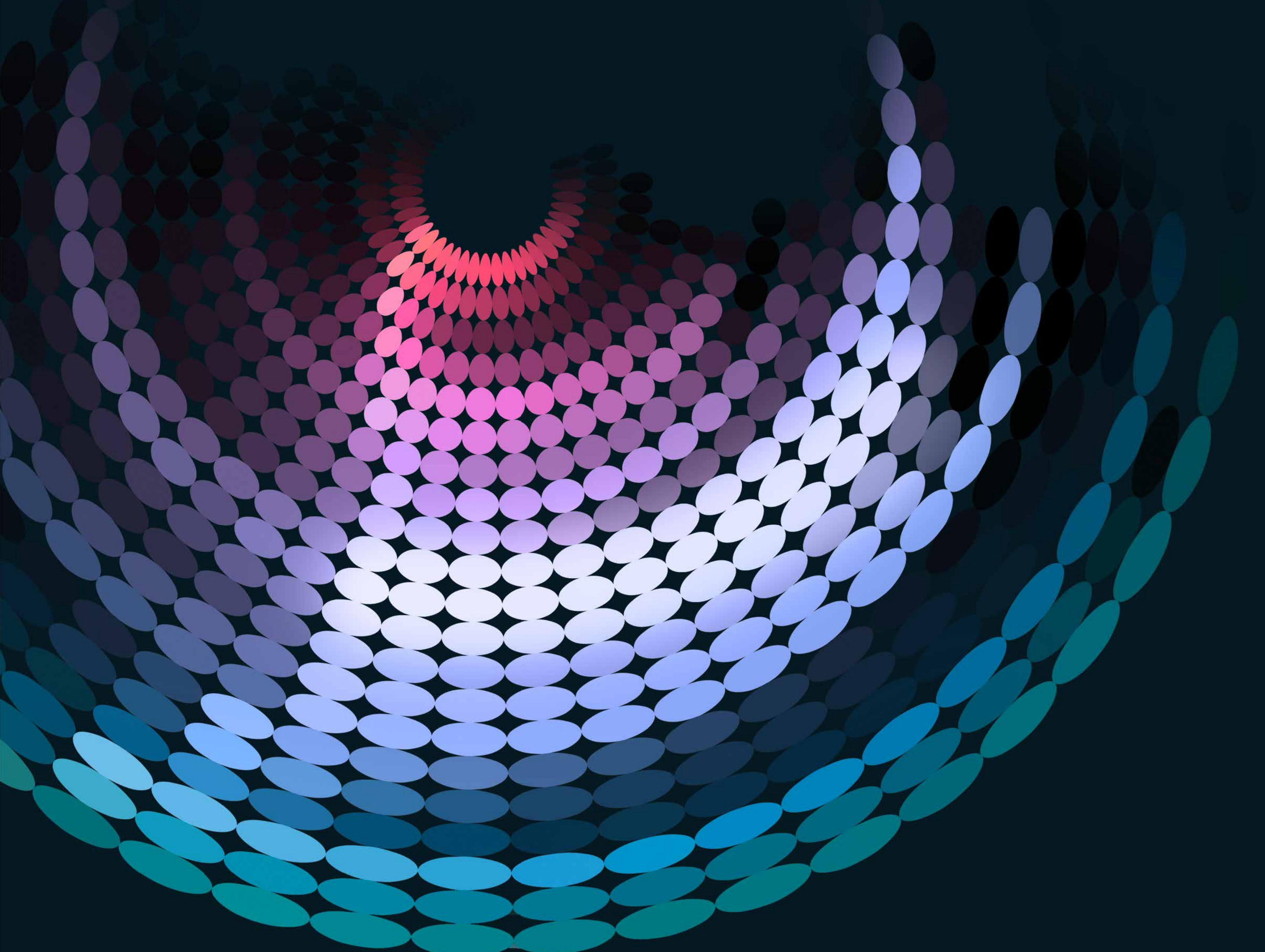
CARLON | MCALPINE | LEE | MITRIONE | KIRK | WONG

FINANCIAL ACCOUNTING

REPORTING, ANALYSIS AND DECISION MAKING

SIXTH EDITION



WILEY

Financial accounting

Reporting, analysis and decision making

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PREFACE

In recent years accounting education has seen numerous changes to the way financial accounting is taught. These changes reflect the demands of an ever-changing business world, opportunities created by new technology and instructional technologies, and an increased understanding of how you (students) learn. The foundation of this text is based on a number of unique principles and innovations in accounting education.

'Less is more.'

The objective of this text is to provide you with an understanding of those concepts that are fundamental to the preparation and use of accounting information. Most will forget procedural details within a short period of time. On the other hand, concepts, if well taught, should be remembered for a lifetime. Concepts are especially important in a world where the details are constantly changing.

'Don't just sit there — do something.'

You learn best when you are actively engaged. The overriding pedagogical objective of this text is to provide you with continual opportunities for active learning. One of the best tools for active learning is strategically placed questions. Our discussions are framed by questions, often beginning with rhetorical questions and ending with review questions, and our analytical devices, called 'Decision-making toolkits', use key questions to demonstrate the purpose of each.

'I'll believe it when I see it.'

You will be more willing to commit time and energy to a topic when you believe that it is relevant to your future career. There is no better way to demonstrate relevance than to ground discussion in the real-world. Consistent with this, we adopted a macro-approach — starting in chapter 1, you are shown how to use financial statements of companies, demonstrating the relevance of accounting. As you become acquainted with the financial successes and fluctuations of these companies, many will begin to follow business news more closely, making their learning a dynamic, ongoing process. We also discuss small to medium-sized companies to highlight the challenges they face as they try to grow.

'You'll need to make a decision.'

In a business environment there are many and varied decisions to be made. Illustrative examples of the types of decisions internal management and external financial statement users make are discussed throughout the text. Decision making involves identifying and sourcing the relevant information, analysing data and critically evaluating alternatives, and this takes practice.

In addition, to develop your analysis and decision-making skills we have integrated important analytical tools throughout the text. After each new decision-making tool is presented, we summarise the key features of that tool in a decision-making toolkit. At the end of each chapter, we provide a comprehensive demonstration of an analysis of a real or hypothetical company using the decision tools presented in the chapter. The presentation of these tools throughout the text is logically sequenced to take full advantage of the tools presented in earlier chapters.

'It's a small world.'

Business operates in a global environment. Rapid and ever-changing improvements in information technology, logistics and transport continue to strive toward a single global economy. The internet has made it possible for even small businesses to sell their products virtually anywhere in the world. Few business decisions can be made without consideration of international factors. To heighten your awareness of the issues that concern business most we have included a range of case studies that explore international, environmental, financial analysis and ethical issues in the 'Building business skills' section.

'Apply what you learn.'

In developing this text, we have been mindful of the Accounting Threshold Learning Outcomes and, accordingly, we have integrated case studies into the resources available for instructors. The case studies feature a series of capstone cases aligned to the first 12 chapters of the text, and have been designed to challenge you to apply analytical skills, exercise judgement and communicate a financial decision.

ABOUT THE AUTHORS

Shirley Carlon

Shirley Carlon MCom (Hons), CA, is a senior lecturer in the Business School at the University of New South Wales. Her teaching interests include financial and managerial accounting, auditing and tax. Shirley has considerable experience in the delivery of both external and internal programs, including web-based courses. Shirley has received a national teaching citation award for outstanding contributions to student learning for innovations in curriculum development and the creation of peer support mechanisms for off-campus students. She has taught extensively in China and has been a guest speaker on accounting issues at government functions. Shirley's research interests are in financial reporting where she has published several articles on peer mentoring, risk reporting, intangible assets, accounting policy choice and tax in Australian and international journals. She is a chartered accountant with experience in both large and medium-sized audit firms.

Rosina McAlpine

Rosina McAlpine BCom, MCom (Hons), MHEd, PhD, is a social entrepreneur and CEO of Win Win Parenting. Rosina is a former associate professor at the University of Sydney Business School and holds a Masters degree and a PhD in education. She is an internationally recognised, award-winning researcher and educator, having received 5 outstanding teaching awards at the faculty, university and national levels as well as 5 international best paper awards. Since becoming a parent, Rosina has been developing programs to help parents overcome the challenges of modern-day parenting using the latest research in child development. Rosina's research interests include navigating and negotiating work–life balance, gender equality and parenting education. Rosina's workplace education programs are delivered across a variety of corporations and government organisations to support working parents better manage the work–family interface. Rosina is the contributing editor of the book entitled *Inspired children: how the leading minds of today raise their children*.

Chrisann Lee

Chrisann Lee is a lecturer in accountancy at Queensland University of Technology. She is a CPA and has a PhD (QUT), a Master of Commerce (CSU) and a Graduate Diploma in Management (AGSM). She lectures in introductory accounting, management accounting, superannuation and personal financial planning. Prior to joining the tertiary sector in 2004, Chrisann worked as a management accountant for a manufacturing company in Hong Kong as well as in the financial services industry in Sydney. Chrisann is passionate about teaching and learning. She was awarded the QUT Vice-Chancellor's Performance Award 2009 and 2015 in teaching excellence. Her research interests are in the areas of accounting education, financial literacy and superannuation where she has published numerous articles in Australian and international journals and has received several grants and awards.

Lorena Mitrione

Lorena Mitrione BCom, MBus, PGrad DipEc&Comm, is a lecturer in accounting at the Monash Business School. Prior to joining Monash in 2009, Lorena worked at CPA Australia. From 2001 she was the CPA Program Manager responsible for the development and maintenance of CPA Program materials and examinations. In this role Lorena developed a sound sense of the requirements for accounting learning materials while maintaining an up-to-date knowledge of accounting standards, accounting research, technical accounting matters and business practices. She is currently enrolled in a PhD. Her thesis title is 'Motivation and self-regulated learning strategies applied by accounting students in a blended learning environment'.

Ngaire Kirk

Ngaire Kirk BBS, BBS (Honours), MBS, CA, has a background in sheep and cattle farming and in the public and private health sectors. Her recent teaching responsibilities at Massey included coordinating and teaching introductory and intermediate financial accounting papers and teaching advanced auditing. Her research interests focused mainly on financial accounting, financial reporting and accounting education, in particular the use of electronic and online resources to enhance both internal and distance learning. Ngaire retired from Massey University at the end of April 2017, but prior to her retirement, she was a member of two key Massey Business College committees whose role is to enhance assurance of learning, and teaching and learning development across the college. Despite retiring, Ngaire accepted a request from Victoria University of Wellington to coordinate their large first-year accounting class for nonaccountants (ACCY130) in trimester 2, 2017 and has continued as a teaching fellow, teaching ACCY130 and the second-year financial accounting paper in trimester 1, 2018.

Lily Wong

Lily Wong BBus, MBus, PhD, CPA is an honorary professor in the College of Business, Victoria University, Australia. Lily is a recipient of international best paper awards, as well as university and national teaching excellence awards for her contribution to student learning in accounting education. Lily's key research interests relate to improving the learning experience and academic outcomes for first-year accounting students. Current areas of interest include blended learning, development of online teaching resources and examining the impact of technology-enhanced teaching options on student learning outcomes.

KEY FEATURES

Print text

This text is designed for students studying accounting for the first time. Real and hypothetical company financial information to support your understanding of accounting as an information system is presented in a clear, easy-to-follow way.

- Financial data from various companies are used to highlight comparative financial results and measure financial performance.
- There is a clear, well-developed balance between the perspectives of the users and the preparers of financial statements.
- In several chapters, 'Review it' questions relate chapter topics to real-world scenarios.
- In the 'Building business skills' section at the end of each chapter, financial reporting problems use financial statements to align the chapter material to the real-world.
- Analysis and decision making incorporated throughout the chapters reinforce applications to decision making and use of accounting information by management.

Pedagogical framework

We have used many constructive pedagogical tools to help you learn accounting concepts and apply them to decision making in the business world.

Understanding the context

- **Learning objectives**, listed at the beginning of each chapter, form a framework throughout the text, with each objective repeated in the main body of the chapter and again in the **Summary**. Also, end-of-chapter assignment materials are linked to the learning objectives.
- A **chapter preview** provides an overview of the major topics of the chapter. First, an introductory paragraph explains how the story relates to the topics to be discussed, and then a graphic outline of the chapter provides a 'road map', useful for seeing the big picture as well as the connections between subtopics.

Learning the material

- This text emphasises the accounting experiences of real entities throughout, from chapter preview to the chapter's last item of homework material. Details on these many features follow. In addition, every financial accounting chapter uses **financial statements** from companies.
- **Illustrations** support and reinforce the concepts of the text. Infographics help you visualise and apply accounting concepts to the real-world. The infographics often portray important concepts in entertaining and memorable ways.
- **Learning reflection and consolidation** sections occur at the end of each key topic and consist of two parts. *Review it* serves as a learning check within the chapter by asking you to stop and answer knowledge and comprehension questions about the material just covered. These exercises help cement your understanding of how topics covered in the chapter are reported in financial statements. Answers to questions using financial statements appear at the end of the chapter. *Do it* is a brief demonstration problem that gives immediate practice using the material just covered. Solutions are provided in the text to help you understand the reasoning involved in reaching an answer.
- **Accounting equation analyses** are included in each chapter underneath key journal entries. This feature reinforces your understanding of the impact of an accounting transaction on the financial statements.
- **Helpful hints** in italicised text throughout the chapters expand on or help clarify concepts under discussion in the surrounding text. Sometimes the hints also provide alternative terminology — synonymous

terms that students may come across in subsequent accounting courses and in business — or international notes — exposing international issues in accounting, reporting and decision making.

- Each chapter presents decision tools that are useful for analysing the financial statement components discussed in that chapter. At the end of the text discussion relating to the decision tool, a **Decision-making toolkit** summarises the key features of that decision tool and reinforces its purpose. For example, chapter 7 presents the receivables turnover and average collection period as tools for use in analysing receivables. At the end of that discussion the toolkit shown below appears.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Are collections being made in a timely fashion?	Net credit sales and average receivables balance	$\text{Receivables turnover} = \dfrac{\text{Net credit sales}}{\text{Average net receivables}}$ $\text{Average collection period} = \dfrac{\text{365 days}}{\text{Receivables turnover}}$	Receivables turnover and average collection period should be consistent with the entity's credit policy. Any significant deviation which results in a slower receivables turnover or a longer collection period may suggest a decline in the financial integrity of credit customers.

- A **Using the decision-making toolkit** exercise, which follows the final **Learning reflection and consolidation** section in the chapter, asks you to use the decision tools presented in that chapter. You will need to evaluate the financial situation of a company, often using ratio analysis to do so.

Putting it together

- At the end of each chapter, between the body of the text and the homework materials, are several useful features for review and reference: the **Summary** lists the main points of the chapter under each learning objective; the **Decision-making toolkit — a summary** presents in one place the decision tools used throughout the chapter; and the **Key terms** section provides a concise list of all important terms in the text and gives their definitions.
- Next, a **Demonstration problem** gives you another opportunity to refer to a detailed solution to a representative problem before you do homework assignments. Problem-solving strategies help establish logic for approaching similar problems and assist you in understanding the solution.

Developing skills through practice

Throughout the homework material, certain questions, exercises and problems make use of the decision tools presented in the chapter.

- **Self-study questions** comprise a practice test to enable you to check your understanding of important concepts. These questions are keyed to the learning objectives, so you can go back and review sections of the chapter for which you find you need further work.
- **Questions** provide a full review of chapter content and help you prepare for class discussions and testing situations.
- **Brief exercises** build your confidence and test your basic skills. Each brief exercise focuses on one of the learning objectives.
- Each of the **Exercises** focuses on one or more of the learning objectives. These tend to take a little longer to complete, and they present more of a challenge than the brief exercises. The exercises help to make a manageable transition to more challenging problems.

- **Problem sets** stress the applications of the concepts presented in the chapter. Problems are keyed to the learning objectives. Certain problems help build business writing skills.
- Each brief exercise, exercise and problem has a description of the concept covered and is keyed to the learning objectives.

Building business skills

This is a unique section at the end of each chapter that offers a wealth of resources to help you pull together the learning for the chapter. This section offers problems and projects for those who want to broaden the learning experience by bringing in more real-world decision-making and critical-thinking activities.

- **Financial reporting and analysis** problems use financial statements of companies or other sources, such as journals, for further practice in understanding and interpreting financial reporting. A selection of some of the following types of problems is used in each chapter. A *Financial reporting problem* directs you to study various aspects of the financial statements. A *Comparative analysis problem* offers the opportunity to compare and contrast the financial reporting of two companies. Since the ability to read and understand business publications is an asset in one's career, *Research cases* direct you to articles published in popular business periodicals for further study and analysis of key topics. The *Interpreting financial statements* problems ask you to read parts of financial statements of actual companies and use the decision tools presented in the chapter to interpret this information. A *Global focus* or *Real-world* problem asks you to apply concepts presented in the chapter to specific situations faced by actual international companies. *Financial analysis on the web* exercises guide you to web sites from which you can obtain and analyse financial information related to the chapter topic.
- **Critical thinking** problems offer additional opportunities and activities. A selection of the following types of problems is used in each chapter. The *Group decision cases* help promote group collaboration and build decision-making skills by analysing accounting information in a less structured situation. These cases require teams of you to analyse a manager's decision or to make a decision from among alternative courses of action. They also give practice in building business communication skills. *Communication activities* provide practice in written communication — a skill much in demand among employers. *Ethics cases* describe typical ethical dilemmas and ask you to analyse the situation, identify the ethical issues involved, and decide on an appropriate course of action.

Interactive eBook

Students who purchase a new print copy of *Financial accounting: Reporting, analysis and decision making*, 6th edition will have access to the interactive eBook version (a code is provided on the inside of the front cover). The eBook integrates the following media and interactive elements into the narrative content of each chapter.

- **Practitioner videos** provide insights into the application of financial accounting concepts.
- **Animations of worked examples** talk you through the steps in solving financial accounting problems.
- **Interactive questions** provide you with the scaffolding to attempt and solve problems.

CHAPTER 1

An introduction to accounting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1.1 explain the business context and the need for decision making
1.2 define accounting, describe the accounting process and define the diverse roles of accountants
1.3 explain the characteristics of the main forms of business organisation
1.4 understand the *Conceptual Framework* and the purpose of financial reporting
1.5 identify the users of financial reports and describe users' information needs
1.6 identify the elements of each of the four main financial statements
1.7 describe the financial reporting environment
1.8 explain the accounting concepts, principles, qualitative characteristics and constraints underlying financial statements
1.9 calculate and interpret ratios for analysing an entity's profitability, liquidity and solvency.

Chapter preview

Welcome to the accounting journey, it is not just about recording numbers. Throughout this text you will explore the concepts and regulations that underlie the preparation of the accounting reports and the various decisions that need to be made in preparing the financial information and reports. As well, we will examine the decisions made using the accounting information as inputs into the decision-making process, both inside and outside the business organisation. Accounting information can help you understand a business entity's past performance and its current financial position, and provide some insight into its future prospects.

It is an exciting ever-changing business environment which keeps pace with the changes in technology and knowledge management. For example, Domino's Pizza Enterprises Ltd commenced as a single franchise in Australia and now is the largest franchisor of the US's largest pizza chain, with operations in Europe, Japan, Australia and New Zealand. How did this occur? Why did it embrace technologies such as online ordering, including a mobile phone app and Facebook? Domino's effectively obtains information from customers using this technology, which feeds into the sale growth predictions and the strategic future directions of the business.

In this chapter we introduce the business environment, including the role of accounting, the forms of business organisation, the regulatory environment, the financial statements, and some tools that can help you analyse financial statements for decision making. The content and organisation of this chapter are as follows.

An introduction to accounting

Introduction to accounting	Forms of business organisation	Introduction to the *Conceptual Framework*	Users and uses of financial information	Financial statements	The financial reporting environment	Concepts, principles and qualitative characteristics	Analysing financial statements
• The business world • Accounting — the language of business • The accounting process • The diverse roles of accountants	• Sole proprietorship • Partnership • Company • Other forms of business organisation • Not-for-profit organisations	• The objective of general purpose financial reporting • The reporting entity	• Internal users • External users • Financing activities • Investing activities • Operating activities • Sustainability reporting	• Statement of profit or loss • Statement of changes in equity • Statement of financial position • Statement of cash flows • Inter-relationships between the statements	• Australian Securities and Investments Commission • Financial Reporting Council • Australian Accounting Standards Board • Australian Securities Exchange • Regulation in New Zealand • Professional accounting bodies	• Concepts and principles • Qualitative characteristics	• Analysis and decision making • Profitability • Liquidity • Solvency

1.1 Introduction to accounting

LEARNING OBJECTIVE 1.1 Explain the business context and the need for decision making.

The business world

What's your favourite business? Apple, Google, Nike? Would you like to start your own business? How do you start a business? How do you make it grow and become widely recognised like Domino's? How do you determine whether your business is making or losing money? How do you manage your resources?

When you need to expand your operations, where do you get money to finance the expansion — should you borrow, should you issue shares, should you use your own funds? How do you convince lenders to lend you money or investors to buy your shares? Success in business requires countless decisions, and decisions require financial and other information. A **decision** is a choice among alternative courses of action.

Architects use technical and structural knowledge of the building codes together with their creative ability to design a model or plan of a building. Just like architects, in order to start and run a business you need not only your creative ideas and marketing plan, but also information on the business environment in order to understand the context of your business. Accounting provides an economic model of the business world. It plays a key role in the provision of financial information for decisions made by people inside and outside a business. The continued growth of Domino's in both the European and the Australian and New Zealand markets required a variety of information including the past and current performance of the Domino's operations. Projections on future store sales growth and potential market share growth from opening new stores was also required in order to plan ahead and to help towards the achievement of targets. The provision of accounting information within the business entity is referred to as **management accounting**. **Financial accounting** is the term used to describe the preparation and presentation of financial reports for external users. However, both financial accounting and management accounting draw on the same information system used to record and summarise the financial implications of transactions and events. Businesses also need to provide information on the environment and the community within which the business operates. The concept of sustainability is explained later in this chapter.

The business environment is ever changing. Driven by technology, life cycles of businesses are shortening. New technologies, new processes, new products, faster information flows are driving changes. How often do you update your mobile phone? Everyone in society is affected by technology change. Computers provide the technology to process the information so more time is devoted to the analysis of the information to make the best informed decisions. Accountants work in businesses as part of management teams who analyse the information gathered to make decisions. So how do we go about the decision making?

The first step in the process of decision making is to identify the issue or the decision to be made. The next step is to gather the relevant information required for the analysis. Once gathered, you identify the tool or technique that will assist analysis of the issue so a decision can be made. The final step is to evaluate the results of the analysis and make the decision. The decision-making toolkit summarises this process.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Which film your friends wish to see	Cinema times and films showing Who are the lead actors Personal preferences	Eliminate unsuitable times and films Discuss which preferences are left and rank in popularity	Film most wish to see is the one chosen If none suitable, re-evaluate or select another social activity and start the decision process again.

Note: Each chapter presents useful information about how decision makers use financial statements. Decision-making toolkits summarise discussions of key decision-making contexts and techniques.

For example, if you were wanting to choose which film a group of friends wish to watch, you would need information concerning each of your preferences for the genre and how flexible you are in your preferences, maybe who is in the leading roles and the times the movie is being shown. The tool would be to rank the films in order of preference starting with what is showing at the times your group is available, then reducing the alternatives to which films are showing, and then eliminating any alternative which one of your group didn't want to see. You may end up with no suitable film or you may go back and change the parameters, which may include looking for another social activity. Even with this analysis your group may not enjoy the film as it was a dud, but that is the risk you take. Decisions are future oriented and you need to make informed judgements.

Similar to the social activity decision, in the business world, even with all the information available, the final outcome of the decision may not be what was expected. Next, we are going to consider what accounting is and how it is used in the decision-making process in the business environment.

1.2 Accounting: the language of business

LEARNING OBJECTIVE 1.2 Define accounting, describe the accounting process and define the diverse roles of accountants.

The primary function of accounting is to provide reliable and relevant financial information for decision making. Accounting has been around for centuries and has developed significantly since its humble beginnings in ancient times when scribes recorded simple agreements between parties and other information on clay tablets. Today, almost every person engages in business transactions in relation to the financial aspects of life such as purchasing products and paying bills. This means that accounting plays a significant role in society.

Accounting can be referred to as the 'language of business' as it is a means of common communication where information flows from one party to others. In order for information to be effective it must be understood. Accounting, like many other professions, has its own terminology or jargon that is unique to the profession and can have alternative meanings in different contexts. Accounting terms, concepts and symbols are used to provide financial information to a variety of users including managers, shareholders and employees. You will need to learn these specialised terms and symbols in order to be able to prepare and use accounting information effectively. The definitions of key terms listed at the end of each chapter will support your learning. Providing reliable and relevant accounting information is a complex process.

The accounting process

Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation. Table 1.1 summarises these main steps.

TABLE 1.1 **The accounting process**

Identifying	Measuring	Recording	Communicating
Taking into consideration all transactions which affect the business entity	Quantifying in monetary terms	Analysing, recording, classifying and summarising the transactions	Preparing the accounting reports; analysing and interpreting

Identifying involves determining which economic events represent transactions. **Transactions** are economic activities relevant to a particular business and include, for example, the sale of a good to a customer or the purchase of office stationery from a supplier. Transactions are the basic inputs into the accounting process. **Measurement** is the process of quantifying transactions in monetary terms and must be completed in order to record transactions. The recording process results in a systematic record of all of the transactions of an entity and provides a history of business activities. To enhance the usefulness of the recorded information, it must be classified and summarised.

Classification allows for the reduction of thousands of transactions into meaningful groups and categories. For example, all transactions involving the sales of goods can be grouped as one total sales figure and all cash transactions can be grouped to keep track of the amount of money remaining in the business's bank account. The process of summarisation allows the classified economic data to be presented in financial reports for decision making by a variety of users. These reports summarise business information for a specific period of time such as a year, 6 months, one quarter or even a month. Domino's provides 6-monthly reports that are available to the general public via the securities exchange web site.

Communicating is the final stage in the accounting cycle. Communicating involves preparing accounting reports for potential users of the information. There are many reasons for maintaining accurate financial accounting records, including legal and other reporting requirements. The Australian Taxation Office (ATO) and the New Zealand Inland Revenue (NZIR) require businesses to provide a variety of financial information to comply with legal requirements. Users of financial information, both internal and external to the entity, will require financial information to make decisions in relation to the business. Once the users have acquired the information, they can use a variety of techniques to analyse and interpret the data. In most of the chapters, there are sections which demonstrate a variety of techniques that are useful for analysing and interpreting financial statements. These sections are intended to support the development of your skills in analysis and interpretation of financial information, and to enhance your understanding of accounting.

To recap this section, accounting provides an economic model of the business world and plays a key role in the provision of financial information for decision making. Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation to users of financial information. The first three activities of identifying, measuring and recording the business information are commonly referred to as **bookkeeping**. Bookkeeping forms the foundation of the activities underlying accounting and these processes are explained in detail in the early chapters of this text, using a manual accounting system. In the early part of the twentieth century, the role of the accountant did not extend much beyond this bookkeeping function. Today, however, the roles and responsibilities extend far beyond preparing accounting records.

The diverse roles of accountants

Accountants practise accounting in four main areas: commercial accounting, public accounting, government accounting and not-for-profit accounting.

Commercial accounting

Commercial accountants work in industry and commerce. Companies like Domino's and Qantas employ a number of accountants in different roles, such as management accounting and financial accounting. The accounting information system provides these accountants with the information they need for planning, decision making, and compiling reports for a range of users. The **chief financial officer (CFO)** is a senior manager in an organisation and directs the accounting operations. Financial accountants oversee the recording of all of the transactions and prepare reports for users external to the business entity, such as shareholders and creditors. Management accountants focus on providing information for internal decision making as they prepare specifically tailored reports for use by management. Commercial accountants are employed within organisations, and their work is directed by their employers. Public accountants, on the other hand, run their own businesses and are therefore more autonomous.

Public accounting

Public accountants, as the name suggests, provide their professional services to the public. They can practise in business organisations that range from small single-person-run offices to very large organisations with branches all over the world and thousands of employees. Public accountants tend to specialise in one or more areas of accounting when providing services to the public. Auditing is one of the primary services provided by large public accounting firms such as Deloitte and KPMG. An **audit** is an independent examination of the accounting data presented by an entity in order to provide an opinion as to whether the financial statements fairly present the results of the operations and the entity's financial position. Public accounting firms also provide a wide range of taxation services including advice for minimising an entity's tax liability, of course within the law, and preparation of tax returns, among other things. In more recent years, management advisory services have been a growing area for public accountants. Services include provision of advice on improving their clients' business efficiency and effectiveness, design and installation of accounting information systems, and assistance with strategic planning. Public accounting firms may also provide advisory services to government organisations or be employed by the government.

Government accounting

Government accountants, employed within government entities, engage in a variety of roles and activities, such as financial accounting and auditing. Local councils, state governments and federal government receive and pay out large amounts of funds each year and these activities need to be accounted for. Nowadays, many of the issues and decisions faced by government entities are the same as those in the commercial sector. As a result, these entities often follow accounting policies and practices similar to those in the private sector. Although most government entities are not-for-profit, some government departments, such as the Brisbane City Council, run profit-making businesses.

Not-for-profit accounting

Not-for-profit accountants, working in the not-for-profit sector, engage in many activities including planning, decision making, and preparing financial and management reports for both internal and external users. Management processes, accounting systems and operational methods are often similar between profit-making and not-for-profit entities. However, there is one major difference and that is the *profit motive*.

A **not-for-profit entity** focuses on successfully fulfilling its mission and administrative goals, rather than focusing on making a profit. Not-for-profit entities include public hospitals, clubs, some schools and charities. For example, the World Vision charity works with poor, marginalised people and communities to improve their lives and help them take control of their futures. Not-for-profit entities are exempt from income taxes on activities related to their exempt purpose and have fiduciary responsibilities to members, contributors and other constituents, and their activities may require reporting to supervising government entities.

In summary, accountants have many diverse roles and can work in different forms of organisation from small one-person businesses to large corporations with a worldwide presence. Once trained as an accountant, you can also work in organisations in non-traditional accounting roles or be better equipped to run your own business.

Would you like to run your own business? How would you decide how to structure your business and what resources would be required? In the next section, we explore the different forms of business organisation in more depth.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What information would you require to set up and run your own business?
2. What is the primary objective of accounting?
3. Accountants practise accounting in four main areas. Describe these areas, with examples.

Note: *Review it* questions at the end of major text sections prompt you to stop and review the key points you have just studied. Sometimes these questions stand alone; other times they are accompanied by practice exercises called *Do it*.

1.3 Forms of business organisation

LEARNING OBJECTIVE 1.3 Explain the characteristics of the main forms of business organisation.

Business organisations can be classified into profit-oriented businesses such as sole proprietorship, partnership or company, and not-for-profit entities such as charities and government departments. Throughout this text, we concentrate on preparing financial reports for the profit sector. However, many of the concepts and regulations apply equally to the not-for-profit sector.

Suppose you graduate with a marketing degree and open your own marketing agency. One of the first important business decisions you will need to make is the organisational structure under which the business will operate. You have three choices: sole proprietorship, partnership or company. Figure 1.1 outlines the three main forms of business organisation. In selecting a suitable business structure, some of the factors to consider are:
- establishment fees and maintenance costs
- asset protection (business and personal assets)
- the type of business and how it impacts on your record keeping
- legitimate tax minimisation.

FIGURE 1.1 Characteristics of the main forms of business organisation

Sole proprietorship
- Simple to establish
- Owner controlled

Partnership
- Simple to establish
- Shared control
- Broader skills and resources

Company
- Easier to transfer ownership
- Easier to raise funds
- Limited liability

Sole proprietorship

A **sole proprietorship** is a business owned by one person. It is the simplest form of business structure and has very few legal formalities. It is quick and inexpensive to establish and inexpensive to wind down. Under this structure, the owner of the business has *no separate legal existence* from the business. You might choose the sole proprietorship form if you have a marketing agency. You would be referred to as a *sole trader*. As a sole trader, the business is fully owned by you and you have total autonomy over the business's strategic direction and all business decisions. The assets and profits completely belong to you. The business's income is treated as the business owner's individual income (hence, no separate legal existence). Sole traders pay the same tax as individual taxpayers, according to the marginal tax rates. Depending on the level of profits from the business, this could be a disadvantage. In the 2017 year, at an income level of around \$137 000, the effective average tax rate of an individual is equal to the 30% company tax rate, so for any profits above this level the sole trader is paying more income tax than if the business was organised as a company. Other disadvantages are that the business is limited by the owner's skills, the funds available to invest, and the time available for running the business, as well as bearing full personal liability for the business's debts. Small owner-operated businesses such as restaurants, dentists and panel beaters are often sole proprietorships, as are farms and small retail shops.

Partnership

Another possibility for your new marketing agency is for you to join forces with other individuals to form a partnership, in which all partners share control. A **partnership** is a relationship or association between two or more entities carrying on a business in common with a view to making a profit. Entities forming the partnership may be individuals or companies.

There is little formality involved in creating a partnership. Partnerships are often formed because one individual does not have enough economic resources to initiate or expand the business, or because partners bring unique skills or resources to the partnership. You and your partner(s) should formalise your duties and contributions in a written partnership agreement. All partnerships should be formed on the basis of an agreement (which may be made in writing, verbally or by implication). In Australia, partnerships are governed on a state-by-state basis by the Partnership Act in each Australian state. In New Zealand, the *Partnership Act 1908* is the national legislation. Partners must also decide how profit (or losses) should be allocated among the partners. Accounting information is often used to determine each partner's share, as specified in the partnership agreement.

Traditionally, partnerships have *not* been incorporated. This means that, like a sole proprietorship structure, the business structure has **unlimited liability**, so each partner is personally liable for all the debts of the partnership even if they are caused by decisions made by other partners. More recently, changes to state and territory legislation have allowed for limited liability partnerships (LLPs). Similarly, New Zealand introduced limited partnerships in 2008. These are an emerging trend and are often used for raising venture capital for new businesses, such as a new mining venture. However, because *limited partnerships* are taxed as companies and the general partner still bears unlimited liability, this form of business structure is not very popular. Another disadvantage of a partnership structure is that a partnership has a limited life. If a partner wishes to sell or leave the partnership, or a partner dies, a new partnership agreement must be formed. The partnership agreement often has conditions on who can be admitted as a new partner in the event of a partner wishing to sell their share of the business. Finally, if there are disputes between the partners, it can be costly and damaging to the business, as well as to friendships.

Partnerships are often used to organise retail and service-type businesses, including professional services such as accounting, medical and legal practices.

Company

As a third alternative, a marketing agency can be organised as a company. A **company** or corporation is a separate legal entity formed under the *Corporations Act 2001* (Cwlth) in Australia or the New Zealand *Companies Act 1993* (Public Act). The process of setting up a company is called *incorporation*. The owners of a company are called **shareholders** (or *stockholders* in the US) and their ownership interests are represented by the number of shares they own in the company.

Under a company structure, the company can sue and be sued and enter into contracts in its own name. As a result, the shareholders of most companies have *limited liability*. **Limited liability** means the shareholders are liable for the debts of the business only to the extent of amounts unpaid on their shares. If a company breaches an agreement, it is generally solely liable — unless there is some misconduct by the directors or officers, such as misrepresentation or misleading or deceptive conduct. If misconduct or misrepresentation is proven, it is possible for the company directors to be held personally liable for debts. Another advantage of the corporate form is that a company has an indefinite life. The owners can more easily transfer their ownership interest by selling their shares in the company to other investors.

Companies vary in size from small privately owned and often family-run companies (proprietary limited companies — Pty Ltd) to large public companies listed on a securities exchange (limited companies — Ltd) managed by directors, with thousands of shareholders. If you use a company structure, there are establishment costs and ongoing fees and regulations to comply with. These make it more expensive to run than unincorporated business structures. We will discuss these issues in more depth in chapter 10.

When considering the business structure of your marketing agency, you need to decide on two factors: the decision-making structure you want for your business (sole trader, partnership or company) and the financial and legal ramifications of the structure you choose. Will the business be an incorporated or unincorporated business? A sole trader, for example, has all the decision-making power but also has full responsibility (is liable) for the actions of the business. A company, on the other hand, has limited liability but, if there is more than one director, the decision making is usually a shared responsibility. Thus, the decision to incorporate or to remain unincorporated has distinct legal and financial ramifications. Many businesses start as sole proprietorships or partnerships and eventually incorporate. For example, R.M. Williams was established as a small proprietary family company, was subsequently floated as a public company and, more recently, the family members repurchased the shares and delisted the company — so now it operates once again as a family business.

Other forms of business organisation

Although the sole proprietorship, partnership and company are the most common forms of business structure, others such as trusts, cooperatives and not-for-profit forms are discussed below.

Trusts

A **trust** is a relationship or association between two or more parties, whereby one party holds property in trust for the other; i.e. they are vested with the property. A trust, in its simple form, has:

- a settlor (who sets up the trust)
- a trustee (who is the legal owner and manages the trust property — investments, assets etc. — and pays out any net income for the benefit of the beneficiaries); and
- beneficiaries (the person or people who are the equitable owners and for whom the investments or assets are held and to whom income is paid).

The trustee has full control over the assets held by the trust, so it is important that the trustee be entirely trustworthy and able to manage all aspects of trust administration. Trusts may be made expressly in writing or implied from the circumstances. Trusts can range from relatively simplified structures to more complex structures. It is possible, for example, for a family member to act as a trustee for a family trust. It is very common in family-owned small businesses for a Pty Ltd company to be the trustee and the family members the beneficiaries, which means the business has the protection of limited liability for asset protection but profits can be split effectively for taxation. It is also possible for a company to trade as the trustee of a trust. For example, DEXUS Property Group is a property trust listed on the Australian Securities Exchange, with total funds under management as at 30 June 2016 of approximately $22.2 billion. The listed property portfolio comprises almost $11 billion of direct property assets in Australia, New Zealand, the United States and Europe.

Cooperatives

A **cooperative** is a form of business organisation that is member-owned, controlled and used. It must consist of five or more people. Cooperatives are legislated at state level in Australia. They are distinctive for fostering a highly participative and democratic style of work, pooling resources to be more competitive and sharing skills. Cooperatives play an important role in the community. They supply goods and services to their members and to the general public in areas as diverse as retailing, recycling, manufacturing, labour hiring, printing and agriculture. Examples include Australian Forest Growers, South Gippsland Herd Improvement Association Inc., Ballina Fishermen's Co-operative Ltd and Bermagui Pre School Co-operative Society Limited.