. Akzo Nobel, viewed 30 July 2014, www.dantes.info/Projectinformation/Glossary/Glossary.html

In this section we examine the concept of **integrated reporting**, which involves organisations reporting on all activities relevant to value creation. Such reporting includes financial information but also includes information on strategy, environmental, social, governance and other value-relevant activities in an integrated report. The International Integrated Reporting Committee (IIRC) was an outcome of a Sustainability Forum meeting on 17 December 2009 initiated by Prince Charles of the United Kingdom.

Many organisations have for some years provided additional information in relation to environmental and social issues beyond what is required in financial statements. The practice of publishing various types of corporate social reports is largely voluntary and has emerged with the increasing concern about sustainable development. There are a variety of names for this type of report. These include: environmental report, corporate social report, sustainability report, social impact report, stakeholder impact report, **corporate social responsibility** report and triple bottom line report.

A **triple bottom line** (**TBL**) report refers to the publication of economic, environmental and social information in one report. Integrated reporting is extending the TBL to include information about governance, strategy and any other relevant information about how an organisation creates value. The target audience for an integrated report is the providers of financial capital while for a sustainability report it is a broader range of stakeholders who want to know about an organisation's environmental and social impacts and how it is managing them.

The three components of a TBL are the environmental, social and economic activities of the organisation. Some organisations, such as mining organisations, have certain mandatory reporting obligations and conditions, such as restoring the land to its original condition after they have finished mining operations. However, such mandatory obligations only apply in certain industries and, in general, most organisations providing information about social and environmental issues do so on a voluntary basis.

A TBL report has three components, as noted below.

- *Environmental*: disclosures about many issues associated with the environment and the organisation's activities within this area. These may include issues to do with air, water, land, natural resources, flora, fauna and human health (e.g. greenhouse gas emissions, water contamination and workers' safety).
- *Social*: disclosures about many social issues such as the diversity of the organisation's employees, treatment of minorities, employment conditions for employees and community activities (e.g. criticism of Nike's 'sweatshop' production operations in Asian countries).
- *Economic*: the more traditional financial data and, for this reason, likely to contain more quantitative data than the previous two components.