

Edition

8

HORNGREN'S FINANCIAL ACCOUNTING

Nobles - Mattison - Matsumura - Best - Fraser - Tan - Willett

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HORNGREN'S FINANCIAL ACCOUNTING

Edition

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In memory of **Charles T. Horngren** (1926-2011)

whose vast contributions to the teaching and learning of accounting impacted—and will continue to impact—generations of accounting students and professionals.

Edition

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HORNGREN'S FINANCIAL ACCOUNTING

Nobles - Mattison - Matsumura - Best - Fraser - Tan - Willett

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PREFACE

This eighth edition of Horngren's *Financial Accounting* continues to provide accounting students with a complete learning resource. It is focused on current accounting theory and practice in Australia. The new edition covers all the requirements of introductory accounting courses. The text and accompanying learning and teaching packages provide both students and lecturers with the most effective tools available for learning the fundamentals of financial accounting.

Business context of accounting

Horngren's Financial Accounting provides students with a *business approach* to the study of accounting by emphasising how financial decision making is based on accurate and complete accounting information. A running case, Smart Touch Learning, is used throughout the text to illustrate, in a practical way and with gradually increasing complexity, the topics covered in each chapter. Similarly, a Continuing Exercise and a Continuing Problem are included in the assignment material for each chapter so that students can follow how accounting concepts and techniques develop.

The text also develops student awareness of the ethical issues facing the accounting profession. Chapter 1 includes a discussion of ethics in business and the accounting profession today. The end-of chapter Focus on Ethics provides students with the opportunity for in-depth discussion and analysis. Chapter 1 in this edition has also been completely rewritten, bringing the reader back to basics by chunking material into manageable bite-size portions.

Accuracy and currency

Horngren's Financial Accounting is accurate and up to date. We have been guided in writing this new edition by extensive feedback from students and lecturers, including in-depth chapter reviewing and technical editing. We have also included the very latest, most *up-to-date* information in line with the latest developments in Australian accounting standards. These developments are referenced throughout the text.

Responding to user needs

Our survey of users is an important part of the effort to effectively meet the needs of students and lecturers. We value the positive comments that enable us to identify those aspects of the book that users find most helpful, and we recognise and respond to areas of concern for our readership.

Clear, straightforward approach

Horngren's Financial Accounting continues to provide a clear, straightforward approach to the study of accounting. Great care has once again been taken in writing this new edition to ensure that the text is easier than ever for students to read and understand. We believe it is, for students, the most accessible text available, with clear explanations of both how and why accepted accounting concepts and techniques are used.

GUIDED TOUR

Horngren's Financial Accounting 8e features

The 8th edition preserves the classic, solid foundation of the previous editions, while also including a modern and fresh teaching approach that helps students understand the complexities of accounting.

Getting off to the right start: Chapter openers

The chapter openers in this edition are focused on preparing you for the reading. They outline the learning objectives and include a visual of a **balance sheet** that highlights what will be covered within the chapter.

THE ROLE OF ACCOUNTING IN DECISION MAKING 1

SMART TOUCH LEARNING
Balance sheet
as at 30 June 2016

As you'll learn in this chapter, the accounting equation (Assets = Liabilities + Equity) is the balance sheet!

Assets		Liabilities	
Current assets		Current liabilities	
Cash	\$ 4 800	Accounts payable	\$ 48 700
Accounts receivable	2 600	Salary payable	3 000
Inventory	30 500	Interest payable	1 100
Supplies	600	Unearned service revenue	400
Prepaid rent	2 000	Total current liabilities	56 100
Total current assets	\$ 40 500	Non-current liabilities	20 000
Non-current assets		Loans payable	20 000
Furniture	118 000	Total liabilities	76 100
Less accumulated depreciation—furniture	800		
Building	45 000	Owner's equity	
Less accumulated depreciation—building	200	Sharma Bright, owner	25 000
Total non-current assets	117 000	Total liabilities and owner's equity	\$ 101 100
Total assets	\$ 157 500		

THINK ABOUT A DECISION YOU HAVE MADE RECENTLY. While many of your decisions are routine and can be made without reference to detailed information, such as which detergent to wear in the evening, other decisions are more infrequent and have longer-lasting effects, such as choosing a mobile phone network and contract type. The bigger the decision, the more information you will want before making it. In the choice of which type of mobile phone to buy, in order to make the best decision you would need to know what each option provides (for example, the number of minutes/SMS messages and the amount of data allowed), as well as the cost of each plan. What you are doing is weighing up the costs and benefits of each option.

In the world of commerce and beyond, organisations use accounting information to inform them prior to making important decisions. For example, if the retail giant Myer considered a bid to purchase rival David Jones, how much should it pay? The answer depends partly on what the accounting information says David Jones is worth.

The balance sheet shown above is one of the most important and central financial statements prepared by accountants. Accounting information enables people and organisations to make better decisions.

Learning objectives

- 1. Explain the accounting equation and how it is used to determine the missing element.
- 2. Explain the accounting equation and how it is used to determine the missing element.
- 3. Explain the accounting equation and how it is used to determine the missing element.
- 4. Explain the accounting equation and how it is used to determine the missing element.
- 5. Explain the accounting equation and how it is used to determine the missing element.

Put the concepts in context: Stop&think boxes

Improved *Stop&think* boxes relate accounting concepts to your everyday lives by presenting you with relevant examples of the topic in practice.

STOP&THINK Have you ever walked along the beach and gathered sea shells? Perhaps you had more than one bucket and you put all the shells in one, all the crabs in another, and so on. That **separation** is essentially what happens in posting. All we are doing is gathering transactions that affect the same account (for example, all the transactions to Cash) and putting them in the T-account. They are placed either on the left or the right side of the T-account based on whether they were on the left or the right side of the journal entry. Posting is merely a sorting process—no change to debits or credits occurs from transaction to posting.

**Illustrate the concepts:
Decision guidelines**

Decision Guidelines explain why the accounting concepts addressed in the chapter are important to making decisions in a business setting. The left-hand side of the *Decision Guidelines* table explains the decision or action asked of the student in simple terms, while the right-hand side shows the accounting topics that will help facilitate those decisions.

DECISION GUIDELINES 16.1

Using cash flow and related information to evaluate investments

Ann Browning is a private investor. Over the years, she has devised some guidelines for evaluating investments. Here are some of her guidelines.

QUESTION	FINANCIAL STATEMENT	WHAT TO LOOK FOR
INVESTORS		
Where is most of the company's cash coming from?	Cash flow statement	Operating activities → Good sign Investing activities → Bad sign Financing activities → Okay sign
Do high sales and profits translate into more cash?	Cash flow statement	Usually, but cash flows from operating activities must be the main source of cash for long-term success.
If sales and profits are low, how is the company generating cash?	Cash flow statement	If investing activities are generating the cash, the business may be in trouble because it is selling off its long-term assets. If financing activities are generating the cash, that cannot go on forever. Sooner or later, investors will

**Keep it consistent:
Consistent examples**

Rather than learn about a new company each time an example is presented, this text provides two sets of company data (Smart Touch and Greg's Tunes) that are carried through the in-chapter examples. As a result, you gain a sense of familiarity with the context of these examples and can focus your energy on learning the accounting principles in question.

SMART TOUCH LEARNING LTD
Income statement
For the year ended 30 June 2016
(Amounts in thousands)

Revenues		
Sales revenue		\$284
Interest revenue		12
Dividend revenue		9
Gain on sale of non-current assets*		8
Total revenues		313
Expenses		
Cost of sales	\$150	
Salary and wage expense	56	
Depreciation expense	18	
Interest expense	16	
Other operating expense	17	
Total expenses		257
Profit before income tax		56
Income tax expense		15
Profit		\$ 41

*Net of proceeds less carrying amount.

EXHIBIT 16-6
Income statement:

Sustainability in action

Boxes occur in most chapters that show that sustainability issues are integral aspects of accounting. The companies profiled illustrate the kinds of changes that are occurring in managing sustainability. Each example is accompanied by relevant questions.

Corporate sustainability reporting: Trends

Corporations are facing increasing pressures to be accountable and transparent, and to disclose a wide variety of information about activities, including their sustainability. Sustainability is an emotionally-charged topic and its meaning may differ between individuals and corporations. ... Sustainability reporting [may be defined as] the communications which corporations make concerning their corporate social-responsibility (CSR) activities, including social and environmental impacts in addition to financial performance.

The International Integrated Reporting Council (IIRC) has proposed a revolutionary change in the way that corporations report activities to stakeholders, essentially by replacing current financial statements with integrated reports that contain financial information, operational data and sustainability information.

Sustainability in action

Master the material: Review/Assess/Apply

Review

Read the *Accounting Vocabulary* and *Student Success Tips* to ensure you remember and understand the key terms and concepts from the chapter.

Assess

Tackle the *Quick Check* and *Starter* questions, then jump to the more comprehensive and challenging *Exercises* and *Problems* to master the technical aspects of the chapter.

Apply

It's time to pull everything together! Apply your skills to decision-making, ethics and fraud cases.

Continuing problem

Problem 16-9 Preparing the cash flow statement—indirect method (25–35 min)
The problem continues the Draper Consulting Ltd situation from Problem 15-7 of Chapter 15. Refer to the comparative balance sheet for Draper Consulting.

DRAPER CONSULTING LTD Comparative balance sheet as at 31 December 2017 and 2016		
	2017	2016
Assets		
Cash	\$24 706	\$16 200
Accounts receivable	31 708	1 700
Supplies	2 200	300
Equipment	16 000	1 000
Furniture	1 786	4 200
Building	421 000	0
Accumulated depreciation	(11 700)	(1 000)
Total assets	\$325 500	\$18 400
Liabilities		
Accounts payable	\$ 10 000	\$ 4 000
Salary payable	4 786	300
Unearned service revenue	0	500
Interest payable	30 917	0
Income payable	45 000	0
Deferred advertising	600 000	0
Discount on debentures payable	26 186	0
Shareholders' equity		
Ordinary share capital	100 000	16 000
Retained earnings	199 500	1 400
Total liabilities and shareholders' equity	\$325 500	\$18 400

Requirement
Assume profit for 2017 is \$141 235. Prepare the statement of cash flows using the indirect method.

APPLY

Decision cases

Case 16-1
The 2016 comparative income statement and the 2016 comparative balance sheet of East Australia Ltd have just been distributed at a meeting of the company's board of directors. The members of the board of directors raise a fundamental question: why is the cash balance so low? This question is especially troublesome to the board members because 2016 showed record profits. As the controller of the company, you must answer the question.

REVIEW

Accounting vocabulary

cash equivalents (p. 678)	indirect method (p. 671)
cash flow statement (p. 677)	investing activities (p. 676)
cash flows (p. 677)	non-cash financing and investing activities (p. 700)
direct method (p. 671)	operating activities (p. 676)
financing activities (p. 676)	free cash flow (p. 701)

Student success tips

The following are items on some common trouble areas for students in this chapter:

- 1. Keep in mind that the cash flow statement explains why the change in the cash balance isn't the same as the profit or loss for the period.
- 2. Remember that the cash flow statement has three sections: operating, investing and financing.
- 3. Remember that Cash is an asset, so changes in other asset accounts have the opposite effect on Cash (when other asset accounts increase, Cash decreases). Changes in liability and equity accounts have the same effect on Cash (when liability or equity account increases, Cash increases).

ASSESS

Quick check

- The purposes of the cash flow statement are to:
 - evaluate management decisions
 - determine ability to pay liabilities and dividends
 - predict future cash flows
 - all of the above
- The main categories of cash flow activities are:
 - direct and indirect
 - current and non-current
 - non-cash financing and investing
 - operating, investing and financing
- Operating activities are most closely related to:
 - non-current assets
 - current assets and current liabilities
 - non-current liabilities and owners' equity
 - dividends and shares
- Which item does not appear on a cash flow statement prepared by the indirect method?
 - collections from customers
 - depreciation
 - profit
 - gain on sale of land

MyAccountingLab

A GUIDED TOUR FOR STUDENTS AND EDUCATORS

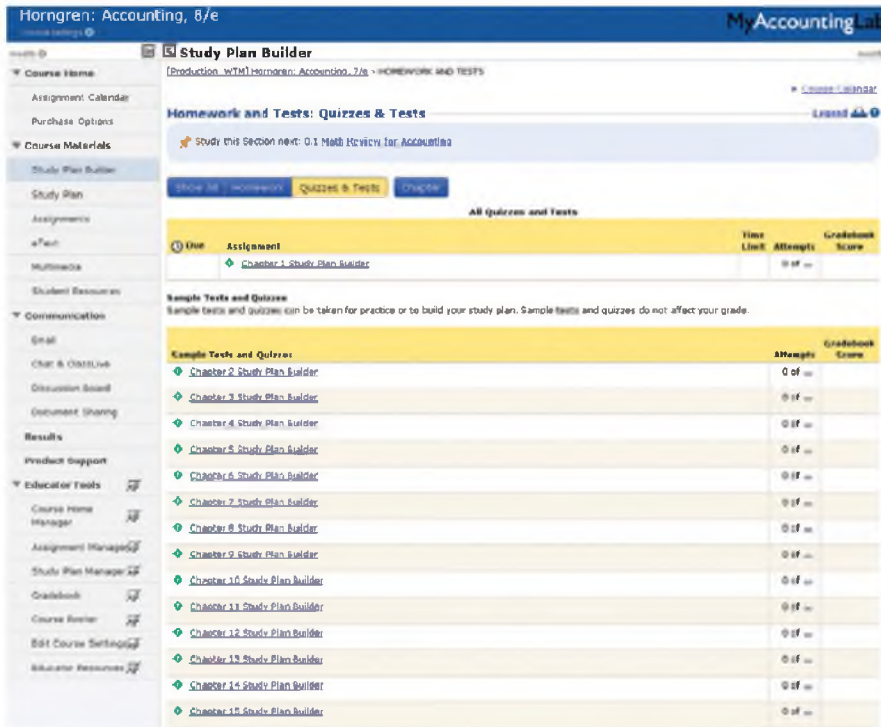
Study plan

A study plan is generated from each student's results on a pre-test. Students can clearly see which topics they have mastered and, more importantly, which ones they need to work on.

Learning resources

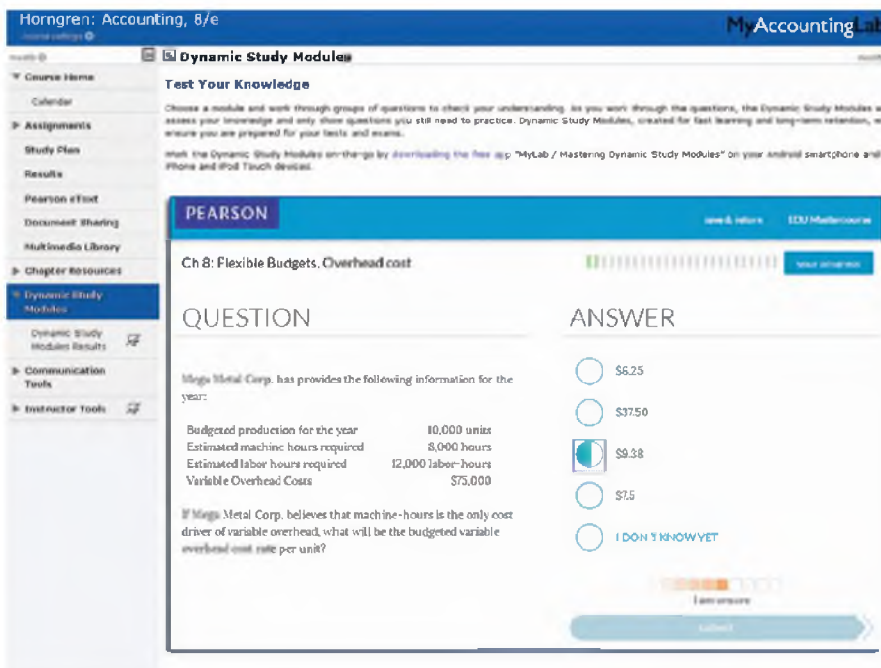
To further reinforce understanding, study plan and homework problems link to the following learning resources:

- The relevant section of the eText, so that students can review key concepts
- Help Me Solve This, which walks students through the problem with step-by-step help and feedback without giving away the answer.



Unlimited practice

MyAccountingLab comes with preloaded assignments covering end-of-chapter questions, all of which are automatically graded. Many study plan and educator-assigned exercises contain algorithmically generated values to ensure that students get as much practice as they need.



Dynamic study modules

Using a highly-personalised process, Dynamic Study Modules continuously assess students' performance and provide additional practice in the areas where they struggle the most. Students can then review material and retest themselves until they 'master' the information. Each Dynamic Study Module—accessed by computer, smartphone or tablet—promotes fast learning and long-term retention.

EDUCATOR RESOURCES

A suite of resources is provided to assist with delivery of the text, as well as to support teaching and learning.

Solutions Manual

The Solutions Manual provides educators with detailed, accuracy-verified solutions to all the in-chapter and end-of-chapter problems in the book.

Test Bank

This Test Bank has been uniquely enhanced for sophisticated testing functionality. It includes accuracy-verified testing material that contains algorithmically generated values to expose students to a variety of problem scenarios. Updated for the new edition, each chapter offers a wide variety of questions, arranged by learning objective and tagged by AACSB standards.

Every question is available in TestGen[®] software for both Windows[®] and Macintosh[®] computers. This easy-to-use testing software is a valuable test preparation tool that allows educators to customise, save and generate classroom tests.

PowerPoint lecture slides

A comprehensive set of PowerPoint slides can be used by educators for class presentations or by students for lecture preview or review. They include key figures and tables, as well as a summary of key concepts and examples from the text.

Digital Image PowerPoint slides

All the diagrams and tables from the text are available for lecturer use.

ABOUT THE AUSTRALIAN AUTHORS



Peter Best (BCom, MEngSci, PhD) is Professor and Head of the Accounting Discipline at Griffith University. He has taught at the University of Queensland, University of Newcastle, University of Adelaide, Flinders University, QUT and University of Southern Queensland. Peter is a Fellow of CPA Australia and an Associate of Chartered Accountants Australia and New Zealand. He has acted as consultant to a variety of accounting firms and government departments both in Australia and overseas. His specialist teaching areas include accounting information systems, auditing, information systems auditing and SAP. Peter is co-author of *Auditing Computer-Based Accounting Systems*; *Auditing, Assurance Services and Ethics in Australia: An Integrated Approach*; and previous editions of Horngren's *Accounting* and *Financial Accounting*.



David Fraser (BEC, MCom) is Emeritus Professor of Accounting at the University of Technology, Sydney (UTS). He was a partner in a chartered accounting practice for many years and has since taught at the University of New South Wales and at UTS, where he was Dean of the Faculty of Business and Head of the School of Accounting. David works as a consultant to CAANZ for the accreditation of university accounting courses. He is a Fellow of both CAANZ and CPA Australia. David is joint author of *Systems Based Audits*, and co-author of *Consolidated Statements and Group Accounts* and previous editions of Horngren's *Accounting* and *Financial Accounting*.



Rebecca Tan (BCom Hons, PhD, CPA) is Senior Lecturer in Accounting at the Research School of Accounting and Business Information Systems at the Australian National University (ANU). Rebecca has taught financial and management accounting courses at both the undergraduate and postgraduate level since starting at the ANU in 2003. Prior to that, she worked at Murdoch University. Her research focuses on teamwork in accounting education, management accounting processes and practices, accounting policy choices in the financial accounting and reporting area, sustainability reporting, and organisational behaviour research. She has been published in journals such as *International Journal of Accounting*, *Australian Accounting Review* and *Asian Review of Accounting*. Rebecca is co-author of *Cost Accounting: A Managerial Emphasis* and has also authored and co-authored 16 MYOB Accounting Practice Sets.



Roger Willett (BA Hons, PhD) is a Professor at the Tasmanian School of Business and Economics. He has been Head of School at QUT and at the University of Otago, and taught at the Australian National University, the University of Wales and the University of Aberdeen. Roger is a member of CPA Australia and a Fellow of the Institute of Chartered Accountants in England and Wales. His teaching areas include financial accounting, financial accounting theory and research methods. Roger worked for a number of years as a chartered accountant. He is an editor of, and is on the editorial boards of, a number of academic accounting journals. Roger is co-author of previous editions of Horngren's *Accounting* and *Financial Accounting*.

ABOUT THE AMERICAN AUTHORS



Tracie L. Nobles, CPA, received her bachelor's and master's degrees in accounting from Texas A&M University. She is currently a Senior Lecturer at Texas State University, San Marco, TX. Previously she served as an Associate Professor of Accounting at Austin Community College and has served as department chair of the Accounting, Business, Computer Information Systems and Marketing/Management department at Aims Community College, Greeley, Colorado. Professor Nobles has public accounting experience with Deloitte Tax LLP and Sample & Bailey, CPAs.

Professor Nobles is a recipient of the Texas Society of CPAs Outstanding Accounting Educator Award, NISOD Teaching Excellence Award and the Aims Community College Excellence in Teaching Award. She is a member of the Teachers of Accounting at Two Year Colleges, the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas State Society of Certified Public Accountants. She is currently serving on the board of directors as secretary/webmaster of Teachers of Accounting at Two Year Colleges, as chair of the American Institute of Certified Public Accountants Pre-certification Executive Education committee, and as program chair for the Teaching, Learning and Curriculum section of the American Accounting Association. In addition, Professor Nobles served on the Commission on Accounting Higher Education: Pathways to a Profession.

Tracie has spoken at numerous conferences on such topics as using technology in the classroom, motivating non-business majors to learn accounting, and incorporating active learning in the classroom. In her spare time she enjoys spending time with friends and family, and camping, fishing and quilting.



Brenda L. Mattison has a bachelor's degree in education and a master's degree in accounting, both from Clemson University. She is currently an Accounting Instructor at Tri-County Technical College in Pendleton, South Carolina. Brenda previously served as Accounting Program Coordinator at TCTC and has prior experience teaching accounting at Robeson Community College, Lumberton, North Carolina; University of South Carolina—Upstate, Spartanburg, South Carolina; and Rasmussen Business College, Eagan, Minnesota. She also has accounting work experience in retail and manufacturing businesses.

Brenda is a member of Teachers of Accounting at Two Year Colleges and the American Accounting Association. She is currently serving on the board of directors as Vice President of Registration of Teachers of Accounting at Two Year Colleges.

Brenda engages in the scholarship of teaching and learning (SOTL). While serving as Faculty Fellow at Tri-County Technical College, her research project was Using Applied Linguistics in Teaching Accounting, the Language of Business. Brenda has presented her research findings.

Other presentations include using active learning, and manipulatives, such as building blocks and poker chips, in teaching accounting concepts.

In her spare time, Brenda enjoys reading and spending time with her family, especially touring the United States in their motorhome. She is also an active volunteer in the community, serving her church, local Girl Scouts and other organisations.



Ella Mae Matsumura is a professor in the Department of Accounting and Information Systems in the School of Business at the University of Wisconsin–Madison, and is affiliated with the university’s Center for Quick Response Manufacturing. She received an A.B. in mathematics from the University of California, Berkeley, and M.Sc. and Ph.D. degrees from the University of British Columbia. Professor Matsumura has won two teaching excellence awards at the University of Wisconsin–Madison and was elected as a lifetime fellow of the university’s Teaching Academy, formed to promote effective teaching. She is a member

of the university team awarded an IBM Total Quality Management Partnership grant to develop curricula for total quality management education.

Professor Matsumura was a co-winner of the 2010 Notable Contributions to Management Accounting Literature Award. She has served in numerous leadership positions in the American Accounting Association (AAA). She was co-editor of *Accounting Horizons* and has chaired and served on numerous AAA committees. She has been secretary–treasurer and president of the AAA’s Management Accounting Section. Her past and current research articles focus on decision making, performance evaluation, compensation, supply chain relationships and sustainability. She has co-authored a monograph on customer profitability analysis in credit unions.

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Peter J. Best

David J. Fraser

Rebecca Tan

Roger Willett

THE ROLE OF ACCOUNTING IN DECISION MAKING

1

SMART TOUCH LEARNING Balance sheet

as at 30 June 2016

As you'll learn in this chapter, the accounting equation (Assets = Liabilities + Equity) IS the balance sheet.

Assets			Liabilities	
Current assets:			Current liabilities:	
Cash		\$ 4 800	Accounts payable	\$ 48 700
Accounts receivable		2 600	Salary payable	900
Inventory		30 500	Interest payable	100
Supplies		600	Unearned service revenue	400
Prepaid rent		2 000	Total current liabilities	50 100
Total current assets			Non-current liabilities:	
Non-current assets:			Loans payable	20 000
Furniture	\$18 000		Total liabilities	70 100
Less: Accumulated depreciation—furniture	300	17 700		
Building	48 000			
Less: Accumulated depreciation—building	200	47 800	Owners' equity	
Total non-current assets			Sheena Bright, capital	35 900
Total assets		\$106 000	Total liabilities and owners' equity	\$106 000

THINK ABOUT A DECISION YOU HAVE MADE RECENTLY. While many of your decisions are routine and can be made without reference to detailed information, such as which clothes to wear in the morning, other decisions are more infrequent and have longer-lasting effects, such as choosing a mobile phone network and contract type. The bigger the decision, the more information you will want before making it. In the choice of which type of mobile phone to buy, in order to make the best decision you would need to know what each option provides (for example, the number of minutes/SMS messages and the amount of data allowed), as well as the cost of each plan. What you are doing is weighing up the costs and benefits of each option.

In the world of commerce and beyond, organisations use accounting information to inform them prior to making important decisions. For example, if the retail giant Myer considered a bid to purchase rival David Jones, how much should it pay? The answer depends partly on what the accounting information says David Jones is worth.

The 'balance sheet' shown above is one of the most important and central financial statements prepared by accountants. Accounting information enables people and organisations to make better decisions.

Learning objectives

- LO 1 Explain why accounting is important
- LO 2 Describe the accounting equation, and define assets, liabilities and equity
- LO 3 Use the accounting equation to analyse transactions
- LO 4 Prepare financial statements
- LO 5 Use financial statements and return on assets (ROA) to evaluate business performance
- LO 6 Describe the organisations and principles that govern accounting
- LO 7 Identify the three main types of business organisation
- LO 8 Explain the role of ethics and sustainability in accounting

Smart Touch, whose balance sheet is illustrated, is a small business, but its balance sheet contains the same type of information as that shown in the balance sheet of very large organisations such as JB Hi-Fi. The same is true for the other financial statements that all well-run businesses prepare and use, and which you will learn about as you work your way through this book.

In this introductory chapter we introduce accounting in a small business context through Sheena Bright's Smart Touch Learning and later, starting in Chapter 5, Greg Moore's Greg's Tunes. You will see how Sheena and Greg run successful businesses by treating people fairly, planning for activities that are sustainable, and capitalising on their general business and accounting acumen. You will also see how understanding financial statements like the balance sheet is one of the first steps towards business success.

We will be following the fortunes of Smart Touch and Greg's Tunes throughout the text to see how different accounting concepts relate to their businesses. In addition, we will use examples from large firms to illustrate the fact that the same accounting principles apply to firms of any size. By the time you get to the chapter on the framework of accounting you will have a broad appreciation of how accountants prepare financial statements for all types of organisation.

1.1 WHY IS ACCOUNTING IMPORTANT?

LO 1

Explain why accounting is important

So you have heard the term *accounting* before, and we have just said that it provides valuable information for decision making, but what exactly is it? **Accounting** measures business activities, processes the data into reports and communicates the results to decision makers. Examples of this information are the amount of profit a business has made and how much the items that the business owns are worth. Accounting is the language of business. The better you understand this language, the better you can manage your own business, be a valuable employee or manage your investments.

'Accountants earn relatively high salaries but their work is boring and dry' is the general misperception of accountancy. If you are considering becoming an accountant, the good news is that the high earning part is true, while the boring part is not! While all accountants need to be comfortable working with numbers, modern-day accounting is much more than simple recordkeeping or bookkeeping.

Through their interpretation as well as provision of financial information, accountants make a real difference to the success of organisations they work in or clients they work for. The profession also provides great opportunities for travel and career progression. This means that today's accountants are often found working at the very top of international businesses—for example, as chief financial officer (CFO)—as the *Concepts in action* box illustrates.

Concepts in action

Sarah Adler is the CFO at Sky's Australian News Channel. She believes it is important to understand the business processes at Sky News, which are complex, involving the delivery of news content through many channels, including mobiles and other online media, as well as television. To understand her company's business, Sarah keeps in close contact with Sky's IT engineers. Sky's IT expenditure and the ongoing operating costs of maintaining IT mean that the cost structures of the business are constantly changing.

Sarah has a degree in French and once trained as an opera singer. Now she is an accountant in the media entity in Australia. To get to where she is now, she trained as an auditor for PwC in their London offices, specialising in investments and insurance. Initially the job seemed

mundane; however, as Sarah moved into more senior positions, she found the work more and more interesting. Now Sarah sees her role as a communicator for her employer, employing financials to show what her business is trying to achieve, and how successful it has been in doing so. The satisfaction for her is doing all of this at a senior, board level using accounting as the language of business.

Source: Adapted from information in an article written by Barbara Bierach published in the October 2013 International edition of *Accounting and Business* magazine, <<http://www.accaglobal.com/gb/en/member/accounting-business/what-story.html>>, accessed 14 January 2015.

QUESTION TO THINK ABOUT

What disciplines (for example, maths, languages, IT, economics, etc.) do students consider appropriate to training in accountancy?

Accounting and the users of accounting information can be divided up into two major fields—financial accounting and management accounting. **Financial accounting** provides information for external decision makers, such as external investors and lenders. Chapters 2–18 of this book deal primarily with financial accounting. **Management accounting** focuses on information for internal decision makers, such as business managers. Chapters 19–23 cover management accounting.

Exhibit 1-1 illustrates the difference between financial and management accounting.

External decision makers

The following external decision makers are among those interested in financial accounting information.

Investors

External investors often provide the money to get a business started by acquiring an ownership interest. You might have the opportunity to invest in the stock market with some cash you have recently inherited. Which investments should you pick? Understanding a company's financial


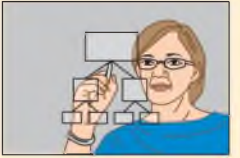
Financial Accounting	Management Accounting
 <p>External Decision Makers:</p> <ul style="list-style-type: none"> Should I invest in the business? Is the business profitable? Should we lend money to the business? Can the business pay us back? 	 <p>Internal Decision Makers:</p> <ul style="list-style-type: none"> How much money should the business budget for production? Should the business expand to a new location? How do actual costs compare to budgeted costs?

EXHIBIT 1-1
Decision making:
financial versus
management
accounting

statements will help you decide. Once you have decided to invest, you can continue to analyse the company's financial statements to help decide whether to sell or to hold on to your share of the company. You can view the financial statements of most large companies online.

Creditors

Any person or business to whom money is owed is a creditor. A creditor is often a bank, but not always. If your friend has lent you \$10, they are your creditor. Before extending credit (lending money) to an organisation, a creditor evaluates the organisation's ability to repay by reviewing its financial statements. Banks follow the same process when you need to borrow money for a new car or a house. What does your financial position tell the creditor about your ability to pay the loan? Are you a good risk for them?

Taxing authorities and other government agencies

Income tax and goods and services tax (GST) is calculated using accounting information. Good accounting records can help individuals and businesses take advantage of lawful methods to minimise tax. Another government agency interested in accounting information is the **Australian Securities and Investments Commission (ASIC)**, which is responsible for administering and enforcing corporations law. Among other powers, ASIC can ban people from running companies (as directors) and prosecute individuals for corporate wrongdoing, which can result in gaol terms for those involved (see *Connect to: Ethics*).

CONNECT TO: Ethics

Former currency trader gaoled

Krishnan Rasaratnam, a former director of Strategic Alternative Investments Pty Ltd (SAI), has today (23 December 2013) been gaoled for 3 years and 3 months on dishonest conduct and deception charges.

In October 2011, Mr Rasaratnam pleaded guilty to one count of using a false instrument and five counts of dishonest conduct in relation to providing a financial service.

Mr Rasaratnam, who was not licensed as a currency trader, misappropriated investor funds by diverting those funds to his personal trading account. As a result of the purported investment activity by SAI, investors incurred losses of more than \$12 million.

In sentencing Mr Rasaratnam, Judge Hoy stressed the seriousness of the conduct, including the length of time over which the offences were committed; the significant amount of money that was invested and subsequently lost by investors; and the fact that Mr Rasaratnam was in a position of trust in acting as a financial advisor, if not by name, then by actions, and said this could not be overlooked.

'Maintaining fair and efficient markets is key for ASIC and we will not hesitate to take action against those who engage in dishonest or deceptive representations,' ASIC Commissioner John Price said.

Source: Adapted from 'Former currency trader jailed', 23 December 2013; <http://www.asic.gov.au/asic/asic.nsf/byheadline/13-360MR++Former+currency+trader+jailed?openDocument>. © Australian Securities and Investments Commission. Reproduced with permission.

Other external users

Employees and labour unions make wage demands partly based on their employer's reported profit. Consumer groups, suppliers and pressure groups are among others interested in the amount of profit that businesses earn. The media report the profits of businesses as details of these are released. Such news, based on accounting information, sometimes influences political decisions.

Internal users

The key internal decision makers in an organisation are normally senior and middle management. These managers use accounting information to set goals, measure progress towards those goals, and make adjustments when needed. The accounting system gives managers the information they need to help make those decisions. For example, imagine you are in charge of setting sales targets over the next year for the fast food chain McDonald's. Where would you start? Probably with last year's sales numbers, which, as you probably guessed, come from the accounting system.

Having established why accounting information is required and who some of its major users are, let's now learn how to prepare this information.

1.2 WHAT IS THE ACCOUNTING EQUATION?

Before we explain the accounting equation, let's run through a simple example to show that the fundamental concepts of accounting are perhaps more readily understandable than you would expect.

Suppose it's a Monday morning during the university holidays and you want to make some money. You had previously noticed that there was nowhere that sold fruits and vegetables near the main business district in your home city. So, as a trial, you start a business of buying and selling bananas by investing \$50 of your savings. This means the business is 'worth' \$50 at this point. That morning, you buy a 12 kg box of bananas in the market for \$36. There are 110 bananas in the box and you sell them all to office workers at lunchtime for \$1 each. As you sit down for a well-earned rest in the early afternoon, you try to work out how much profit your business made in its first few hours of life and how much your business is now worth. Try to work this out before reading on.

If you came up with a profit number of $\$110 - \$36 = \$74$, you have just correctly performed your first piece of accounting (an income statement)! If you came up with the business being worth the original \$50 cash plus the \$74 profit = \$124, then you have just correctly performed the first part of your first balance sheet!

To understand the income statement and balance sheet better, you need to understand the basic tool of accounting, the **accounting equation**. It measures the resources of a business (what the business owns or has control of) and the claims to those resources (what the business 'owes' to lenders and the owners). The accounting equation consists of three parts—assets, liabilities and equity. Assets appear on the left side of the equation, and the liabilities and owners' equity appear on the right side. As it is an *equation*, by definition the two sides must be equal. So, what do accountants mean by the three key concepts of assets, liabilities and equities?

LO 2

Describe the accounting equation, and define assets, liabilities and equity

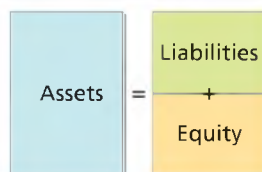


EXHIBIT 1-2
The accounting equation

Assets, liabilities and equity

Assets

An **asset** is an economic resource that is expected to benefit the business in the future. Assets are something the business owns or has control of that has value. Cash, merchandise inventory, furniture and land are examples of assets. Claims to these assets come from two sources: liabilities and equity.