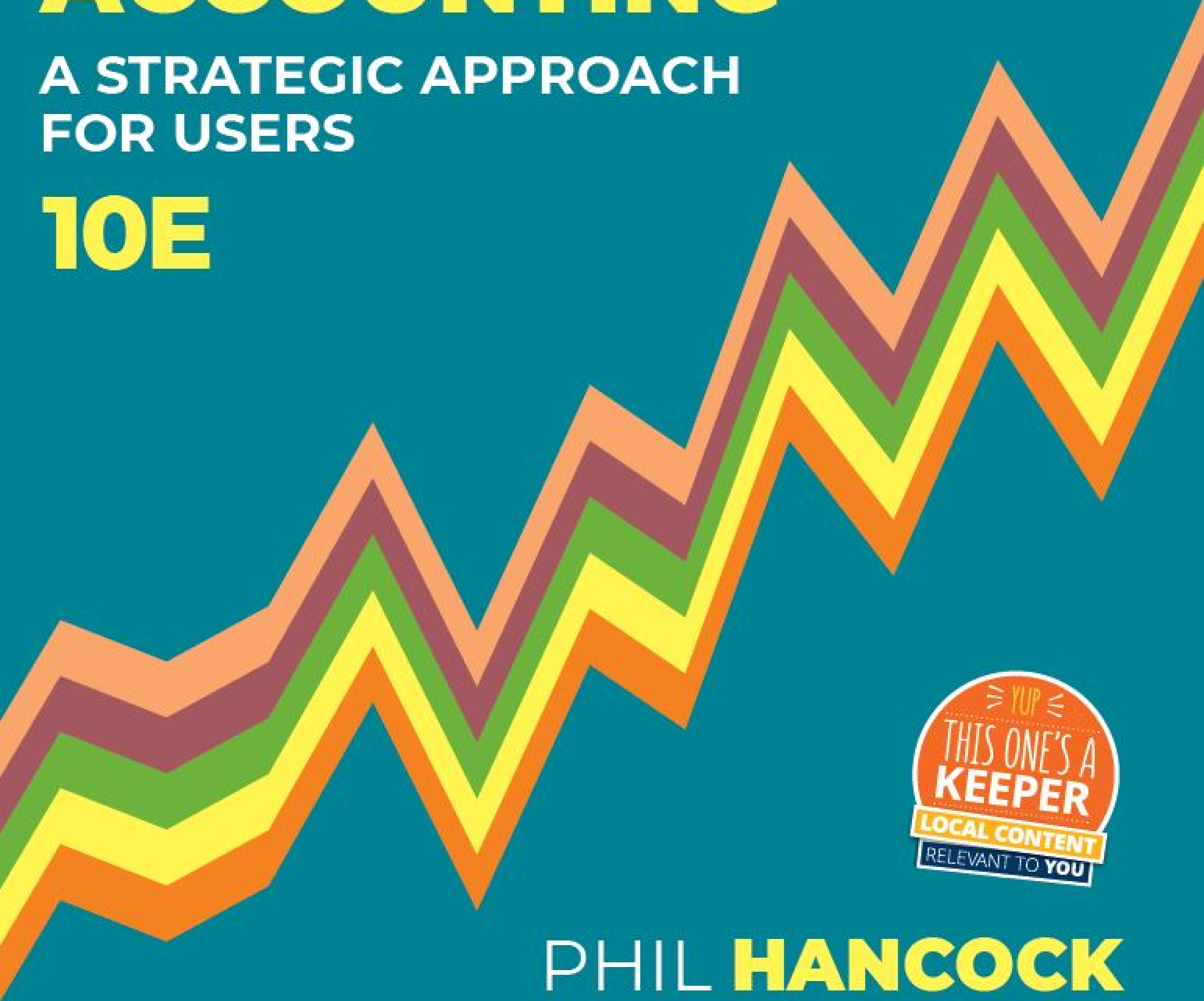
CONTEMPORARY ACCOUNTING

A STRATEGIC APPROACH FOR USERS

10E



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CENGAGE

Contemporary Accounting: A Strategic Approach for Users
10th Edition
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Brief contents

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Preface

Contemporary Accounting, 10th edition, provides an introduction to accounting for students at universities and other higher education institutions. With the nature and extent of topic coverage, the text meets the needs of students completing a first course in accounting. Thus, the text is well suited to fulfilling the requirements of a one-semester unit in accounting for students enrolled in undergraduate accounting and non-accounting majors or MBA or equivalent post graduate qualifications. The book provides an excellent overview of the accounting function in business for non-accounting majors, and the approach taken to financial accounting provides a solid foundation on which accounting majors can better understand the bookkeeping function. Extensive online materials have been prepared to accompany the 10^{th} edition and are available for instructors and students who want more material on double-entry bookkeeping to support the concepts covered in the book. Where relevant, the implications of different accounting policy choices for managers and other external decision makers are discussed.

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

Where appropriate, extracts from annual reports are provided to illustrate contemporary accounting practices. Also included are extracts from the 2018 Woolworths Limited Annual Report. This report appears in Appendix 1 and students are invited to refer to it frequently throughout the text.

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

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

Contemporary Accounting has been presented in a manner that students find easy to read. The response to the first nine editions of this book has been very positive. However, there are major changes in the 10th edition of the book. These changes have been made in response to comments from past and current users of the book, and also in response to changes that have occurred in education, the business world and the accounting profession.

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A new approach

As is usual, a thorough review of the text has been undertaken which incorporates feedback received and important changes arising from the Revised *Conceptual Framework* published by the IASB in 2018. While the main elements of the text remain, including the conceptual approach and the use of the worksheet, a number of changes have been made and are summarised below.

The main changes to each chapter are outlined as follows:

» Chapter 1 has been amended whereby the sections on sustainability reporting have been updated and relocated to Chapter 3.
» Chapter 2 has been renamed to *Business structures and financial reporting*. There are significant changes in Chapter 2 to reflect the new definitions of assets, liabilities, income and expenses arising from the Revised *Conceptual Framework* published by the IASB in 2018. It also reflects the new definition of a reporting entity. There have been changes to simplify the format with the use of more tables to replace long sections of text.
» Chapter 3 has been renamed to *Sustainability reporting*, *ethics and corporate governance*. The material on sustainability from Chapter 1 has been updated and relocated to this chapter. The section on ethics has been reduced and focuses more on ethics in accounting.
» Chapter 4 has been renamed to *Different measurement methods*. Economic value has been altered to value-in-use.
» Chapter 5 has been amended to include the new definitions of assets and liabilities. The organisation of material has also been amended to provide a better flow of the content.
» Chapter 6 has a new section on the relationship between the balance sheet and the profit or loss statement. It also incorporates the impact of the new definitions of income and expenses, plus the new accounting standard AASB15 *Revenue from contracts with customers*.
» Chapter 7 is similar to the 9th edition with the addition of updates where relevant.
» Chapter 8 has been updated with current examples and the section on the theoretical formula in the reducing balance depreciation method has been removed.
» Chapter 9 has been renamed to *Accounting for selected liabilities and sources of financing*. The section on leases has been revised to reflect the new accounting standard AASB 16 Leases. Some additional information on debt ratios has been added.
» Chapter 10 has been renamed *Analysis of financial statements*. It has also been restructured in parts to simplify the format with the use of more tables to replace long sections of text.
» Chapter 11 has been renamed *From the worksheet to debits and credits* and remains similar to the chapter in the 9th edition.
» Chapter 12 continues to build on the theme of management accounting systems being designed to provide information to best meet the strategic decision-making needs of management. Recognising that the contemporary challenge for many managers is to create the greatest value from their organisation's activities, the chapter covers this topic by employing the value chain model of business activities in combination with Michael Porter's generic competitive strategies and five forces analysis of competitive position.
» Chapter 13 continues to examine the material on performance measurement, and this material provides a strategic analysis of performance measurement, including the use of different financial and non-financial performance measures and the use of the balanced scorecard as a comprehensive performance management framework. The use of the balanced scorecard as a means for incorporating the non-financial measures incorporated in an organisation's integrated report is discussed. The material on Economic Value Added (EVA) has been removed and will be available as an extended online resource.
» Chapter 14 provides a comprehensive examination of costs, including the nature and behaviour of costs, direct and indirect costs, product and period costs, and the allocation of overhead costs using traditional volume and activity-based cost allocation models. The importance of effective cost reduction strategies to enhancing the financial sustainability of an organisation, particularly in the resources sector, is identified and serves to reinforce the idea that different costs are used for different decision-making purposes.

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- Chapter 15 examines the nature and purpose of budgets with a detailed practical illustration of the development of a master budget and the nature and purpose of projected financial statements.
- Chapter 16 examines cost-volume-profit analysis, placing greater emphasis on the significance of operating leverage to decisions about pricing, volume and cost structures as they affect organisational profitability.
- Chapter 17 examines short-term decision making with and without resource constraints, as well as key management accounting concepts such as sunk, opportunity and relevant costs.
- Chapter 18 examines long-term decision making (i.e. capital investment projects). Previously incorporated materials on financial maths, dealing with uncertainty, sensitivity analysis and post-implementation audits have been removed and are available as separate online resources.

Additional resources included in the textbook are as follows:

- Appendix 1 provides an extract from the Annual Report of Woolworths Limited for the year ending 30 June 2018. Reference is made to the Woolworths financial report throughout the financial accounting section of the 10th edition, enabling readers to examine the financial report of a real company. Most of the financial accounting chapters include end-of-chapter questions relating to the report. These questions are intended to encourage student interest in reading published financial reports and becoming familiar with the contents.
- Updated recent newspaper articles are used to illustrate the various topics discussed in many chapters. These articles provide a real-world context for the subject matter discussed, as well as stimulating student interest in accounting as a field of professional practice.
- At the end of each chapter we have introduced a new Take it further activity, which affords students the opportunity to apply critical analysis to highly relevant accounting issues and problems. As critical thinking is an important employability skill cited in employer surveys across many different careers, providing students with the further opportunity to develop this significant transferable skill is desirable.

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Guide to the text

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

PART OPENING FEATURES

Meet real professionals in this area in the **Practitioner Perspectives** at the start of each part, and gain an insight into how accounting theory relates to and informs their day-to-day practice.

Practitioner Perspective

Lawrie Tremaine

Lawrie Tremaine is a finance executive with over 30 years' experience in financial and commercial leadership. Lawrie is currently the CFO at Origin Energy and was previously the CFO at Woodside Petroleum for six years. Lawrie also worked at Alcoa for 17 years, culminating in five years in Tokyo and Beijing as Vice President Finance, Alcoa Asia Pacific.

A large part of being a Chief Financial Officer for a publicly listed company is informing capital markets, employees and other stakeholders about the financial position and prospects of the company.

Financial information contained in the Financial Statements, along with the Operating and Financial Review and the results presentation are critical to keeping capital markets, both debt and equity, fully informed.

A company needs to attract capital to grow and create value. By definition, this means the company must invest in opportunities the confidence to invest and to minimise the cost of the invested capital to the company.

Similarly for national economies to grow, they too need to attract capital. Capital flows are fluid and global. Capital will preferentially move to the capital markets which are fair, well-regulated and function well, demonstrated by liquid capital flows. Once again, the availability of reliable financial and operating information is vital to the operation of global and national capital markets.

For these reasons, public companies must ensure that published Financial Statements cases, the efficiency of decision making is dependent on the quality of the underlying financial information.

Part 1 of this text will provide you with a broad understanding of Financial Statements. You will gain an appreciation of their purpose and the knowledge to interpret and utilise financial statements. In addition, you will learn about the issues of estimation, assumptions and judgements underpinning financial statements and how this is vital to the valid analysis of a business.

Contemporary Accounting: a Strategic Approach for Users is

CHAPTER OPENING FEATURES

Identify the key concepts that the chapter will cover with the **Learning objectives** at the start of each chapter.

Chapter 1

Introduction to accounting

Learning objectives

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

- **LO 1.1** explain what is meant by the term 'accounting'
- **LO 1.2** explain the difference between management accounting, financial accounting and tax accounting
- **LO 1.3** identify the main users of accounting information, and the main purposes for which the information is used
- **LO 1.4** identify the limitations of accounting information
- **LO 1.5** discuss the factors that influence the choice of accounting systems for different types of organisations

FEATURES WITHIN CHAPTERS

Identify core ideas and important points with the **Key concept** boxes, which provide concise definitions of accounting concepts.

Key concept 3.5: Audit committee

An audit committee is a subcommittee of the board of directors and part of the corporate governance of a company. Its roles vary according to the company but, in general, the role of the audit committee is to ensure that the financial statements have been reliably prepared and verified.

Test your progress through each chapter by answering the **Stop and think** questions as you read. **Solutions** are provided at the end of the chapter.

Stop and think 1

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

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FEATURES WITHIN CHAPTERS

See step-by-step examples of how to approach important concepts in the **Worked examples**.

Worked example 4.1: Alexia

Alexia came up with the following list of assets and told us that she owed nothing.

At the start of the year: T_0	At the end of the year: T_1
A new Toyota Corolla	A one-year-old Toyota Corolla
One new dress	The same dress
Five shirts	The same five shirts
Four pairs of jeans	Five pairs of jeans
One surfboard	One surfboard
$400 cash	$500 cash


Scout Kozakiewicz

While the lists above might accurately reflect the assets Alexia controls and what she owes, we cannot easily see whether she is better or worse off at the end of the year than she was at the start. With the benefit of our own knowledge of the world, we could perhaps say that she must be worse off because everything is one year older. This, however, assumes that the value of her possessions decreases with time. In many cases that is a reasonable assumption, but clearly there are cases where the value increases. For example, would our attitudes towards the value of her possessions change if the car was a 1956 FJ Holden? Leaving that question aside for a moment, you may have noticed that as soon as we started to discuss the measurement of wealth we also started talking of the more abstract concept of value.

Analyse in-depth **Case studies** that present issues in context, encouraging you to integrate and apply the concepts discussed in the chapter to the workplace. Each one has a clearly marked **Commentary** section that discusses the case.

Case study 9.1

	Company A	Company B
	$	$
Assets		
Current assets	100 000	100 000
Non-current assets	1 900 000	1 400 000
Total assets	2 000 000	1 500 000
Liabilities		
Current liabilities	500 000	500 000
Non-current liabilities	500 000	–

Commentary

The only difference between the balance sheets of Company A and Company B is $500 000 in non-current assets and $500 000 in non-current liabilities. Company A has just borrowed $500 000 from the bank over a period of 10 years. It has purchased a machine that has an estimated life of 10 years with zero residual value. B has just signed a lease agreement to acquire the use of an identical machine to that purchased by A. The lease agreement is for 10 years and cannot be cancelled by

Extracts from the **Woolworths Ltd 2018 Annual Report** are included in the **Appendix**, and the margin icon indicates places in the text where reference is made to these extracts. These will help you become familiar with and appreciate the functioning of a real company's financial report.

Appendix 1

Extracts from Woolworths Ltd 2018 Annual Report

To see the full annual report, please visit **http://www.woolworthslimited.com.au** and follow the links to the *Investor Centre* and then to *Reports*.

Auditor's Independence Declaration

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The Board of Directors
Woolworths Group Limited
1 Woolworths Way
Bella Vista
NSW 2153

20 August 2018

Dear Board Members

Woolworths Group Limited

In accordance with section 307C of the *Corporations Act 2001*, I am pleased to provide the following declaration of independence to the directors of Woolworths Group Limited.

As lead audit partner for the audit of the financial statements of Woolworths Group Limited for the financial year ended 24 June 2018, I declare that to the best of my knowledge and belief, there have been no contraventions of:

(i) the auditor independence requirements of the *Corporations Act 2001* in relation to the audit; and

(ii) any applicable code of professional conduct in relation to the audit.

The **Ethics and corporate social responsibility icons** in the margin highlight ethical issues and discussion of CSR throughout the text.

Ethics/CSR
Sometimes managers might feel the temptation to try to enhance assets on a balance sheet when applying for a loan. There can be severe penalties for this.

There are also issues relating to the ways in which a business is perceived and the v
management wishes the business to be perceived. Research has shown that managers,
managers of smaller entities, believe bankers are interested in the amount of assets availa
for a loan or overdraft. There is therefore a temptation to try to enhance the value of asse
revaluing land and buildings, before applying for a loan. Similarly, in a number of cases wh
is in trouble, assets have been revalued in order to bolster the image of the business and t
impression of a sound asset base.

In Australia there are severe penalties for directors of public companies or other entities
fraudulently to inflate assets or decrease liabilities. In Chapter 1, we discussed contacts, age
incentives for managers to select certain accounting policies but this does not include fraudul

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END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

Review your understanding of the key chapter topics with the **Summary**.

Study tools

Summary

LO 1.1

Explain what is meant by the term 'accounting'

In this chapter we have tried to give an idea of what accounting is and how it pervades both the internal workings of organisations and the external commercial environment. It can be seen at one level as a functional area of business and at an external level as an important determinant of business survival through its effect on groups such as shareholders, lenders and employees.

These definitions and recognition criteria are discussed in Chapter 2.

LO 1.5

Discuss the factors that influence the choice of accounting systems for different types of organisations

The factors that influence the choice of an accounting system include the size of the organisation, the type of business activity being undertaken and whether it is simple or complex, the structure of the organisation and whether the organisation

Test your knowledge and consolidate your learning through the **Review questions**, **Take if further** activity and **Problems for discussion and analysis**.

Review questions

1 For what purposes is accounting information used:
 – by the individual
 – by the entity or organisation?
2 Examples were given of certain limitations of accounting information. Can you give examples of your own?
3 What are some of the careers for accountants?
4 Why would employees require financial information about an employer?
5 When would customers require financial information about a provider of a product or service?
6 Do you think companies would provide financial information if they were not required to by the *Corporations Act*?
7 What is the impact of technology on accounting?
8 What is the difference between management and financial accounting?

Take it further

Much has been written about the impact of technology on accounting and the potential loss of jobs as a result of automation. The 2015 publication the *Australia's Future Workforce?*, published by the Committee for Economic Development of Australia, is one example. Conduct internet research to see if you can locate other more recent examples.

Problems for discussion and analysis

1 Refer to the 2018 Woolworths financial statements in Appendix 1.
 a What is the name of the auditing firm?
 b Does Woolworths include shares as part of the remuneration for employees?
 c Do these shares affect the determination of net profit for Woolworths?
2 In your own words, describe what you think accounting means and what accountants do in a small and very large business.
3 Discuss what information you believe would be useful to the following groups of report users:
 a employees
 b investors

Apply what you have learned to real-world ethical dilemmas In the **Ethics case study** at the end of every chapter.

Ethics case study

Tom has been employed at New Incentives Ltd for six months, after recently graduating from university with a degree in accounting. It is his first job after trying to find employment for six months. Tom's boss has asked him for a favour in preparing the profit or loss and statement of comprehensive income for the year. She wants Tom to include in income cash received for services to be provided next year. She also wants him to record as an asset cash paid for advertisements that were screened on television two weeks before the end of the accounting period. Tom is aware that management is to be paid bonuses based on the net profit for the period.

Discuss

 a How the transactions should be reported according to your understanding of the IASB *Conceptual Framework 2018*
 b What Tom should do.

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Guide to the online resources

FOR THE INSTRUCTOR

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- "Why it matters" whiteboard animations illustrating core concepts
- Concept Check and Revision Quizzes
- Additional case studies and appendices
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SOLUTIONS MANUAL

The **Solutions manual** provides detailed solutions to the review questions and problems in the text.

TEST BANK

This bank of questions has been developed in conjunction with the text for creating quizzes, tests and exams for your students. Deliver these through your LMS and in your classroom.

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FOR THE STUDENT

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About the authors

Phil Hancock is a Professor of Accounting and the Associate Dean of Teaching and Learning for the Faculty of Arts, Business, Law and Education at the University of Western Australia. Phil has extensive experience in the regulation of corporate financial reporting, management and international accounting in both the educational and private sectors. Phil was Chair of the Accounting Learning Outcomes Working Party, which was responsible for drafting the threshold learning standards for graduates of bachelor and master degrees in accounting in 2010 and revised in 2016. Phil is a Fellow of CPA Australia and the Chartered Accountants Australia and New Zealand and the Accounting and Finance Association of Australia and New Zealand (AFAANZ). In 2013 Phil was awarded the Outstanding Contribution to Accounting and Finance Education by AFAANZ. He is a previous President of the Western Australian Divisional Council for CPA Australia. As an academic, Phil has held senior positions at the University of Western Australia, Edith Cowan University and Murdoch University, where he was an Associate Professor in Accounting.

Peter Robinson has taught at all West Australian universities, spending more than 20 years with each of Curtin University and the University of Western Australia (UWA). Peter has also held teaching appointments with the University of Melbourne, the University of New South Wales (UNSW), the University of Texas at Austin and the University of South Africa. Peter has taught the breadth of the accounting curriculum at undergraduate and post graduate level with strategic management accounting and public sector financial management being his more recent areas of teaching specialisation. Peter is Academic Co-ordinator for Work Integrated Learning (WIL) for the Faculty of Arts, Business, Law and Education at the University of Western Australia. Peter is a Fellow of CPA Australia and a member of the Accounting and Finance Association of Australia and New Zealand (AFAANZ). Peter has also been an active contributor to the development and delivery of study materials used by candidates seeking admission to the former Institute of Chartered Accountants in Australia and CPA Australia; to the professional development of managers and senior executives in the for-profit, not-for-profit and public sectors, both in Australia and internationally; and has regularly consulted with clients in these sectors upon a wide range of financial and performance management topics. Apart from Peter's undergraduate and post graduate studies in accounting with Curtin, UWA and UNSW, he has a Master of Education (UWA). Over the past five years, Peter has contributed, as reviewer, presenter of professional development material to high school teachers, and as chief examiner in 2011, 2012 and 2017 and as independent examiner in 2018 to the development and delivery of Western Australia's Certificate of Education Accounting and Finance course of studies for Year 12 senior secondary school students.

Mike Bazley (1931–2013) was the inspiration behind the first edition of this book, which now enters its 10th edition. The success of this text is a tribute to Mike's perseverance, as many of the publishers he initially approached were not particularly interested in his idea of adapting the UK text Accounting in Business Context. However, Thomas Nelson, now Cengage Learning, finally agreed and in 1991 the first edition was published. Sadly Mike Bazley passed away in February 2013. Mike was an excellent teacher and highly regarded by the students he taught, an outstanding work colleague, a valued friend and a true gentleman to all that he met. He is deeply missed by his family and many friends and former colleagues.

Mike Bazley was born in the United Kingdom where, having undertaken national service, he joined a medium-sized company and worked his way to joint managing director. In 1969, Mike migrated to Australia and began his period of employment at the University of Western Australia, which eventually led him to taking up a lectureship in 1977 in UWA's then Department of Accounting and Finance. He subsequently took up a position with Murdoch University where he was Dean of Studies and Chair of the School of Commerce and Senior Lecturer. In addition to his academic work, he also consulted for the West Australian state government, conducted public seminars and contributed to various academic and professional publications. Mike was a Fellow of CPA Australia. Having retired in 1995, Mike still continued to take great interest in the development of this text.

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Part 1

Financial Accounting

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Practitioner Perspective

Lawrie Tremaine

Lawrie Tremaine is a finance executive with over 30 years' experience in financial and commercial leadership. Lawrie is currently the CFO at Origin Energy and was previously the CFO at Woodside Petroleum for six years. Lawrie also worked at Alcoa for 17 years, culminating in five years in Tokyo and Beijing as Vice President Finance, Alcoa Asia Pacific.

A large part of being a Chief Financial Officer for a publicly listed company is informing capital markets, employees and other stakeholders about the financial position and prospects of the company.

Financial information contained in the Financial Statements, along with the Operating and Financial Review and the results presentation are critical to keeping capital markets, both debt and equity, fully informed.

A company needs to attract capital to grow and create value. By definition, this means the company must invest in opportunities which provide returns in excess of the cost of capital. The cost of capital is determined by the availability of capital and the relative risk of the company or business opportunity. The perceived risk is in turn impacted by a number of factors, including the quality of the investment thesis, leverage, the reputation and quality of management and country risk, among many others. The availability of reliable, complete and consistently prepared financial and operating information is vital to provide investors with the confidence to invest and to minimise the cost of the invested capital to the company.

Similarly for national economies to grow, they too need to attract capital. Capital flows are fluid and global. Capital will preferentially move to the capital markets which are fair, well-regulated and function well, demonstrated by liquid capital flows. Once again, the availability of reliable financial and operating information is vital to the operation of global and national capital markets.

For these reasons, public companies must ensure that published Financial Statements and other disclosures fully inform current and prospective investors of all the material matters which may impact their investment. This means ensuring reporting is consistent with all regulatory requirements but also going beyond this standard as required to meet the objective.

As a CFO I am also the user of the Financial Statements of other companies. I rely on their financial information as we consider them as suppliers, trading counterparties, joint venture partners or even acquisition targets. In each of these cases, the efficiency of decision making is dependent on the quality of the underlying financial information.

Part 1 of this text will provide you with a broad understanding of Financial Statements. You will gain an appreciation of their purpose and the knowledge to interpret and utilise financial statements. In addition, you will learn about the issues of estimation, assumptions and judgements underpinning financial statements and how this is vital to the valid analysis of a business.

Contemporary Accounting: a Strategic Approach for Users is written from the viewpoint of a user and not a preparer. It avoids debits and credits and focuses on the language of accountants and how to use and analyse financial statements.

With this being the 10th edition, the text remains up to date and relevant, incorporating the Revised Conceptual Framework issued by the IASB in 2018 and new accounting standards. I commend this text to you as providing valuable, up-to-date insight in the use, interpretation and analysis of financial statements.

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Chapter 1

Introduction to accounting

Learning objectives

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

LO 1.1 explain what is meant by the term 'accounting'

LO 1.2 explain the difference between management accounting, financial accounting and tax accounting

LO 1.3 identify the main users of accounting information, and the main purposes for which the information is used

LO 1.4 identify the limitations of accounting information

LO 1.5 discuss the factors that influence the choice of accounting systems for different types of organisations

LO 1.6 demonstrate an understanding of the regulatory and environmental considerations that can influence accounting decisions

LO 1.7 explain what is meant by the term 'economic consequences' and relate this to the choice of accounting policies

LO 1.8 identify career opportunities for accountants.

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Introduction

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

accounting
(Chapter 1) The process of identifying, measuring and communicating economic information to permit informed judgement and decisions by users of the information.

Figure 1.1
What is accounting?

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

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

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value
(Chapter 1) An item's equivalence in money.

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

double-entry bookkeeping
(Chapter 1) The system developed for recording accounting information based on the concept that every transaction affects two or more components of the balance sheet (accounting) equation.

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

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

LO 1.1
Explain what is meant by the term 'accounting'.

1.1 What is accounting?

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

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

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

financial statements
(Chapter 1) The means of conveying a concise picture of the profitability and financial position of a business to management and interested outside parties.

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

» to provide information, through **financial statements**, for the making of economic decisions
» to provide information for predicting, comparing and evaluating the effectiveness of management's use of scarce resources

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» to provide information to predict and evaluate the **going concern** of an **entity**
» to provide information on earnings, **cash** flows, profitability and the financial position of the entity.

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

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

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

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

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

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

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

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

going concern
(Chapter 1) The assumption that a business will continue to operate in the future without any intention to liquidate or to significantly reduce its scale of operations.

entity
(Chapter 1) A fictional or notional being, such as a business, club, company or partnership, in respect of which financial statements occur and accounts are kept.

cash
(Chapter 1) Cash on hand and cash equivalents.

Key concept 1.1: Accounting

Important points made in these definitions are that:
» accounting is about **quantitative** information
» the information is likely to be financial in nature
» it should be useful for decision making in the allocation of scarce resources.

quantitative
(Chapter 1) The amount or size of information.

1.2 For what purpose is accounting information used?

LO 1.2
Explain the difference between management accounting, financial accounting and tax accounting.

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

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

An entity also uses accounting in planning, controlling and decision making (which are all internal activities or functions). The major difference between the two levels is that in the case of an entity, accounting also has

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

financial accounting
(Chapter 1) That part of an accounting system that tries to meet the needs of various external user groups.

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

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

accounting system
(Chapter 1) A collection of source documents, records, procedures, management policies and data-processing methods used to convert economic data into useful information.

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

management accounting
(Chapter 1) That part of an accounting system that tries to meet the needs of management and internal users.

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

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

creditor
(Chapter 1) A person or entity to whom a debt is owed.

LO 1.3
Identify the main users of accounting information, and the main purposes for which the information is used.

1.3 Who uses accounting information?

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

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

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Internal users

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

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


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

The form of each report will also vary according to its purpose. If the purpose of the report is to assist management, it needs to show the past transactions and performance, probably measured against some predetermined standard. For planning purposes, though, a forecast of what is likely to happen in the future is more important. These different forms of reports and ways of grouping information are normally referred to under the heading of 'management accounting'.

As stated earlier, management accounting is the focus of the second part of this book. At this stage it is worth briefly summarising the different categories of management accounting reports. To do this we need to make some generalisations about the needs of managers and to categorise those needs. In practice, of course, there is a certain amount of overlap between the categories but we need not concern ourselves with this at present. The broad categories that we have referred to in terms of the needs of managers can be found in **Table 1.1**.

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

Stop and think 1

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

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Table 1.1

stewardship
(Chapter 1) The need to protect a firm's economic resources (normally referred to as assets) from theft, fraud, wastage and so on.

assets
(Chapter 1) An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. (IASB *Conceptual Framework*, para. 4.3 and 4.4)

Needs of managers	
Need	**Explanation**
Stewardship	**Stewardship** is when managers need to protect the entity's economic resources (normally referred to as **assets**) from, for example, theft, fraud and wastage.
Planning	Managers need to plan activities so that finance can be raised, marketing and promotional campaigns set up and production plans made.
Control	Managers need to control the activities of the entity. This includes measures such as setting sales targets, managing human resources, and ensuring that there are sufficient raw materials to meet the demands of production and sufficient goods in stock to satisfy customer demand. It will also include identifying where targets can be set.
Decision making	Managers need to make specific decisions. For example, should we produce the item ourselves or buy it in? How much will it cost to produce a particular item? How much money will we need in order to run the entity?

External users

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

lenders
(Chapter 1) Persons or organisations which permit the temporary use of money; for example, in return for payment.

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

These groups are normally provided with information by means of published financial statements prepared in accordance with GAAP, except for governments which as stated earlier receive information about an organisation's activities based on tax rules. In order to decide to what extent the financial statements meet the needs of the external users and to understand more fully the importance of accounting, we shall briefly discuss the needs of the external users listed above (see also **Figure 1.2**).

Owners and shareholders

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

Key concept 1.2: Financial accounting

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

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