

ATRILL'S

# ACCOUNTING

FOR BUSINESS STUDENTS

ATRILL • McLANEY • HARVEY

Copyright © 2017, P.Ed Australia. All rights reserved.



Atrill, Peter, et al, Accounting for Business Students eBook, P.Ed Australia, 2017. ProQuest Ebook Central, <http://ebookcentral.proquest.com/lib/usyd/detail.action?docID=5220577>. Created from usyd on 2018-03-05 19:48:28.

# ACCOUNTING

## FOR BUSINESS STUDENTS

Copyright © 2017. P.Ed Australia. All rights reserved.

This page is intentionally left blank



• ATRILL'S •

# ACCOUNTING

FOR BUSINESS  
STUDENTS

ATRILL • McLANEY • HARVEY

Copyright © Pearson Australia (a division of Pearson Australia Group Pty Ltd) 2018

Pearson Australia  
707 Collins Street  
Melbourne VIC 3008

www.pearson.com.au

Authorised adaptation from the original UK editions, entitled *Accounting and Finance for Non-Specialists 10/e* (ISBN: 9781292135601) by Peter Atrill & Eddie McLaney © 2017 and *Accounting and Finance: An Introduction 8/e* (ISBN: 9781292088297) by Peter Atrill & Eddie McLaney © 2016, both published by Pearson Education Limited. Licensed for sale in Australia and New Zealand only.

First adaptation edition published by Pearson Australia Group Pty Ltd, Copyright © 2018 by arrangement with Pearson Education Ltd, United Kingdom.

The *Copyright Act 1968* of Australia allows a maximum of one chapter or 10% of this book, whichever is the greater, to be copied by any educational institution for its educational purposes provided that that educational institution (or the body that administers it) has given a remuneration notice to Copyright Agency Limited (CAL) under the Act. For details of the CAL licence for educational institutions contact: Copyright Agency Limited, telephone: (02) 9394 7600, email: info@copyright.com.au

All rights reserved. Except under the conditions described in the *Copyright Act 1968* of Australia and subsequent amendments, no part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the copyright owner.

Senior Portfolio Manager: Joanne Hobson  
Development Editor: Anna Carter  
Project Manager: Anubhuti Harsh  
Production Manager: Abhishek Agarwal, iEnergizer Aptara®, Ltd  
Product Manager: Sachin Dua  
Content Developer: Victoria Kerr  
Rights and Permissions Editor: Kim Morgan  
Copy Editor: Kathryn Lamberton  
Lead Editor: Dina Cloete  
Proofreader: iEnergizer Aptara®, Ltd  
Indexer: iEnergizer Aptara®, Ltd  
Cover and internal design by Squirt Creative  
Cover illustrations: coffee cup: © goner13/Envato Market; coffee beans: © Vasya Kobelev/Shutterstock.com;  
wave pattern: © Markovka/Shutterstock.com  
Typeset by iEnergizer Aptara®, Ltd

Printed in Malaysia

1 2 3 4 5 22 21 20 19 18

National Library of Australia Cataloguing-in-Publication Data

Creator:	Atrill, Peter, author.
Title:	Accounting for business students / Peter Atrill; Eddie McLaney; David Harvey.
ISBN:	9781488616570 (paperback)
ISBN:	9781488616594 (eBook)
Notes:	Includes index.
Subjects:	Accounting--Textbooks. Financial statements. Accounting--Problems, exercises, etc.
Other Creators/Contributors:	McLaney, E. J., author. Harvey, David

Every effort has been made to trace and acknowledge copyright. However, should any infringement have occurred, the publishers tender their apologies and invite copyright owners to contact them.

Pearson Australia Group Pty Ltd ABN 40 004 245 943



# BRIEF CONTENTS

About the Australian author	xii
Preface	xiii
About the contributor	xvii
Acknowledgements	xviii
For students: How do I use this book?	xx
Resources for students and educators	xxii
<b>1</b> Introduction to accounting	1
<b>2</b> Measuring and reporting financial position	46
<b>3</b> Measuring and reporting financial performance	92
<b>4</b> Recording transactions—the journal and ledger accounts	162
<b>5</b> Accounting systems and internal control	227
<b>6</b> Introduction to limited companies	280
<b>7</b> Regulatory framework for companies	326
<b>8</b> Measuring and reporting cash flows	376
<b>9</b> Corporate social responsibility and sustainability accounting	430
<b>10</b> Analysis and interpretation of financial statements	472
<b>11</b> Cost-volume-profit analysis and relevant costing	534
<b>12</b> Full costing	582
<b>13</b> Planning and budgeting	634
<b>14</b> Capital investment decisions	705
Glossary	759
Index	767

# CONTENTS

About the Australian author	xii
Preface	xiii
About the contributor	xvii
Acknowledgements	xviii
For students: How do I use this book?	xx
Resources for students and educators	xxii

## CHAPTER 1

<b>Introduction to accounting</b>	<b>1</b>
<b>Nature and role of accounting</b>	<b>3</b>
Accounting as a service function	4
Costs and benefits of accounting information	5
Accounting as an information system	6
<b>Users of accounting information</b>	<b>8</b>
<b>Financial and management accounting</b>	<b>9</b>
<b>What is the financial objective of a business?</b>	<b>11</b>
Stakeholder theory	13
Balancing risk and return	14
<b>The main financial reports—an overview</b>	<b>15</b>
Financial accounting	15
Management accounting	18
<b>Business and accounting</b>	<b>20</b>
What kinds of business ownership exist?	20
How are businesses managed?	25
Not-for-profit organisations	26
<b>The changing face of business and accounting</b>	<b>28</b>
Ethics and ethical behaviour in business	30
<b>How useful is accounting information?</b>	<b>33</b>
Why do I need to know anything about accounting and finance?	34
<b>The ALTC's Academic Standards for Accounting</b>	<b>35</b>
Characteristics of successful business people	37
<b>Summary</b>	<b>38</b>
<b>Reference</b>	<b>39</b>
<b>Discussion questions</b>	<b>39</b>
<b>Case study</b>	<b>41</b>
<b>Solutions to activities</b>	<b>42</b>

## CHAPTER 2

<b>Measuring and reporting financial position</b>	<b>46</b>
<b>Nature and purpose of the statement of financial position</b>	<b>47</b>
Assets	47
Claims against the assets	48
<b>The accounting equation</b>	<b>50</b>
The effect of trading operations on the statement of financial position	52
<b>The classification of assets and claims</b>	<b>55</b>
The classification of assets	55
The classification of liabilities	56
The classification of owners' equity	57
<b>Formats for statements of financial position</b>	<b>58</b>
Financial position at a point in time	61
<b>Factors influencing the form and content of the financial reports</b>	<b>62</b>
Conventional accounting practice	63
Valuing assets	67
<b>Usefulness of the statement of financial position</b>	<b>72</b>
<b>Statement of financial position deficiencies</b>	<b>74</b>
<b>Summary</b>	<b>77</b>
<b>Discussion questions</b>	<b>78</b>
<b>Application exercises</b>	<b>79</b>
<b>Case study</b>	<b>87</b>
<b>Solutions to activities</b>	<b>88</b>

## CHAPTER 3

<b>Measuring and reporting financial performance</b>	<b>92</b>
<b>The statement of financial performance—its nature and purpose, and its relationship with the statement of financial position</b>	<b>93</b>
The stock approach to calculating profit	95
<b>The format of the income statement</b>	<b>97</b>
Key terms	97
Classifying expenses	99
The reporting period	101







## CHAPTER 6

### Introduction to limited companies 280

<b>The main features of companies</b>	<b>281</b>
Legal nature	281
Unlimited (perpetual) life	281
Limited liability	282
Legal safeguards	282
Public and proprietary (private) companies	283
Transferring share ownership—the role of the stock exchange	284
Separation of ownership and management	284
Extensive regulation	285
Advantages and disadvantages of the company entity structure	288
<b>Equity and borrowings in a company context</b>	<b>289</b>
Equity/capital (owners' claim) of limited companies	289
Reserves	292
Bonus shares	293
Raising share capital	294
Borrowings	298
<b>Restrictions on the rights of shareholders to make drawings or reductions of capital</b>	<b>299</b>
<b>The main financial statements</b>	<b>303</b>
The income statement	304
The statement of financial position	305
Dividends	305
<b>Accounting for groups of companies</b>	<b>307</b>
<i>Summary</i>	<b>312</b>
<i>Discussion questions</i>	<b>312</b>
<i>Application exercises</i>	<b>313</b>
<i>Case study</i>	<b>321</b>
<i>Solutions to activities</i>	<b>323</b>

## CHAPTER 7

### Regulatory framework for companies 326

<b>The directors' duty to account—the role of company law (Corporations Act)</b>	<b>327</b>
Auditors	328

<b>The need for accounting rules</b>	<b>331</b>
The role of accounting standards in company accounting	331
International accounting standards	332
The conceptual framework	334
<b>The role of the Australian Securities Exchange (ASX) in company accounting</b>	<b>337</b>
Corporate governance	338
<b>Presentation of published financial statements</b>	<b>344</b>
Statement of financial position	344
Statement of comprehensive income	345
Statement of changes in equity	350
Statement of cash flows	352
Notes	352
General points	352
<b>Segmental financial reports</b>	<b>353</b>
Segmental reporting rules	354
Segmental disclosure	354
Segmental reporting problems	356
<b>Creative accounting</b>	<b>358</b>
Creative accounting methods	358
Checking for creative accounting	361
Creative accounting and economic growth	361
<i>Summary</i>	<b>363</b>
<i>Discussion questions</i>	<b>363</b>
<i>Application exercises</i>	<b>365</b>
<i>Case study</i>	<b>370</b>
<i>Solutions to activities</i>	<b>372</b>

## CHAPTER 8

### Measuring and reporting cash flows 376

<b>The importance of cash and cash flow</b>	<b>378</b>
Differences between the four external financial reports	381
<b>The statement of cash flows</b>	<b>382</b>
<b>Preparation of the statement of cash flows—a simple example</b>	<b>386</b>
Deducing cash flows from operating activities	388
Deducing cash flows from investing activities	390
Deducing cash flows from financing activities	391

Reconciling profit for the year with cash from operating activities	396
Some complexities in statement preparation	400
The investing section	401
The financing section	402
What does the statement of cash flows tell us?	404
<i>Summary</i>	<b>408</b>
<i>Discussion questions</i>	<b>408</b>
<i>Application exercises</i>	<b>409</b>
<i>Case study</i>	<b>424</b>
<i>Solutions to activities</i>	<b>425</b>

## CHAPTER 9

<b>Corporate social responsibility and sustainability accounting</b>	<b>430</b>
Social issues in accounting	431
General background	431
Stakeholder concept	431
What is social responsibility?	433
Corporate social responsibility (CSR)— what does it mean?	436
Accounting for corporate social responsibilities	440
Triple bottom line reporting	442
The Global Reporting Initiative (GRI)	444
General background	444
Background and development of the GRI Guidelines	444
Current position—the GRI Standards	446
Integrated reporting	455
The balanced scorecard approach	457
The financial perspective	457
The business process perspective	458
The customer perspective	458
The learning and growth perspective	458
Overall conclusion	461
<i>Summary</i>	<b>462</b>
<i>References</i>	<b>462</b>
<i>Discussion questions</i>	<b>463</b>
<i>Application exercises</i>	<b>464</b>
<i>Case study</i>	<b>467</b>
<i>Solutions to activities</i>	<b>470</b>

## CHAPTER 10

<b>Analysis and interpretation of financial statements</b>	<b>472</b>
Financial ratios	473
Financial ratio classification	473
The need for comparison	474
The key steps in financial ratio analysis	475
The ratios calculated	475
A brief overview	478
Profitability ratios	479
Return on ordinary shareholders' funds (ROSF) (also known as return on equity (ROE))	479
Return on capital employed (ROCE)	480
Operating profit margin	481
Gross profit margin	481
Efficiency ratios	483
Average inventories turnover period	483
Average settlement period for accounts receivable (debtors)	484
Average settlement period for accounts payable (creditors)	485
Sales revenue to capital employed	486
Sales revenue per employee	486
Alternative formats	486
The relationship between profitability and efficiency	487
Liquidity	489
Current ratio	489
Acid test ratio	490
Cash flows from operations ratio	490
Financial gearing (leverage) ratios	491
Gearing ratio	494
Interest cover ratio (times interest earned)	494
An aside on personal debt	496
Investment ratios	497
Dividends per share ratio	497
Dividend payout ratio	498
Dividend yield ratio	498
Earnings per share ratio	499
Operating cash flow per share	500
Price/earnings ratio	500

Issues relating to financial analysis	502
Financial ratios and the problem of overtrading	502
Trend analysis	503
Index or percentage analysis	506
Ratios and prediction models	507
Limitations of ratio analysis	511
<b>Summary</b>	<b>516</b>
<b>References</b>	<b>517</b>
<b>Discussion questions</b>	<b>517</b>
<b>Application exercises</b>	<b>518</b>
<b>Case study</b>	<b>529</b>
<b>Solutions to activities</b>	<b>529</b>

## CHAPTER 11

<b>Cost–volume–profit analysis and relevant costing</b>	<b>534</b>
<b>The behaviour of costs</b>	<b>535</b>
Fixed costs	535
Variable costs	536
Semi-fixed (semi-variable) costs	537
<b>Break-even analysis</b>	<b>540</b>
<b>Contribution</b>	<b>543</b>
Profit–volume charts	545
Margin of safety and operating gearing	546
Weaknesses of break-even analysis	548
<b>Use of spreadsheets</b>	<b>551</b>
Expected costs rather than historic costs	554
More complex cost and revenue behaviour patterns	555
<b>Relevant cost, outlay cost and opportunity cost</b>	<b>556</b>
<b>Marginal analysis/relevant costing</b>	<b>559</b>
Accepting/rejecting special contracts	560
The most efficient use of scarce resources	560
Make or buy decisions	561
Closing or continuing a section or department	562
<b>Summary</b>	<b>567</b>
<b>Discussion questions</b>	<b>567</b>
<b>Application exercises</b>	<b>569</b>
<b>Case study</b>	<b>576</b>
<b>Solutions to activities</b>	<b>577</b>

## CHAPTER 12

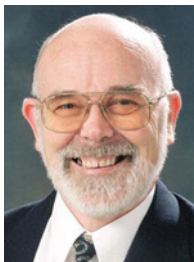
<b>Full costing</b>	<b>582</b>
<b>The nature of full costing</b>	<b>583</b>
<b>Deriving full costs in a single or multi-product or service operation</b>	<b>584</b>
Single-product businesses	584
Multi-product operations	585
<b>Segmenting the overheads</b>	<b>594</b>
Dealing with overheads on a departmental (cost centre) basis	594
Batch costing	601
The forward-looking nature of full costing	602
<b>Activity-based costing (ABC)</b>	<b>603</b>
Costing and pricing: the traditional way	603
Costing and pricing: the new environment	603
An alternative approach to full costing	604
ABC contrasted with the traditional approach	605
Attributing overheads	606
Benefits of ABC	607
Criticisms of ABC	610
<b>Uses of full (absorption) cost information</b>	<b>611</b>
Full cost (cost-plus) pricing	612
Criticisms of full costing	613
<b>Summary</b>	<b>618</b>
<b>References</b>	<b>619</b>
<b>Discussion questions</b>	<b>619</b>
<b>Application exercises</b>	<b>620</b>
<b>Case study</b>	<b>628</b>
<b>Solutions to activities</b>	<b>629</b>

## CHAPTER 13

<b>Planning and budgeting</b>	<b>634</b>
<b>Planning and control</b>	<b>635</b>
Corporate objectives, long-term plans and budgets—their relationship	635
Exercising control	636
<b>The role of projected financial statements</b>	<b>637</b>
Likely information needed for forecast statements	638



# ABOUT THE AUSTRALIAN AUTHOR



## Emeritus Professor David Harvey

After qualifying as an accountant in the United Kingdom, David began lecturing in 1971 at Portsmouth Polytechnic (now Portsmouth University) with a subsequent move to Plymouth Polytechnic (now the University of Plymouth) in 1977. During his time in the United Kingdom he developed a keen interest in curriculum development and teaching methods and was involved with the writing of several books with an open learning style, many of these in collaboration with Peter Atrill and Eddie McLaney. During this time he also completed a Masters degree in Managerial Financial Controls and a PhD in the areas of investment and financing decisions. This research work covered both traditional investment appraisal and corporate strategy.

In 1991 he moved to Australia to take up the position of Professor of Accounting and Head of the Centre for Accounting and Finance at the University of New England (Northern Rivers), which subsequently became Southern Cross University. In 1992 he became the Dean of the Faculty of Business and Computing, a position he held until 1996, before reverting to his Professorship. In 2000 he took up the position of the Dean of the Faculty of Commerce at the University of Southern Queensland. In 2001 the Faculty of Commerce was merged with the Faculty of Business and David became Dean of the enlarged Faculty of Business. David has had extensive experience in developing and teaching programs internationally. His most recent position was as Pro Vice-Chancellor (International Quality), a position he held from 2004 until his retirement in 2005.

# PREFACE

This new textbook is primarily targeted at undergraduate and postgraduate students of business-oriented programs who want a fairly comprehensive introduction to accounting.

The book aims to provide engaging and relevant content, something which we regard as critical to success for today's learners.

This first-edition textbook is the result of considerable review activity with user groups. The end product is a book which was designed for courses that require learners to be both preparers and users of financial statements. Courses of this nature require a balanced approach that is relevant to both students majoring in accounting and students of business generally. This book therefore aims to provide a comprehensive first course in accounting which will support students who wish to go on to an accounting major, and also those who plan to do other majors, or are studying general business.

A critical part of this is use of a first-principles approach to accounting, from which we can then move on to the actual recording process. This avoids creating the misconception that accounting is a mechanical process; rather it enables us to focus more on the importance of critical thinking and decision making. The inclusion of two chapters on what is essentially record keeping aims to provide students with a deeper understanding of how financial information is collected and communicated, while also identifying its limitations.

The emphasis of the book is clearly decision making. It uses a problem-solving approach and focuses on real-world business situations. A key objective throughout is to assist in the development of generic skills, including communication, teamwork, critical thinking, problem-based learning, ethics, self-management, planning and organisation. The book provides a range of activities which should help in the development of these generic qualities.

## Background

This book has its origins in *Accounting: An Introduction*, which has been through six editions, and which has been regularly reviewed and improved. This book will in future be published as *Accounting for Non-Specialists*. However, after considerable market research, it was agreed that the sixth edition, while more clearly targeting the non-specialist

market, was not satisfying all market needs. As a result, *Accounting for Business* was developed. This book builds on the eighth edition of a second British book by Peter Atrill and Eddie McLaney, namely, *Accounting and Finance: An Introduction*, and uses a considerable part of it.


Quite a lot of the coverage of *Accounting for Business* is common with the non-specialist book. However, it expands the content of most chapters, in order to provide a more comprehensive underpinning for all business students, and specifically for those who want to go on to an accounting major. Also, there has been a significant demand for content relating to the recording system, so two chapters have been added, covering journals and ledger accounts, and internal control and accounting systems in practice. In order to make room for the additional material, two chapters on finance, which are in the non-specialist book, have been omitted from the new textbook. The style of both books is very similar.

It is worth noting that the two British books which underpin this book, namely *Accounting and Finance for Non-Specialists* and *Accounting and Finance: An Introduction*, are in their tenth and eighth editions respectively. These books reflect many years of development in the UK, and share content where appropriate. In *Accounting for Business*, we have tried to ensure that the content reflects Australian needs and conditions, while also adding some new features. We have been working together on our Australian non-specialist book for many years and this is now in its seventh edition. Collaboration of this type has helped with the development of an international perspective on a range of issues which should provide benefit to students.

## Features

- ▶ Interspersed throughout each chapter are numerous activities, with at least one for every learning objective. These are relatively short 'quick-fire' questions of a type a lecturer might pose to students during a lecture or tutorial, and are intended to serve two purposes: to give readers the opportunity to check that they have understood the preceding section, and to encourage them to think beyond the immediate topic and make linkages to topics either previously covered or covered in the next section. An answer to each activity is





provided at the end of the chapter, to which readers should refer only after they have attempted the activity.

- ▶ At the end of each section, which covers a specific learning objective, there are several concept check questions. These are short multiple-choice questions which aim to provide you with a quick check of your understanding of the learning objective/section. The answers are at the end of the chapter.
- ▶ Towards the end of each chapter, but also at an appropriate point in some chapters, there is a self-assessment question or questions. These are much more demanding and comprehensive than the activities, in terms of both the breadth and the depth of the material they cover. As with the activities, it is important to make a thorough attempt at each question before referring to the solution. Solutions to these questions are available online.
- ▶ Discussion questions occur at the end of each chapter. These are relatively short, typically require a descriptive or analytical answer, and are intended to enable readers to assess their recollection and critical evaluation of the main principles in each chapter. They might be used as the basis for tutorial discussion.
- ▶ Application exercises are also positioned at the end of most chapters and these have been categorised as easy, intermediate or challenging. These are usually of a numerical type, and are designed to enable readers to further apply and consolidate their understanding of topics. A single case study can also be found at the end of each chapter. Some of these are simply more complicated problems, but in the main they are questions based on current issues. Their aim is to get students to think in a broader manner than usual, and to develop a wider approach to dealing with issues that are real and current.
- ▶ This new book continues to include what we have called ‘Real World’ examples (typically three or four per chapter), which aim to provide a link between theory and current practice. Following each Real World example is a set of classroom discussion

points, which should facilitate discussion on issues that have occurred in business relatively recently.

- ▶ Each chapter has an ‘Accounting and You’ section, which aims to relate the content of the chapter to the individual student reader. All too often students feel that the content is big-business oriented and has nothing really to do with them. This section illustrates that what they are learning has real relevance to their everyday lives. Each of these also has a series of classroom discussion points for the class to ponder.

### Coverage and structure

Although the topics included are, to some extent, relatively conventional, the coverage and treatment of material is designed to meet the needs of business students. While the emphasis is primarily on underlying concepts, and the application and interpretation of information for decision making, this book also includes sections on data collection and recording, as well as the preparation of statements and reports.

One major difference between this book and many others relates to its early structure. As business and accounting become more complicated it becomes more difficult to cover these issues in a reasonably straightforward way. So, in this book we introduce (in Chapters 2 and 3) two of the major accounting statements in the context of relatively simple business organisations, mainly sole proprietorships and partnerships or very simple companies. We use the balance-sheet approach to enable us to build up a balance sheet from a set of basic transactions, and then extend this approach by explaining the income statement as part of the equity section of the balance sheet. This is all done using a first-principles approach.

The approach used in Chapters 2 and 3 enables us to cover the basic accounting statements without adding the complications of a complex corporate regulatory framework. Once the underlying principles and nature of the statement of financial position (the balance sheet) and the statement of financial performance (the income statement) have been understood, we can then complicate it by adding (Chapters 6 and 7) companies and their regulatory framework.





In Chapters 4 and 5, we show how the two main statements are built up in practice, using a system of ledger accounts and books of original entry (or, as is more likely, by a computerised accounting system using the same basic principles).

We have ordered the chapters and their component topics to reflect what we consider to be a logical sequence. For this reason, we advise readers to work through the text in the order presented, particularly since we have been careful to ensure that earlier chapters do not refer to concepts or terms that are not covered until a later chapter.

Chapters 1–10 can be said to be broadly financial-accounting oriented, while Chapters 11–14 focus on what are clearly management accounting areas. Having said this, much of the financial accounting material effectively underpins the later chapters and students should not get too hung up on which area is which. For example, the financial accounting framework links very closely with the planning section in Chapter 13.

Chapter 1 provides a general introduction to the scope, purpose and interrelationships of the text's core coverage—financial accounting and management accounting—together with a brief overview of the main financial statements. It also examines user groups and their needs; introduces the main types of business organisation, together with the way in which a business is typically organised and managed and identifies ways in which business and accounting have been changing over time. This chapter includes more on stakeholder theory, ethics and ethical behaviour in business, and the Academic Standards Statement for Accounting, than does the non-specialist book.

Chapter 2 explains the nature and purpose of the statement of financial position. This is done in the context of relatively simple organisations, so as to not unnecessarily complicate things. The method in which the statement is built up and its typical format are both covered, followed by the main factors that influence the content and values in the statement. Finally, the main uses and limitations of the statement are examined.

Chapter 3 explains the nature and purpose of a statement of financial performance, usually referred to as an income statement. The way in which the statement is built up and the way in which it is typically presented

are covered comprehensively, for relatively simple organisations. Extra material, compared with the non-specialist book, includes the unit-of-production method of depreciation and more on the perpetual inventory system.

Chapter 4 provides the student with an introduction to double-entry book keeping, including the link with the first-principles approach, ledger accounts, use of trial balance, the closing-down process and a series of period-end adjustments. It also introduces the adjusted trial balance and worksheet, before concluding with a section on the nature and importance of the chart of accounts.

Chapter 5 discusses internal control and the various ways in which accounting transactions are recorded in books of original entry, and then outlines the major elements of computerised accounting systems. Students should have a thorough grounding in the basic recording process as a result. Real-world examples in this chapter aim to prepare the student for a variety of ways in which the basic principles are applied in practice.

Chapters 6 and 7 concentrate on limited companies. Chapter 6 focuses on the main features associated with limited companies. Many users will have dealings with groups of companies so the requirements of group accounts are outlined. Chapter 7 explains the importance of company law, accounting standards, the stock exchange and the importance of good corporate governance. Corporate governance remains an ongoing issue for many businesses. The chapter then identifies the main requirements relating to the published annual report. It contains far more information on accounting standards than does the non-specialist book. It also introduces sections on segment reporting and creative accounting.

Chapter 8 focuses on the statement of cash flows and the importance of cash to any business. The chapter also completes the coverage of the main external reports prepared.

Chapter 9 introduces the areas of corporate social responsibility together with social and environmental accounting and also explains the current state of development of sustainability reporting and integrated reporting. Further work on these areas is likely to be needed over the foreseeable future as the world faces



continued issues including climate change, a range of other environmental issues, peak oil, world poverty, child-labour abuse, and human rights and responsibilities generally.

Chapter 10 deals with the analysis and interpretation of the main financial statements. There is also more detail on ratios and prediction models than is included in the non-specialist book.

Our formal coverage of management accounting begins in Chapter 11 with a discussion of the interrelationships between costs, volume and profit in decision making. Extra material, compared with the non-specialist book, includes more on semi-variable costs, and the use of spreadsheets to develop profit profiles and associated charts.

Chapter 12 covers full costing and activity-based costing. Extra material, over and above that found in the non-specialist book, includes more on the apportionment process for overheads and cost-plus pricing.

Chapter 13 includes a section on planning and forecasting using the basic financial statements. This includes use of spreadsheets and sensitivity analysis. This is seen as an additional feature of planning and budgeting over and above that used in the non-specialist book. The remainder of the chapter focuses on short-term planning and control and deals with various aspects of budgeting. The chapter includes a section on Beyond Budgeting.

Chapter 14 deals with capital budgeting, the decision to invest in medium- and long-term assets, and considers how businesses appraise such projects. There is material on mutually exclusive projects and capital rationing, and more on practical aspects of identifying and dealing with cash flows, and the link with strategic planning.

*Peter Atrill*  
*Eddie McLaney*  
*David Harvey*



# ABOUT THE CONTRIBUTOR

## **Maria Tyler:** Chapter 5 contributor

Dr Maria Tyler is a certified practising accountant (CPA) and an accounting and finance lecturer (currently with CQUniversity's School of Business & Law). She has more than 13 years' tertiary teaching experience at undergraduate and postgraduate levels, and is experienced in curriculum design, development and implementation. Dr Tyler gained her PhD in Accounting from CQUniversity in Mackay, Queensland, and also holds a Bachelor of Business/Bachelor of Information Systems, Bachelor of Business with First Class Honours, MBA, Graduate Certificate in Management, Graduate Diploma in Management, and a Diploma in Financial Services (Conveyancing).

# ACKNOWLEDGEMENTS


We are indebted to the accounting education community for the time and expertise invested as proposal reviewers, digital reviewers, manuscript reviewers and focus-group participants. Their invaluable insights have greatly improved the clarity, consistency and focus of this textbook.

Dr Paul J. Blayney, University of Sydney  
Dr Peta Stevenson-Clarke, RMIT  
Dr Angela Tan-Kantor, Swinburne University of Technology  
Ms Dianne English, Griffith University  
Maria Tyler, CQ-University  
Mr Chris Williams, RMIT  
Amitav Saha, University of Notre Dame Australia  
Dr Terri Trireksani, Murdoch University  
Wes Hamilton-Jessop, University of Sydney  
Abdul Razeed, University of Sydney  
Olga Gouveros, University of Sydney  
Matt Dyki, University of Melbourne  
Nicholas McGuigan, Monash University  
Jodie Nelson, Griffith University  
Warwick Baines, Charles Stuart University  
Mark Valley, University of Southern Queensland  
David Xiang, Edith Cowan University  
Youngdeok Lim, University of New South Wales  
Stephanie Perkiss, University of Wollongong  
Marcus Rodriqs, Newcastle University  
Julie Walker, University of Queensland  
Samantha Sin, Macquarie University  
Maurice Sheridan, RMIT

Special thanks from the authors and publisher to Angela Tan-Kantor for carrying out the technical editing for this edition.

## COPYRIGHT

ASX material reproduced in this book is © ASX Corporate Governance Council Association of Superannuation Funds of Australia Ltd, ACN 002 786 290, Australian Council of Superannuation Investors, Australian Financial Markets Association Limited ACN 119 827 904, Australian Institute of Company Directors ACN 008 484 197, Australian Institute of Superannuation Trustees ACN 123 284 275, Australasian Investor Relations Association Limited ACN 095 554 153, Australian Shareholders' Association Limited ACN 000 625 669, ASX Limited ABN 98 008 624 691 trading as Australian Securities Exchange, Business Council of Australia ACN 008 483 216, Chartered Accountants Australia and New Zealand, CPA Australia Ltd ACN 008 392 452, Financial Services Institute of Australasia ACN 066 027 389, Group of 100 Inc,



The Institute of Actuaries of Australia ACN 000 423 656, ABN 50 084 642 571, The Institute of Internal Auditors – Australia ACN 001 797 557, Financial Services Council ACN 080 744 163, Governance Institute of Australia Ltd ACN 008 615 950, Law Council of Australia Limited ACN 005 260 622, National Institute of Accountants ACN 004 130 643, Property Council of Australia Limited ACN 008 474 422, Stockbrokers Association of Australia ACN 089 767 706. All rights reserved 2017.

AASB material © Commonwealth of Australia (2017). All legislation herein is reproduced by permission but does not purport to be the official or authorised version. It is subject to Commonwealth of Australia copyright. The *Copyright Act 1968* permits certain reproduction and publication of Commonwealth legislation. In particular, s.182A of the Act enables a complete copy to be made by or on behalf of a particular person. For reproduction or publication beyond that permitted by the Act, permission should be sought in writing from the Commonwealth available from the Australian Accounting Standards Board. Requests in the first instance should be addressed to the National Director, Australian Accounting Standards Board, PO Box 204, Collins Street West, Melbourne, Victoria, 8007.









# RESOURCES FOR STUDENTS AND EDUCATORS

## Students

Solutions to the self-assessment questions are available at [www.pearson.com.au/9781488616570](http://www.pearson.com.au/9781488616570).

## Educators

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

### Solutions Manual

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

### Test Bank

The Test Bank provides a wealth of accuracy-verified testing material. Updated for the new edition, each chapter offers a wide variety of question types, arranged by learning objective and tagged by AACSB standards. Questions can be integrated into Blackboard or Moodle Learning Management Systems.

### 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 course content.

### Digital Image PowerPoint Slides

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

## CHAPTER 7

# INTRODUCTION TO ACCOUNTING

### LEARNING OBJECTIVES

When you have completed your study of this chapter, you should be able to:

- L01** Explain the nature and role of accounting
- L02** List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information
- L03** Compare and contrast financial and management accounting
- L04** Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship
- L05** Provide an overview of the main financial reports prepared by a business
- L06** Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context
- L07** Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting, including current thinking on ethics in business
- L08** Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting
- L09** Identify the learning outcomes associated with the Australian Learning and Teaching Council's Academic Standards Statement for Accounting: namely judgement; knowledge; application skills; communication and teamwork; and self-management; and examine how these compare with characteristics of successful business people.

People need economic information to help them make decisions and judgements about businesses. Whether we are talking about a business manager making decisions about the most appropriate level of production, a bank manager responding to a request from the business for a bank loan or trade unionists deciding how much pay increase to seek for their members, accounting information should help them with their decision.

In this opening chapter, we begin by considering the roles of accounting. As we shall see, accounting can be a valuable tool in the decision-making, planning and control process. We shall identify those people who are the main users of accounting and financial information, and discuss the ways in which this information can improve the quality of decisions that they make. In subsequent chapters, we develop this decision-making theme by considering in some detail the kinds of financial reports and methods used to aid decision-making.

Since this book is mainly concerned with accounting and financial decision-making for private-sector businesses, we shall devote some time to examining the business environment. We shall, therefore, consider the key financial purpose of a private-sector business, the main forms of business enterprise and the ways in which a business may be structured, organised and managed. These are all important as they help to shape the kind of accounting and financial information that is produced.

Finally, we shall consider how business is changing and identify key issues regarding stakeholder interests, ethics and sustainability. These issues have considerable implications for the public perception of business, for businesses themselves, and for accountants and their measurement and reporting systems. Some of these issues are difficult and not easily resolved, but they are issues that you need to be aware of.

## ACCOUNTING AND YOU



### MAKING DECISIONS

So how do you make decisions?

- What kind of decisions do you need to make?
- How important is economic information in your decision-making?
- How do you deal with numbers and quantitative information?
- Are you comfortable with these areas, or are there areas with which you are uncomfortable?

Let us consider the kind of decisions that are commonly made at some stage of our lives.

- Keeping expenditure in line with income—something just about every student will wrestle with.
- Buying new things—these might include buying simple things like a new mobile phone, or a new vehicle, whether an old banger or a new BMW, or a really major decision, such as buying a home.
- Starting a new business venture, either on your own or in collaboration with others.
- Investing for the future in shares or government bonds.

All of these decisions will require you to collect information, much of which can be classified as economic. Economic information is largely quantitative. The typical economic decision involves choosing the best outcome for you, given that your resources are scarce.

None of what has been said to date should imply that decisions are made solely on economic lines. Many decisions are based on things such as personal preference, family considerations, a sense of duty or aesthetics, with a few people even using the stars to assist! However, many decisions have a clear economic orientation, and accounting can help with these decisions.

So what information do you need to keep your expenditure in line with income? You will probably need a clear understanding of your income, its amount and nature. You will also need to have a clear understanding of your spending patterns, and you will almost certainly need to differentiate between ongoing regular expenditure and one-off expenditure.

Decisions to buy new things may be relatively easy, such as buying a new phone, which may well be bought out of normal spending. Decisions about major assets, such as the purchase of a home, will require much more careful information gathering and analysis. This analysis will probably include ideas around how the asset will be funded.

Decisions regarding potential business ventures also require substantial data collection and analysis. Your future lifestyle is likely to be substantially influenced by the success or failure of a venture of this type. The analysis will need to contain information about markets and competition, as well as specifics regarding the particular business.

Decisions regarding the possible purchase of new shares or bonds will require the collection of relevant data. In the case of shares, this will probably mean detailed information about the past performance of the company and estimates of its future prospects.

Clearly, any decision that has an economic element will require substantial economic information. Basically, the role of the accounting system is to provide much of that information. The system cannot and does not attempt to cover all economic input, but essentially focuses on the collection, recording and reporting of key economic data as they relate to a particular individual or entity. Just what information is covered is the subject of this book.

You may not be comfortable with numbers and quantified information. However, it is difficult for an entity to be successful without having someone who does understand and can communicate such information. So good luck with your studies.

### Class discussion points

- 1 If you were to consider starting a business, what information would you be seeking before commencing?
- 2 Who might you want to work with and in what capacity?
- 3 How important is teamwork and good communication in decision-making? Do you see any particular issues that might arise with the people identified above?
- 4 How comfortable are you likely to be in a team where expertise in a particular area is held by only one team member?

## NATURE AND ROLE OF ACCOUNTING

**Accounting** is concerned with the collection, analysis and communication of economic information. Such information can be used as a tool of decision-making, planning and control. This is to say that accounting information is useful to those who need to make decisions and plans about businesses, and for those who need to control those businesses.

Examples of the kind of decisions for which the managers of businesses may need accounting information include the following:

- decisions to develop or terminate new products or services
- decisions to change the price or quantity of existing products
- decisions to borrow money to help finance the business
- decisions relating to the scale of the business, and
- decisions to change the methods of purchasing, production or distribution.

You might spend a few moments reflecting on the implications of some of these. Some decisions have far-reaching consequences; for example, moves to take activities offshore have the potential to impact substantially on the business, its workforce, and the local and regional communities.

Although managers working in a particular business are likely to be significant users of accounting information, they are by no means the only people who are likely to use accounting information about that particular business. People outside the business (whom we shall identify later) may need information to help make decisions such as whether to invest in the business—as owner or lender, whether to grant credit for goods provided or whether to enter into a major contract with the particular business.

It is generally recognised that accounting fulfils two distinct roles: a ‘stewardship’ role and a ‘decision-usefulness’ role. Traditionally, accounting focused more on providing a stewardship, or accountability, report on the status of transactions for the period; that is, what was the position at the beginning of the period, what happened during the period and what the position was at the end of the period. More recently, accounting has been seen as a way of assisting a wide range of users to make informed choices about the allocation of scarce resources. Sometimes, the impression



LO1  
Explain the nature and role of accounting

### accounting

The process of identifying, measuring and communicating information to permit informed judgements and decisions by users of the information.

is given that the purpose of accounting is simply to prepare financial reports on a regular basis. While it is true that accountants do this kind of work, it does not represent an end in itself. The ultimate purpose of accountants' work is to discharge the accountability function of management and to influence the decisions of those who use the information produced. This decision-making perspective of accounting is central to the theme of this book and shapes the way we deal with each chapter.

## Accounting as a service function

Accounting can be seen as a form of service. Accountants provide financial information to their 'clients'. These clients are the various users identified in the next main section of the chapter. The quality of the service provided will be determined by the extent to which it meets the information needs of the various user groups. To be useful to users, the information must possess certain qualities. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. These two qualities, which are regarded as **fundamental qualities**, are covered in more detail below.

### fundamental qualities

These are the two most important qualities which underline the preparation of accounting reports namely relevance and faithful representation.

#### relevance

A quality that states that, in order to be relevant, accounting information must be able to influence decisions.

#### materiality

The quality of information which has the potential to alter the decisions that users make.

#### faithful representation

A quality that says that accounting information should represent what it is supposed to represent—it should be complete, neutral and free from error.

- **Relevance.** Accounting information must be able to influence decisions—otherwise, there really is no point in producing it. To do this, it must be relevant to the *prediction of future events* (such as estimating next year's profit) or to the *confirmation of past events* (such as establishing last year's profit), or to both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

To be relevant, accounting information must cross a threshold of **materiality**. A key question to be asked is whether its omission or misrepresentation would alter the decisions that users make. If the answer is no, the information is not material. This means that it should not be *separately* included within accounting reports, as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret them. All figures need to be included in the accounts: the question is whether a particular figure needs to be separately identified or whether it can be included elsewhere, under a more general heading. The threshold of materiality will vary from one business to the next. To identify the threshold, the nature of the information and the amounts involved must be considered within the context of the accounting reports of the particular business.

- **Faithful representation.** Accounting information should represent what it is supposed to represent. This means that it should be *complete*, by providing all of the information needed to understand what is being portrayed. It should also be *neutral*, which means that it should be presented and selected without bias. Finally, it should be *free from error*. This is not the same as saying that it must always be perfectly accurate; this is not really possible. Estimates may have to be made which eventually turn out to be inaccurate. It does mean, however, that there should be no errors in the way in which these estimates have been prepared and described. In practice, a piece of information may not perfectly represent these three aspects of faithful representation. It should try to do so, however, insofar as possible.

Note that accounting information must satisfy both fundamental qualities of relevance and reliability if it is to be useful. There is little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, but which is faithfully represented.

## Further qualities

Where accounting information is both relevant and faithfully represented, there are other qualities that, if present, can enhance its usefulness. These are comparability, verifiability, timeliness and understandability. Each of these qualities is now considered.

- **Comparability.** This quality helps users to identify similarities and differences between items of information. It may help them, for example, to identify changes in the business over time (such as the trend in sales revenue over the past five years). It may also help them to evaluate the performance of the business in relation to similar businesses. Comparability is enhanced

### comparability

A quality which helps users identify similarities and differences between items of information.

by treating items that are basically the same in the same manner for accounting purposes. It is also enhanced by making clear the policies that have been adopted in measuring and presenting the information.

- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.
- **Timeliness.** Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later accounting information is produced, the less useful it becomes.
- **Understandability.** Accounting information should be set out as clearly and concisely as possible. It should also be able to be understood by those at whom the information is aimed.

#### verifiability

Something that can be checked and verified.

#### timeliness

Being available early enough to be of use to users.

#### understandability

Clearly set out to facilitate understanding.

## ACTIVITY 1.1

**Do you think that accounting reports should be understandable by those who have not studied accounting?**

Despite the answer to Activity 1.1, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible for non-accountants.

It is worth emphasising that the four further qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented. It is also worth noting that the qualitative characteristics may conflict.

## Costs and benefits of accounting information

In addition to the characteristics described above, there is also a seventh key characteristic which is at least as important as any of these six. In theory, a particular piece of accounting information should be produced only if the cost of providing it is less than the benefits, or value, to be derived from its use. This cost–benefit issue will limit the amount of accounting information provided. In practice, however, these costs and benefits are difficult to assess.

To illustrate the practical problems of establishing the value of information, let us assume that someone has collided with our car in a carpark, dented one of the doors and scraped the paintwork. We want to have the dent taken out and the door resprayed at a local service station. We know that the nearest service station would charge \$700, but we believe that other local service stations may offer to do the job for a lower price. The only way of finding out the prices at other service stations is to visit them, so that they can see the extent of the damage. Visiting the service stations will involve using some fuel and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local service stations? The answer, as we have seen, is that, if the cost of discovering the price is less than the potential benefit, it is worth having that information.

To identify the various prices for the job, there are several points to be considered, including:

- How many service stations shall we visit?
- What is the cost of fuel to visit each service station?
- How long will it take to make all the visits?
- At what price do we value our time?

The economic benefit of having the information on the price of the job is probably even harder to assess. The following points need to be considered:

- What is the cheapest price that we might be quoted for the job?
- How likely is it that we shall be quoted a price cheaper than \$700?

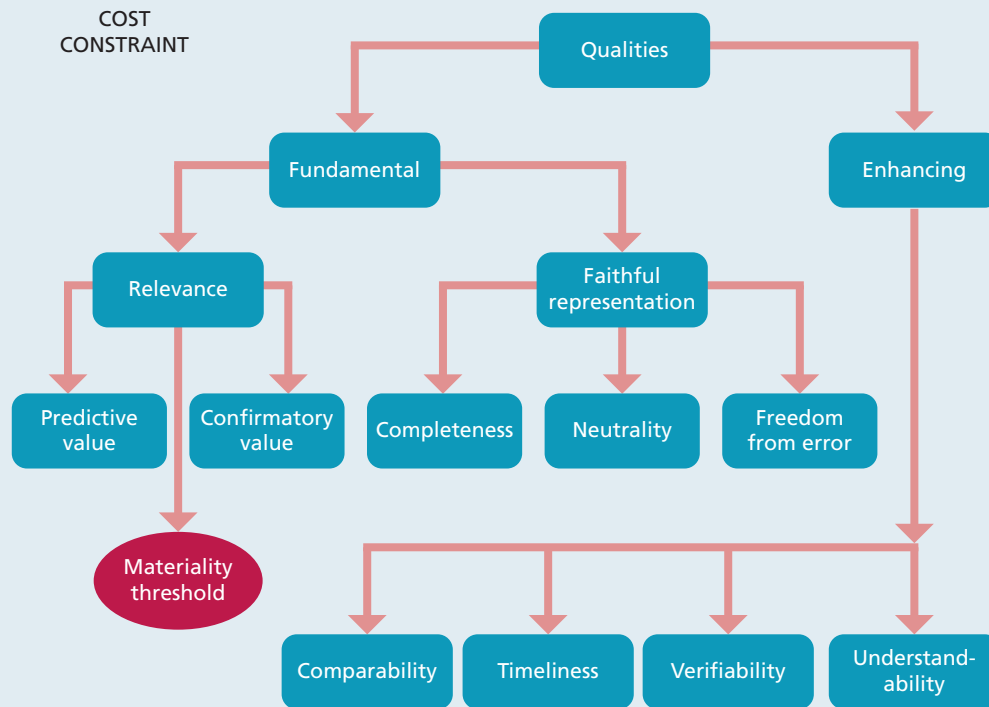
As we can imagine, the answers to these questions may be far from clear—remember that we have only contacted the local service station so far. When assessing the value of accounting information we are confronted with similar problems.



Producing accounting information can be very costly. The costs, however, are often difficult to quantify. Direct out-of-pocket costs, such as salaries of accounting staff, are not usually a problem, but these are only part of the total costs involved. There are other costs, such as the cost of user's time spent on analysing and interpreting the information provided.

There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some 'science' to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, which have been discussed above, are summarised in Figure 1.1.



**FIGURE 1.1**

**The characteristics that influence the usefulness of accounting information**

Two fundamental qualities determine the usefulness of accounting information. In addition, four qualities enhance the usefulness of accounting information. The benefits of providing the information, however, should outweigh the costs.

## Accounting as an information system

Accounting can be seen as an important part of the total information system for a business. Users, both inside and outside the business, have to decide how to allocate scarce economic resources. To try to ensure that these allocation decisions are efficient and effective, users require economic and other information. It is the role of the accounting system to provide much of that information. Thus, we can view accounting as an information-gathering, processing and communication system. The accounting system will involve the following four stages shown in Figure 1.2:

- 1 identifying and capturing relevant economic information
- 2 recording the information collected in a systematic manner
- 3 analysing and interpreting the information collected
- 4 reporting the information in a manner that suits the needs of users.



**FIGURE 1.2****The accounting information system**

The figure shows the four sequential stages of an accounting information system. The first two stages are concerned with preparation, and the last two stages are concerned with using the information collected.

Given the decision-making emphasis of this text, we shall primarily concentrate on the final two elements of the process—the analysis and reporting of financial information. We are concerned with how information is used by, and is useful to, decision-makers rather than with how it is collected and recorded. However, in Chapters 4 and 5 we will provide a brief overview of data collection and recording for those who are interested or need a foundation for more detailed work on these two aspects of accounting.

**Concept check 1**

**The purpose of accounting is to:**

- A** Provide information to assist users' decision-making
- B** Report on the status of transactions for the period
- C** Prepare financial reports on a regular basis
- D** Provide financial information to clients
- E** None of the above are true.

**Concept check 2**

**The two most important qualities for accounting information are:**

- A** Relevance and materiality
- B** Relevance and accuracy
- C** Faithful representation and relevance
- D** Completeness and relevance
- E** Freedom from error and relevance.

**Concept check 3**

**The usefulness of accounting information is increased by:**

- A** Not being overly complex
- B** Being provided on schedule (e.g. not late)
- C** Being supported by reasonable evidence
- D** All of the above
- E** None of the above.