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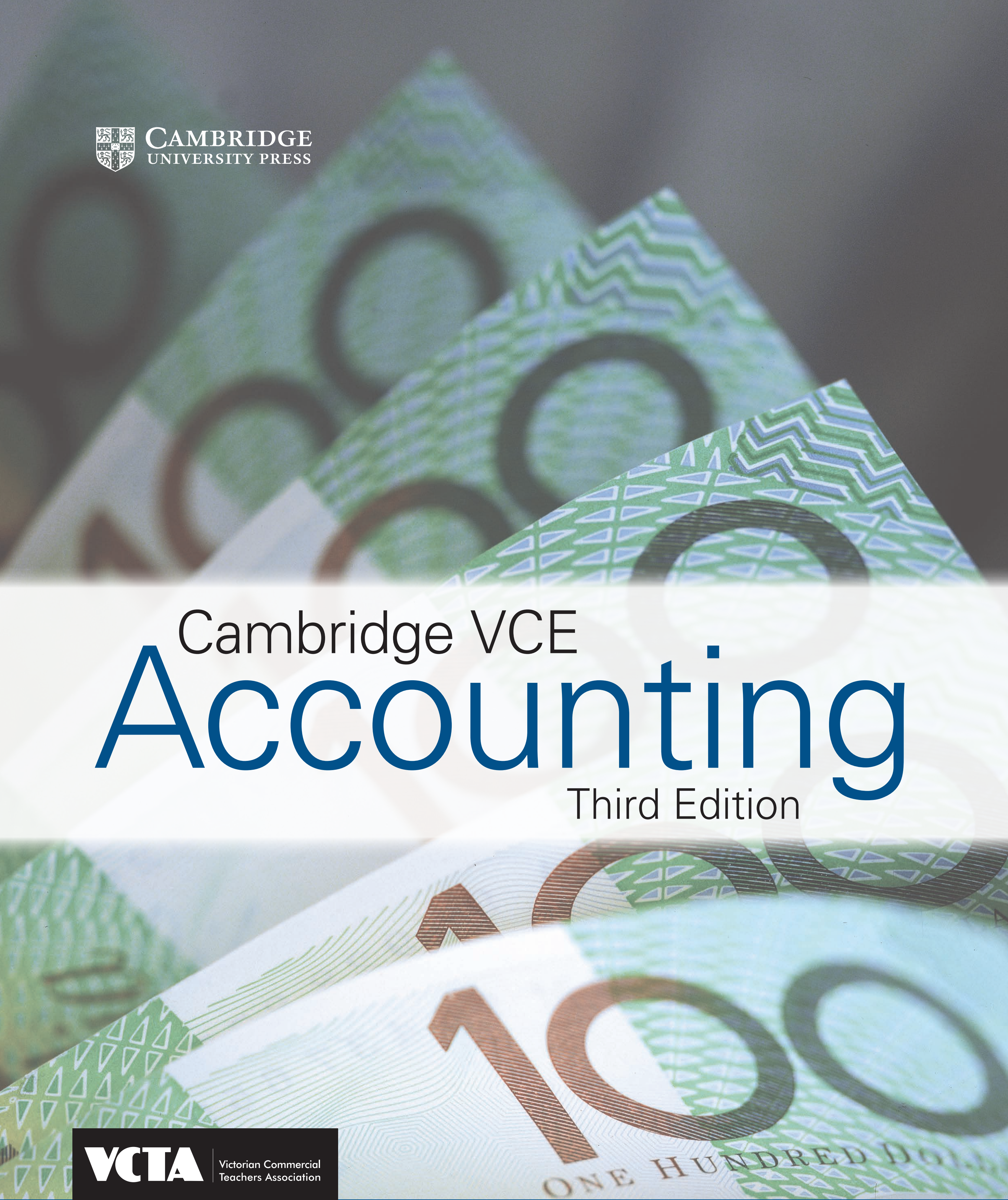

Cambridge VCE

Accounting

Third Edition

VCTA Victorian Commercial Teachers Association

Anthony Simmons
Richard Hardy

Units 1&2

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*includes ethical considerations

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About the authors

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Anthony Simmons B.Comm, Dip.Ed, M.Ed (Ed. Management) is Head of McNab House at Penleigh and Essendon Grammar School. Having spent over 20 years as a teacher of VCE Accounting, he has made important contributions to the understanding of how students learn the discipline and think about Accounting, and how that should influence the way in which the subject is taught. Anthony continues to be involved in all aspects of teaching VCE Accounting, from development of the Curriculum to assessment of student understanding. As evidenced by his involvement in this textbook series, Comview, VCTA professional learning sessions with teachers, student lectures and published articles, Anthony is a leading voice on how Accounting is taught and learned.

Richard Hardy

Richard Hardy B.Ec (Accounting), G Dip.Ed, PG EdAdmin, M.Ed (Admin) is Dean of Academic Administration at Clayfield College. He has taught Accounting for over 20 years and has been a presenter at Comview and VCTA professional development sessions. Richard has also been a VCE Accounting examination assessor and part of the examination writing panel. He continues to instil his passion for Accounting in all of his students.

Author acknowledgements

Although we have been working on these editions of our textbooks for a year or two, we've been developing our understanding – of both Accounting as well as students and how they learn – for the best part of 50 years between us. And in that time we have had the guidance and support of a whole host of people who, together, have helped these books come into being.

First, we would like to thank our families. Our names might be on the cover but every word herein only exists because of your love, patience and support. You have not only shouldered the extra responsibilities we left every time we sat down to write, but you have given us confidence in our abilities to understand learning, and solve the many challenges that arose along the way. Your names appear in various exercises as a small acknowledgement of your love and support, but to you Kristine and Erin in particular – thank you.

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In the world of VCE Accounting our colleagues have provided ideas, feedback and inspiration and for this we thank them all, but especially (in chronological order) Seb Italia, Jacqui Birt, Keith King, Neville Box, Greg Gould, Diana Russo, Sue Lenz, Erin McEwan, Darrell Cruse, Steve Davis, Vicki Baron and Celia Mara. We are also indebted to our students for providing us with insights and feedback (especially when we got it wrong), not to mention inspiration (and not a few names) for the exercises.

Our very special thanks to all the staff at Cambridge University Press: Nick Alexander, Linda Kowarzik, Thuong Du, Amy Robson and our editor Karen Jayne for managing us and the whole project and its various components. Nick – without your gentle pressure applied relentlessly we'd never have finished.

Finally, thank you for choosing this resource. We hope it helps you to understand Accounting as a discipline, and that as a result of using it you are able to think a little bit more like an Accountant, so that your decisions are just a little more informed, and help you in making your own sound financial decisions.

Anthony and Richard

Foreword

Cambridge Accounting for Units 1 and 2 Third Edition written for the current study design by Anthony Simmons and Richard Hardy, represents an excellent reflection and interpretation of the course. Each chapter follows and collates all the relevant key knowledge into one comprehensive chapter allowing students to gain a complete and in depth understanding of the relationships between the various key knowledge points.

Examples and scenarios provided in each chapter enable students and teachers to be guided as to the process and provide detailed explanations of the whys with links to accounting assumptions, qualitative characteristics and the ever-important new concept of ethical considerations in decision-making.

Above all else, the main features of the original text remain. The layout with margin definitions, study tips and review questions throughout each chapter guide students in their learning and alert them to key information.

I am pleased to be able to recommend this as an excellent resource for VCE Accounting teachers and their students.

Vicki Baron
2018

Features of this resource

Chapter openers: Each chapter opens with a summary of what is to come (*Where are we headed?*) as well as a list of Key terms for you to familiarise yourself with.

Glossary terms and definitions: All of the glossary terms in each chapter are defined for you in the margin and in the glossary at the end of the book. The glossary is also marked with page references for ease of use.

Use of colour: Colour has been used to make it easy for you to follow particular transactions through the Accounting process. You can simply track what impact a transaction had in the journals, the ledger and in various reports.

Review questions: Review questions are placed at the end of each section within each chapter, giving you the opportunity to review and reinforce your understanding as you work through the book.

Study tips: Study tips are included in the page margin to draw attention to particular issues, provide a technique for understanding or remembering an element of the course content.

Ethical considerations: Ethical considerations are highlighted in the page margin to draw attention to this particular element of the course.

End of chapter sections: At the end of each chapter, you will find a chapter summary (*Where have we been?*) and exam-style Exercises, each of which is linked with an icon to the corresponding Workbook proforma.

Downloadable Exercise proformas: In the Interactive Textbook you will find downloadable versions of all Review questions, as well as Exercise proformas in both Excel and Word formats.

To access a list of websites and links related to this book, go to:
www.cambridge.edu.au/vceaccounting12

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Role of Accounting in business

Unit 1

In Unit 1 of the VCE Accounting course, we will cover the following chapters:

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Chapter 1

The nature and role of Accounting in business

Where are we headed?

After completing this chapter, you should be able to:

- **explain** the role of Accounting
- **identify** the users of Accounting information and the financial information they require
- **distinguish** between financial data and financial information
- **identify** and **explain** the stages in the Accounting process
- **state** the various forms of source documents
- **identify** and **explain** the four Accounting assumptions, the six Qualitative characteristics and **explain** their relationship to each other
- **identify** ethical considerations.

Key terms

After completing this chapter, you should be familiar with the following terms:

- Accounting
- stakeholder
- financial data
- financial information
- non-financial information
- ethical considerations
- transaction
- source documents
- recording
- reporting
- advice
- Accounting assumptions
  – Accounting entity
  – Going concern
  – Period
  – Accrual basis
- Qualitative characteristics
  – Relevance
  – Faithful representation
  – Comparability
  – Verifiability
  – Timeliness
  – Understandability.

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1.1 The need for Accounting

The next time you visit a shopping centre, take a look at the types of businesses operating there. Chances are, you'll see a variety of shops: some with names you know, and some that are unfamiliar; some selling clothes, food, or household goods; and some providing services such as building or hairdressing. Behind each of these businesses is a small business owner who has detailed knowledge of the product or service they are selling. But unfortunately, this product knowledge on its own is not enough to guarantee the success of their business. Business is not just about making and selling; it is about *managing* – managing people, managing inventory, managing customers and suppliers and, last but not least, managing cash. And if a business owner is to manage their business *effectively*, then they will need accurate information that can be relied upon to assist them in the decisions they make.

This is why Accounting is important; it is essentially an information service. **Accounting** is the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making. It is a process that turns the day-to-day operations of a small business (such as sales over the counter or payment of bills) into a form that the owner can study to determine which areas of their business need improvement.

Accounting
the collecting and recording of financial data to produce and report financial information to assist business owners in decision-making

The purpose of Accounting then is to provide business owners with financial information that will assist them in making decisions about the activities of their firm. This does not mean that Accounting will ensure owners make the right decision, but it should help them to make a *more informed* decision, one which will hopefully improve the performance of the firm and its chance of success.

Users of Accounting information

Accounting in this course concentrates on small businesses where the person managing the business is also the owner of that business. Thus, any Accounting information will be generated primarily for the benefit of the owner/manager. However, it is important to note that in businesses of all types and sizes there will be a number of different parties besides owners, directors or managers who will also be interested in the firm's financial information. All of these parties are known as **stakeholders**, and also include:

- *Accounts Receivable and other customers*, who may wish to know about the firm's continuing ability to provide them with inventory
- *Accounts Payable and other suppliers*, who may wish to know about the firm's ability to repay what it owes them

stakeholder
a person or organisation that has an interest in the performance of the business and can affect operations or be affected by them

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- *banks and other financial institutions*, which will certainly want to know about the firm's current levels of debt and their ability to repay before providing them with any additional finance
- *employees*, who may wish to know about the firm's long-term viability, and their own long-term employment prospects, or its ability to afford improvements in wages and conditions
- *prospective owners*, who may wish to know about the firm's financial structure and earnings performance, and its assets and liabilities to determine the firm's worth
- *The Australian Tax Office (ATO)*, which will require financial information for taxation purposes.

There is a wide variety of users of Accounting information, and each of them may require different information. The Accounting system must ensure that it can generate the information necessary to satisfy the users' needs. This means that it is the intended user, not the Accounting system, who decides what information needs to be prepared.

Financial data versus financial information

financial data
raw facts and figures upon which financial information is based

financial information
financial data that has been sorted, classified and summarised into a more usable and understandable form

Accounting is about providing information; however, that information has to come from a source and actually begins its life as raw facts (source documents) before being transformed into a form that is useful for decision-making (financial reports). Therefore, we need to distinguish between financial *data* and financial *information*. **Financial data** refers to the raw facts and figures on which financial information will be based. For most businesses this data is contained in their source documents such as receipts, cheque butts, invoices, memorandums (memos) and Bank Statements. This data then becomes **financial information** once it has been sorted and processed into a more usable and understandable form. For instance, a pile of source documents (data) may provide specific details of the firm's transactions over the past week or so, but a pile of documents conveys no useful information. The data has not been sorted, or classified into groups, or summarised in any way. Once this data is sorted, classified and summarised, it becomes financial information that can be used as the basis for business decisions. This is the role of the Accounting system.

Non-financial information

Most information used in Accounting is financial in nature. Important information like sales revenue, monthly wages, cash in the bank and even Net Profit are all measured in dollars and cents (or another currency) and reported in the financial statements. This information is critical but does not present the whole picture as to how a business is performing. A business may present well on paper financially; however, there may be things occurring that will not be identified by the financial statements that could be cause for concern, for example a high staff turnover.

non-financial information
any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation

Non-financial information is a very broad term that includes any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation. Examples include employee absentee rates (sick days), website hits, the amount of wastage in production, market share and adoption rates of new products. It is seen as an indicator of a business's future financial performance. For example, an increasing number of customer complaints about a particular product or service and declining customer satisfaction will eventually lead to deterioration in financial performance. It can also include other information such as strike rates – the percentage of inquiries that turn into sales.

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Taken together with the financial information, this non-financial information presents a more complete and accurate picture of the firm's circumstances, allowing the owner to make more informed and thus more effective decisions.

Ethical considerations

Ethical considerations

Stakeholders also want to look beyond the financial statements of a business and examine its corporate social responsibility or the ethics it displays. The financial decisions that a business makes often have non-financial consequences. For this reason, Accounting is increasingly concerned not just with the financial parameters of decision-making, but also with its ethical ramifications. These **ethical considerations** include the social and environmental consequences of a decision: the effects on people, communities and society, and the local and wider environment. Some ethical considerations a business needs to consider include:

- the way a business looks after its employees in terms of pay, opportunities and work environment
- its choices regarding suppliers and products and whether those choices are sustainable
- whether a business is representing itself, regarding its products and practices, fairly and accurately, for example product safety and warranties.

ethical considerations the social and environmental consequences of a financial decision

A business needs to be very aware of its ethical decisions as they relate directly to its reputation. This can have serious corporate ramifications in terms of negative publicity, reduced sales, and fines and penalties.

Users of Accounting information need to think about how a decision will affect not only the business, but also the people and community with whom it is connected, and its local and global environment. After all, the long-term success of a business is inextricably linked to the health of the society and environment in which it operates.

Study tip

There is no set list of 'ethical considerations' in this course, but examples will be presented as issues arise.

Review questions 1.1

1. **Define** the term 'Accounting'.
2. **Explain** the purpose of Accounting.
3. **Identify** the 'stakeholders' of a business. **Determine** if they are internal or external to the business and **describe** their interest in the Accounting reports of a business.
4. **Explain** the relationship between financial data and financial information.
5. **Distinguish** between financial and non-financial information providing examples. **Explain** how they support each other.
6. Referring to the three dot points under ethical considerations, **choose** an area and **outline** an actual example where a business has **not** been ethical in its decision-making. **Discuss** what may have led to that decision being made and its consequences.

Ethical considerations

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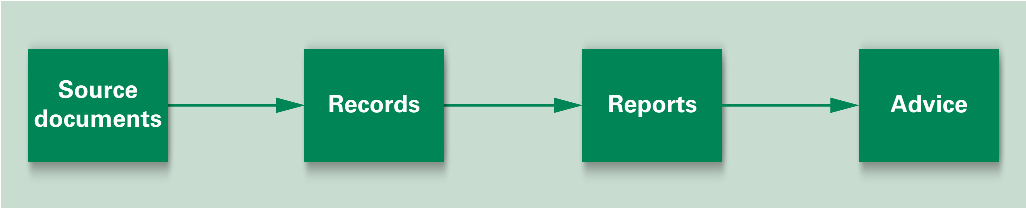
1.2 The Accounting process

The process of turning financial data into financial information is facilitated by what is known as the *Accounting process*.

Figure 1.1 The Accounting process



Stage 1: source documents

Also known as the *input stage*, this is where the business collects the source documents relating to its **transactions**.

transaction
an exchange of goods or services with another party for payment

source documents
documents that provide both the evidence that a transaction has occurred and the details of the transaction itself

Source documents are documents (paper or electronic) that provide both the evidence that a transaction has occurred and the details of the transaction itself. Thus, source documents provide the data on which the Accounting information will be based.

Common source documents include:

- *receipts (including EFTPOS and BPay) and Bank Statements* – provide evidence of cash received by the business
- *cheque butts, EFTPOS receipts (issued by the seller) and Bank Statements* – provide evidence of cash paid by the business
- *invoices* – provide evidence of credit transactions
- *credit notes* – provide evidence of a decrease in an amount owed as a result of returning goods due to incorrect type or damage
- *memos* – provide evidence of transactions within the firm itself.

EFTPOS is an acronym for Electronic Funds Transfer Point of Sale – which means that when a customer uses a card to make a payment, cash is transferred from their account to the business as soon as the transaction has been processed. Bank Statements not only verify the cash transactions of the business but also provide evidence of transactions that the business may have been unaware of, such as the receipt of interest or the charging of a service fee.

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A business will enter into many transactions every day, and each one of these transactions must be detailed on a source document. As far as the Accounting process is concerned, if it isn't on a source document, it didn't happen.

Stage 2: recording

Once the source documents have been collected, the information they contain must be written down or 'recorded'. This is also known as the *processing stage*. **Recording** involves sorting, classifying and summarising the information contained in the source documents so that it is more usable.

recording
sorting, classifying and summarising the information contained in the source documents so that it is more usable

Common Accounting records include:

- *journals*, which record daily transactions of a common type (such as all cash paid, all cash received, or all inventory purchased on credit)
- *inventory cards*, which record all the movements of inventory (stock) in and out of the business.

Stage 3: reporting

The *output stage* of the Accounting process involves taking the information that has been generated by the Accounting records (the journals) and 'reporting' that financial information to the owner of the business in a form that he or she can understand. **Reporting** involves the preparation of financial statements that communicate financial information to the owner, so that decisions can be made.

reporting
the preparation of financial statements that communicate financial information to the owner

There are three general-purpose reports that all businesses should prepare:

- *Cash Flow Statement* – a statement of the cash inflows and outflows of the firm, and the change in its cash balance over a period
- *Income Statement* – a statement of the firm's revenue and expenses over a period
- *Balance Sheet* – a statement of the firm's assets and liabilities at a particular point in time.

Essentially, the Accounting process is about collecting data from source documents; sorting it, classifying it and recording it in journals; and then communicating the information to the owner via financial reports.

Stage 4: advice

Armed with the information presented in the reports, an accountant should be able to make some suggestions on an appropriate course of action. This is where the real skill of an accountant comes into play. Without proper **advice**, the information in the reports is as good as useless, but if the reports are explained carefully and the accountant provides the owner with a range of options, a more informed decision – and a better outcome for the business – should occur.

advice
the provision to the owner of a range of options appropriate to their aims/objectives, and recommendations as to their suitability

Review questions 1.2

1. **Explain** the four stages of the Accounting process.
2. **State** and **describe** five types of source documents and **identify** the type of transaction evidenced by each. **Discuss** the changing nature of transactions and source documents. (Have you ever received a cheque?)
3. **State** and **describe** two types of Accounting records.
4. **State** and **describe** three types of Accounting reports.

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Study tip

Accounting assumptions and Qualitative characteristics are linked, but different: be careful to provide exactly what is asked for in each question.

1.3 Accounting assumptions

As they generate financial information, accountants must follow a number of guidelines and in some cases strict rules governing the way Accounting is done. Some of these guidelines are generally agreed to by all accountants as they have been followed for a long period of time. Others are enforced by law, and they have to be followed or legal sanctions may follow. Together, these guidelines dictate the way records and reports are prepared.

The main guidelines of importance to this course are:

- *Accounting assumptions*, which govern the way Accounting information is recorded
- *Qualitative characteristics*, which inform the way Accounting reports are prepared.

Accounting assumptions are the 'generally accepted rules' that govern the way Accounting information is recorded. In our course, the four assumptions that govern the way Accounting information is recorded are the:

- Accounting entity assumption
- Going concern assumption
- Period assumption
- Accrual basis assumption.

Accounting assumptions
the generally accepted rules that govern the way Accounting information is recorded

Accounting entity assumption

The **Accounting entity assumption** states that from an Accounting perspective, the business is separate from the owner and other entities, and its records should be kept on this basis.

For a small business, this concept may appear strange, as it is the person behind the counter, or the one actually performing the service who owns the business. Surely any money the business earns belongs to the owner and any assets or debts the owner has would be part of the business since they would be one and the same. In the eyes of the law this is true, but in terms of Accounting we assume that the business and the owner are separate entities/beings. If we are to assess the performance of the business itself, we must only include information that is relevant to that business. The owner may have a home and a large loan (mortgage), but if neither of these items is being used by the business, it must not be included as a business asset or liability. If the owner brings these items into the business for business use, then we should treat that as a transaction between the owner and the firm as if they are separate Accounting entities.

Accounting entity assumption
the assumption that the records of assets, liabilities and business activities of the entity are kept completely separate from those of the owner of the entity as well as from those of other entities

Going concern assumption

The **Going concern assumption** assumes that the business will continue to operate in the future, and its records are kept on that basis. The life of the business is assumed to be continuous.

This assumption is important because it allows us to record transactions that affect the future of the business. It allows the business to recognise transactions that occur over more than one period such as credit transactions. For instance, if we sell goods on credit we will not receive the cash for those goods until a later date. However, if we assume that our business will continue, then at some stage in the future we are likely to receive the cash from credit sales, and this allows us to record Accounts Receivable (amounts owed to us by credit customers) as an asset at the time of the sale. The same applies to amounts we owe to our Accounts Payable for our credit purchases. It also helps us to determine if an item should be treated as an asset or an expense. An expense will be consumed within one reporting period; however, an asset will provide benefit to future reporting periods. An example would be an expense like Wages, which has no ongoing benefit compared to assets like Vehicles, which will provide benefits into the future.

Going concern assumption
the assumption that the business will continue to operate in the future, and its records are kept on that basis

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Further, based on this assumption we can recognise long-term assets and liabilities and distinguish them from the short-term ones. This will allow the owner/manager to see the financial position of the business much more clearly and ensure that there are sufficient short and long-term assets to meet the short and long-term liabilities.

Period assumption

The **Period assumption** states that reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results.

This assumption is inextricably linked to the idea that the business is a going concern. Because the life of the business is assumed to be continuous, it is necessary to divide that life into arbitrary periods so that reports can be prepared. We cannot wait until the end of the business's life to calculate profit, because we are assuming that will never come, so we calculate profit for the month, or year. A reporting period can be as short as the owner requires but cannot be longer than a year to meet taxation requirements. (Many businesses will complete a Business Activity Statement (BAS) once per quarter, meaning their reporting period is three months.)

Period assumption
the assumption that reports are prepared for a particular period of time, such as a month or a year, in order to obtain comparability of results

Accrual basis assumption

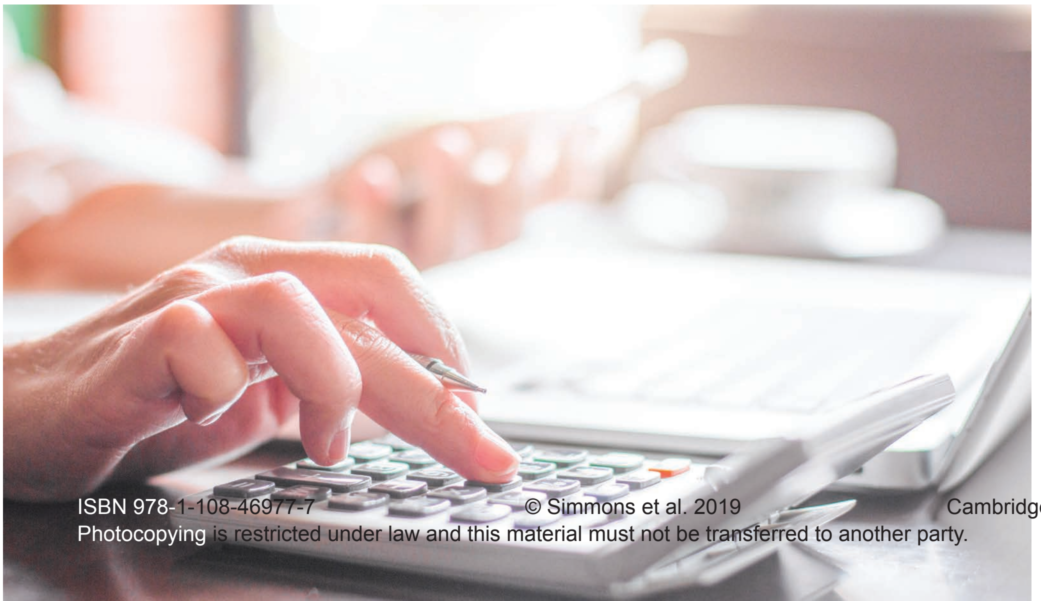
Because it recognises elements of the reports when they meet their respective definitions, the **Accrual basis assumption** will calculate profit by subtracting *expenses incurred* from *revenue earned* in a particular reporting period. Revenue is recognised as earned when the expected inflow of economic benefit can be measured in a faithful and verified way. This is in effect when the good or service is provided. Expenses are incurred when the consumption of a good or service can be measured or when the item is 'used up'.

Importantly, the Accrual basis does not require cash to be received or paid for revenue and expenses to be recognised. Even where a business has made a credit sale and is waiting to receive cash or has not yet paid for some of its expenses, the Accrual basis says these amounts should still be included in the calculation of profit as the revenue has been *earned* (when the goods were sold) and the expense *incurred* (when the item was consumed) during the current period.

Accrual basis assumption
the assumption that the Elements of the reports are recognised when they satisfy the definitions and recognition criteria, meaning profit is calculated as revenue earned in a particular period less expenses incurred in that same period

Review questions 1.3

1. **Explain** the role of the Accounting assumptions.
2. **State** and **explain** the four Accounting assumptions.
3. **Explain** why a business is assumed to have a life separate from its owner.
4. **Define** the length of a reporting period. (Beware: this is a trick question!)



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