Accounting

TENTH EDITION

HOGGETT
MEDLIN
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1.3 outline the range of economic decisions made in the marketplace

1.4 explain the nature of accounting and its main functions

1.5 identify the potential users of accounting information

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1.7 describe the role of accounting information in the decision-making process

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1.10 identify the different areas of the economy in which accountants work

1.11 identify the importance of ethics in business and accounting and how to recognise and handle ethical dilemmas as part of the decision-making process.

SCENE SETTER

Getting started with accountancy

A uniquely caring, fair and inclusive view of society is most often the product of a recipe that includes powerful life lessons, positive cultural understanding and thoughtful reflection.

These influences have turned Corinne Proske CPA into the person she is today. What is perhaps most surprising is that she fell so comfortably into accounting.

Proske grew up in Melbourne, but spent time in the US, France and Germany when she was young. Her parents' respect for nature was passed on to Proske who, as a teenager, once considered chaining herself to a tree during an anti-logging protest. Instead, a philosophical discussion with her father led her in an unexpected direction.

'We had a talk about whether it is more effective to strap yourself to the tree and wait for the bulldozer or to drive the bulldozer yourself,' she says.

'I began to realise the power of blending two worlds together.'

Proske originally dreamed of becoming a park ranger but instead studied commerce, specialising in environmental economics and later completing her accounting professional qualification.

'There is a role for people to be outraged but, using the skills of accounting and economics, I have been able to make the most impactful influences and decisions.'

Proske worked with NAB as head of community finance and development and led NAB's impact investment business, an emerging field of investment activities that aims to generate a measurable and beneficial social or environmental impact along with a financial return. The Australian market for impact investment is estimated to reach A$32 billion by 2022, so it makes economic sense for the bank to be involved.

From 'behind the wheel of the bulldozer', she developed, managed and launched NAB's microfinance program, offering assistance to individuals and businesses that have difficulty accessing mainstream finance.

'There are two key commercial drivers,' says Proske. 'One is that, economically, it makes sense to include everybody; it is good for GDP. Second, we will be regulated if we don't get this right. It is also simply about doing the right thing.'

Research from the Centre for Social Impact, conducted on behalf of NAB, shows that three million adult Australians are fully or severely financially excluded.

Corinne is now General Manager, Online and Retail at Good Shepherd Microfinance.

'I would never have got here without my accounting knowledge and experience,' says Proske. 'It has allowed me some real clarity.

'The tools that accounting offered me have been absolutely essential.'

One piece of advice

'Doing the right thing and achieving commercial outcomes need to, and can, align. Business is only successful when society succeeds. Accountants need to look beyond the numbers.'

Source: Excerpts from Sheedy, C 2016, 'A natural progression', *InTheBlack*, June 2016, p. 70, http://intheblack.com/articles/2016/06/01/could-394000-microfinance-projects-change-australian-market.

Chapter preview

Welcome to your journey into the field of accounting. If your initial reaction to accounting is 'boring!', then think again. Accounting, at times, can be full of politics and intrigue, and the financial figures it produces are useful for informing many business decisions. The figures also may be the result of unethical behaviour whereby people have 'cooked the books'. So let's begin.

Whether you are studying this subject with a view to following a career in community finance (as has Corinne Proske in our scene setter), sports management, financial planning, or simply to gain a basic understanding of the field as it relates to other areas of business, we hope that you find your study of the subject enjoyable, challenging and useful. Inevitably, a study of accounting requires a basic understanding of record keeping, but accounting is far more than that. Accounting plays a vital role in the decision-making processes of every organisation, whether it is a for-profit organisation (e.g. Commonwealth Bank), not-for-profit organisation (e.g. a charity such as Oxfam) or a government organisation (e.g. a local council).

1.1 The dynamic environment of accounting

LEARNING OBJECTIVE 1.1 Outline the dynamic environment in which accountants work.

Accountants traditionally have been viewed as the 'bean counters' or 'number-crunchers' of an organisation, but this is no longer their major task. Computerised accounting systems can now do much of the work. Even small businesses have access to computerised accounting systems such as Mind Your Own Business (MYOB) or Xero, so the role of accountants has changed radically. Accountants working in organisations have become important members of the management team, as organisations have to contend with social changes caused by several factors such as:

- the dramatic development of information and communications technology including electronic banking, the Internet and e-commerce
- the increasing demand by society for information of a non-financial nature. This may include information about an entity's attention to such issues as occupational health and safety, social and equity diversity (e.g. employment of people with disabilities and indigenous people), and environmental considerations (e.g. water usage, the organisation's carbon footprint and other sustainability practices).
- the globalisation of business. Instead of merely being involved in a particular local community, many organisations are seeing the world as their marketplace and as their source of labour and knowledge. This has placed increasing demands on organisations to be accountable for their corporate behaviour in foreign countries, including abiding by their rules and regulations, and their impact on the society and environment of those countries. Questions being asked include: How well does an organisation treat and pay its employees in developing countries? Is business conducted by way of political payments (bribes) to influential officials in those countries? What corporate governance practices apply in those countries?
- the globalisation of regulations affecting business organisations, such as the development and adoption of international financial reporting standards
- digital disruption and unlocking the power of big data.

One thing is certain: change will continue. In order to cope, accountants of the future need to have not only record-keeping knowledge but also analytical and communication skills, and business strategy and planning know-how. They need the ability to think clearly and critically in order to solve problems, a familiarity with information systems and technology, strong interpersonal communication skills with clients and business associates, and sound ethical behaviour in different cultural environments.

This text is designed for all students studying accounting for the first time at university level, both those majoring in accounting and those seeking a basic understanding of accounting but studying in other fields, such as marketing, management, economics, information technology, law, engineering, the arts and sciences. Accounting is usually a core unit in business degrees as it is the 'language of business'.

Many students in non-accounting majors can benefit greatly from reading this text. Engineers are often involved in designing products to reduce costs and meet target prices, so much of their work is driven by accounting measures. Marketers often strive to maximise sales, so a knowledge of costs, pricing and accounting methods is helpful for success. Human resources managers are responsible for one of the major costs in an organisation, so they need to choose a mix of staff to provide a quality service while keeping control of salary and wages costs. Indeed, many professional groups outside of accounting find that having a good grasp of accounting concepts is an advantage and enhances the opportunities for success in their chosen careers.

We begin the text by considering decision making in everyday life, and the role of accounting in providing information for the decision-making process. Also in this chapter, we acquaint you with the types of activities that are carried out by a professional accountant working in business.

LEARNING CHECK

- ☐ Accountants are not purely record keepers but are part of the management team in an organisation.
- ☐ Accountants need to have not only record-keeping knowledge but also analytical skills, and business strategy and planning know-how.
- ☐ Accountants need the ability to think clearly and critically in order to solve problems, a familiarity with information systems and technology, strong interpersonal communication skills with clients and business associates, and sound ethical behaviour in different cultural environments.

1.2 Decisions in everyday life

LEARNING OBJECTIVE 1.2 Discuss the nature of decisions and the decision-making process.

We make many decisions every day. For example, we decide when to get out of bed each morning (sometimes prompted by our parents!); we decide the appropriate clothes to wear for the coming day's activities (influenced by our peers); we decide what to eat for breakfast, unless we are in too much of a hurry, in which case we make another decision to go without breakfast.

Decisions involve choices because it is not possible to do everything we might like to do, as time and resources are always limited. Some decisions can be made in no time at all with little thought, such as putting on a coat if the weather is cold, but others may require much thinking, planning and information gathering, such as choosing a career, buying a house or a car, moving from one city to another, going on an overseas trip, choosing which subjects to study at university, and deciding when to retire from active employment.

Sometimes, decisions made in haste can affect us adversely for the rest of our lives. Each decision we make has outcomes which then affect decisions to be made at a later time. Ultimately, the decisions we make, or the decisions made by others which affect us, determine our destiny in life. Decisions affect our appearance, our economic wellbeing, even our emotional and spiritual wellbeing, so it is important that we make decisions after careful consideration of all information available at the time.

Steps in decision making

In *simple* terms, a **decision** is the making of a choice between two or more alternatives. Every time a problem arises and we need to make a decision, we consciously or unconsciously follow four main steps, which can be framed as questions.

1. *What are we trying to achieve?* We must identify each situation in which a decision is needed and determine the goals we wish to achieve. The decision we make will be influenced by our values, motives and desires.
2. *What information do we need?* Information can help change our attitudes, beliefs or expectations. Information relevant to each decision helps us determine the alternatives available from which to choose given the time, resources and degree of effort that we are prepared to commit to making a choice.
3. *What are the consequences of different alternatives?* Having obtained information to help us determine the alternatives available, we then need to assess the consequences or outcomes of these alternatives. Since the outcomes of each alternative lie in the future, every decision we make involves a degree of

uncertainty, which means that there is an element of risk in achieving a desired outcome. For example, even a decision to take out car insurance involves a degree of risk as we balance the likelihood of causing a car accident with the cost of the insurance premium.

4. *Which course of action will we choose?* Finally, after consideration of the alternatives available and the consequences of those alternatives, we must choose a course of action which we hope will achieve the goals that we established in the first place.

The steps in the decision-making process are illustrated in figure 1.1.

FIGURE 1.1 Steps in the decision-making process

Once we have made a choice, we eventually find a set of actual outcomes or consequences. We may be satisfied or dissatisfied with these outcomes. If we are dissatisfied, we may need to make further decisions to achieve our ultimate goals. Hence, the outcomes or consequences of decisions commonly lead to further decisions, which in turn have further outcomes, and so on.

LEARNING CHECK

- ☐ The decision-making process involves four main steps: (1) establishing goals, (2) gathering information on alternatives, (3) determining the consequences of alternatives, and (4) choosing a course of action.

1.3 Economic decisions

LEARNING OBJECTIVE 1.3 Outline the range of economic decisions made in the marketplace.

Many (if not most) of the decisions that we make involve the use of **economic resources**. These are resources that are traded in the marketplace at a price because they are in limited or scarce supply. Some decisions are made for *consumption* purposes, such as what to eat for lunch and which brand of petrol to buy for the car. Other decisions are made for *investment* purposes. These decisions usually require major uses of resources, such as the decision to buy a car or a house. In business, some decisions require the investment or commitment of many millions of dollars for the purchase of large items of machinery. Still other decisions are of a *financial* nature, for example if a business wants to make an investment decision to purchase new machinery, a decision must be made to find a source of finance.

However, even though the economic aspects of decisions are very important, other factors must also be considered, and may be more important than economic factors in a particular circumstances:

- *personal taste* — our decision to buy a certain brand of clothing may be determined on the basis of preferred appearance or fabrics rather than price
- *social factors* — such as the impact on unemployment in the local community if a business decides to withdraw from that community
- *environmental factors* — such as the potential for carbon emissions or water pollution
- *religious and/or moral factors* — our decision not to purchase particular types of meat may depend on religious beliefs
- *government policy* — such as the prohibition of trade in certain types of drugs.

Economic decisions usually involve a flow of money. We may purchase goods for immediate cash payment, on EFTPOS, payWave or on credit, in which case the flow of money occurs at a later date than the flow of goods. The use of credit card facilities allows businesses to sell merchandise or provide services to us and to collect money from our bank, which then charges the cost to our account. Purchase of goods and services through the use of EFTPOS or payWave facilities, or through the Internet also allows a business to charge the cost to our bank account, which means that the flow of money may occur at a different time from the flow of goods and services.

Individuals and business entities make economic decisions in many different marketplaces. The marketplace with which we are all familiar is the retail market, where we make decisions as we buy groceries, mobile devices, cars, home furnishings and electrical goods. Then there is the wholesale market, where retailers decide to buy their supplies of goods in large quantities from various manufacturers for sale in their different retail outlets. Another popular market is the stock market, where individuals and business entities buy and sell shares, debentures and options. Even the flea market is a place where people make decisions to buy and sell merchandise, some of which they have handcrafted, others of which are second-hand. Services are also traded in a marketplace.

BUSINESS INSIGHT

Professional accountants needed in South-East Asia

With the year coming to a close, many countries in the South-East Asian region are busy preparing for the formal establishment of the ASEAN Economic Community (AEC).

From where I stand, the AEC offers opportunities, not just challenges, for Indonesian businesses, especially professional accountants, who will join a bigger market not limited by borders. The businesses that will reap the benefits are those that meet competition head on, by lifting their skills and knowledge.

For accountants, seeking professional certification would not only support them to do their job well but, more importantly, give them credibility and a competitive edge in AEC markets.

The government of Indonesia is on the right track in addressing the low number of professional accountants. In 2014, the government initiated a strategy to create an additional 100,000 professional accountants over the next few years.

In addition to increasing the number of accountants, the Government blueprint also aims to strengthen accounting regulation, improve the quality of accountants through certification and increase cooperation between the professional accounting association, the regulator and professional accountants.

Throughout history, accounting has always been at the core of every successful business, which makes accounting one of the oldest professions in the world.

In 1954, the Accountant Law (UU Akuntan) was ratified in Indonesia, following the country's independence to secure the national treasury. To satisfy government demand for accountants, the country established the National College of Accounting (STAN) in 1964. Demand for professional accountants then increased in the private sector as Indonesia's economic focus moved to crude oil. However, even with the increase, the number of professional accountants is still low.

Data from the Finance Ministry's Accountants and Appraisers Supervisory Center (PPAJP) in 2014 reveals that Indonesia is still in need of more professional accountants.

In 2014, the Ministry had recorded less than 16,000 professional accountants. Meanwhile, there are more than 226,000 companies in Indonesia that require accounting services. From this, one can see that many opportunities still exist for Indonesian accountants domestically let alone regionally.

To tap into the opportunities provided by the AEC, let alone the untapped domestic demand, quality education is a key factor in determining whether an accountant is able to compete with their ASEAN counterparts.

With the framework already well positioned by Indonesia's Finance Ministry, professional Indonesian accountants have a bright future with a large pool of untapped domestic market potential, and with even bigger regional opportunities ahead.

Source: Excerpts from Bond, D 2015, 'Professional accountants needed in Southeast Asia', *The Jakarta Post*, December.

Economic decisions may be made not only in the local marketplace but also in markets in different cities, states or countries. Many organisations have been prepared to establish places of business not only in their home country but also in overseas countries.

Hence, whenever an economic decision is to be made, there are many aspects and alternatives to consider, and this makes the decision-making process a fascinating study in itself. How do people in business organisations make decisions? What role does accounting play in the decision-making process? If decision makers are able to gain a certain level of accounting knowledge and understand the concepts and standards on which accounting information and reports are based, this will help them make more informed economic decisions, regardless of whether they are engineers, marketers, human resource managers, or any other business decision makers. In the scene setter at the start of the chapter, Corinne Proske, as an accountant, has been confronted with making many decisions about investing for measurable and beneficial social or environmental impact as well as financial return.

LEARNING CHECK

- ☐ Economic decisions are made for consumption purposes, investment purposes and/or financial purposes.
- ☐ Various factors must be considered when making economic decisions such as: financial aspects, personal taste, social factors, environmental factors, religious and/or moral factors, and government policy.
- ☐ Individuals and business entities make economic decisions in many different marketplaces, including the retail market, the wholesale market and the stock market, locally, nationally and overseas.

1.4 The nature of accounting

LEARNING OBJECTIVE 1.4 Explain the nature of accounting and its main functions.

Accounting is a service activity. Its function is to provide and interpret financial information that is intended to be useful in making economic decisions. Business entities, government departments, charitable organisations and not-for-profit organisations, family units and individuals all engage in economic activity which involves making decisions about allocating available resources effectively. People need relevant information to be able to make sound economic decisions.

In a complex society, decision makers have to rely on data supplied by specialists in various fields. For example, lawyers provide information about the ramifications of existing and changing legislation, and medical practitioners offer advice about the possible effects of different healthcare decisions. Accounting as a profession has evolved in response to society's need for economic information to help people make economic decisions. The accountant's main role is to be involved in steps 2 and 3 of the decision-making process illustrated in figure 1.1, to offer advice regarding step 4, and to measure the outcomes or consequences of the decision-making process. However, as you will see once you have studied accounting more closely, much of the information needed to make an economic decision never makes its way into the accounting records, but exists outside of those records.

Accounting is often called the 'language of business'. A language is a means of social communication and involves a flow of information from one person to one or more other people. Everyone involved in business, from the beginning employee to the top manager, eventually uses accounting information in the decision-making process. To be effective, the receiver of the information must understand the message that the sender intends to convey. Accounting uses its own special words and symbols to communicate financial information that is intended to be useful for economic decision making by managers, shareholders, creditors and many others. As you study accounting, you must learn the meanings of these words and symbols if you are to understand the messages contained in financial statements. The end-of-chapter key terms build up this language progressively as you proceed through the text.

The importance of understanding accounting information is not restricted to those engaged directly in business. Many people with little knowledge of accounting must interpret accounting data. For example, lawyers must often understand the meaning of accounting information if they are to represent their clients effectively, marketing consultants must be aware of the costs of developing advertising campaigns, and engineers and architects must consider cost data when designing new equipment and buildings. Thus, accounting plays a significant role in society and, in a broad sense, everyone is affected by accounting information.

Although accounting techniques are used in all types of economic units, in this text we concentrate mainly on accounting for business entities. Business owners and managers need information provided by the accounting system to plan, control and make decisions about their business activities. In addition, shareholders, creditors, government departments and not-for-profit organisations (such as clubs and societies) need financial information to help make investing, lending, regulatory and tax-related decisions.

Accounting defined

Accounting has been defined as the process of identifying, measuring, recording and communicating economic information to permit informed judgements and economic decisions by users of the information.

Identification involves observing economic events and determining which of those events represent economic activities relevant to a particular business. Selling goods to a customer, paying wages to employees and providing services to a client are examples of economic activities. Economic events of an entity are referred to by accountants as **transactions**, and are of two types, external and internal. Accountants use the single term *transaction* to refer to both internal and external transactions. Transactions constitute the inputs of the accounting information system.

External transactions (often called *exchange transactions*) are those that involve economic events between one entity and another entity. When an entity purchases goods from a supplier, borrows money from a bank, or sells goods and services to customers, it participates in external or exchange transactions. *Internal transactions* are those economic events that take place entirely within one entity. For example, when a car component is transferred from the stores department to the assembly line in a car manufacturing business, the transfer must be accounted for, even if it is by simply transferring the cost of the component from the records of one department to those of the other. Similarly, the depreciation of machinery used in the production of goods must be accounted for, and since it does not concern an outside party, it is an internal transaction. Internal transactions may even involve such things as the growth of grapevines held by the entity or the market value of trading securities, because, under certain accounting standards, the increased value of these items must be recognised in the accounts of the organisation.

Measurement must take place before the effects of transactions can be recorded. If accounting information is to be useful, it must be expressed in terms of a common denominator so that the effects of transactions can be combined. We cannot add apples to oranges unless we express them in terms of a common measuring unit. In our economy, business activity is measured by prices expressed in terms of money. *Money* serves as both a medium of exchange and as a measure of value, allowing us to compare the value or worth of diverse objects and to add and subtract the economic effects of various transactions. Accounting transactions are therefore measured and recorded in terms of some monetary unit, such as the dollar.

Recording provides a history of the economic activities of a particular entity. Recording is the process of systematically maintaining a file of all transactions which have affected the business entity after they have been identified and measured. Simply measuring and recording transactions, however, would provide information of limited use. The recorded data must be classified and summarised to be useful in making decisions.

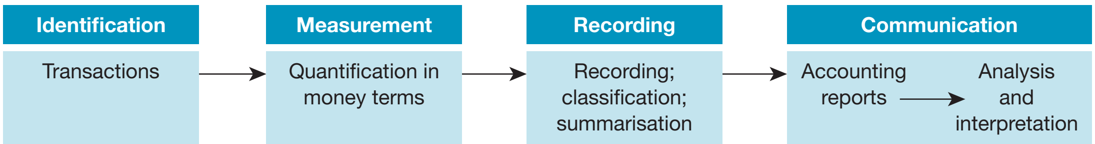
- Classification allows thousands of transactions to be placed into more meaningful groups or categories. All transactions involving the sale of goods, for example, can be grouped into one total sales figure and all transactions involving cash received can be grouped to report a single cash receipt figure.

- Summarisation of financial data is presented in reports and financial statements, which are provided for use by both management and external users of accounting information. These reports usually summarise the effects of all transactions occurring during some time period such as a month, a quarter or a year.

Communication is the final part of the accounting process. Identifying, measuring and recording economic activities are pointless unless the information contained in accounting records can be communicated in some meaningful form to the potential users of the information. Communication can be described as the process of preparing and distributing accounting reports to potential users of accounting information. Once the users of accounting reports have access to appropriate reports, they are able, after analysing and interpreting the reports, often with the assistance of professional advice, to make informed economic decisions. The most common forms of accounting reports are the financial statements, which are introduced in the chapter that looks at financial statements for decision making.

The accounting process briefly overviewed above can be summarised diagrammatically as shown in figure 1.2.

FIGURE 1.2 The accounting process



Many people with little knowledge of accounting tend to view it as being limited to the recording process and do not distinguish clearly between the recording and communicating of accounting data. The *recording* or *record-keeping process* involves measuring and recording business transactions and may take place in one of several forms: handwritten records, mechanical or electronic devices, or simply magnetic tapes or disks in a computerised system.

The *communication process* is a much broader function of accounting. It consists of placing accounting data that have been classified and summarised into financial statements, as well as preparing interpretive disclosures necessary to make the data understandable. The process requires extensive training, business experience and professional judgement.

Computers have had a significant impact on the recording phase of the accounting process. The processes of recording, classification and summarisation can be done electronically, and hence the recording process is much more automated. However, the output from a computerised system is only as good as the data input. Full coverage of the manual system is given in this text to help students understand the processes performed by computerised accounting systems.

The communication process involves many potential users, and accountants who prepare reports must have a full appreciation of who the users of the reports are and their needs for accounting information in order to help them make economic decisions effectively. In this way, the accountant adds significant value to the running of the organisation.

LEARNING CHECK

- ☐ Accounting is defined as the process of identifying, measuring, recording and communicating economic information so that people can make informed judgements and decisions about scarce resources.
- ☐ Accounting deals with ‘transactions’, which can be ‘external’ or ‘internal’. External transactions are those that involve economic events between one entity and another entity. Internal transactions are those economic events that take place within one entity.

1.5 Users of accounting information

LEARNING OBJECTIVE 1.5 Identify the potential users of accounting information.

Although accountants are involved mainly in the analysis and interpretation of financial data when they serve as advisers to users of accounting information, the first objective of accounting is to provide information in reports which can be used by *internal* and *external* decision makers.

Managers (internal decision makers) must have financial data for planning and controlling the operations of the business entity and hence need answers to such questions as follows.

- How much profit is being earned?
- What products should be produced?
- What resources are available?
- What is the most efficient production process?
- How much does it cost to reduce carbon emissions from the production process?
- What will be the effect of increasing or decreasing selling prices?
- How much is owing to outsiders?
- Will cash be available to pay debts as they fall due?
- What are the benefits of purchasing an asset as opposed to leasing it?

Providing data to help answer these and many other questions generally called *management accounting*. The data are presented to management in the form of **special purpose financial statements**. These are prepared for users who have specialised needs and who possess the authority to obtain information to meet those needs. Apart from internal management (which includes marketing, production, finance, human resources, research and development, information systems and general managers), some external users such as banks and government agencies (e.g. Australian Taxation Office) also have the authority to command the type and nature of the information they require and may demand special purpose reports.

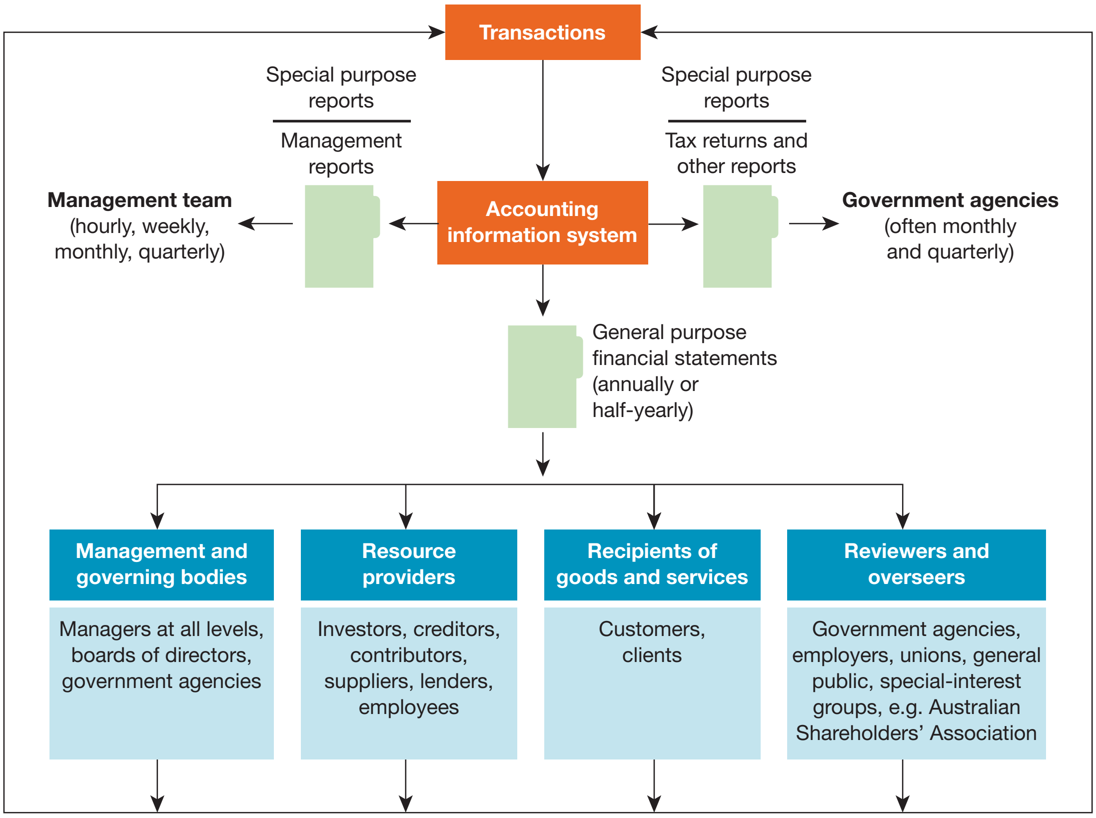
External decision makers such as resource providers (creditors and investors), recipients of goods and services (customers) and reviewers and overseers of business entities (employers, unions, government agencies) need accounting information for making decisions concerning granting credit, investing, purchasing goods and services, and complying with tax laws and other regulatory requirements. Questions raised by external users include the following.

- Should I invest money in this business?
- Am I likely to be paid my wages?
- Will the business be able to repay money lent to it?
- What are the company's earnings prospects?
- Is the business financially sound?
- Is the business providing products that are socially and environmentally friendly?

Reports prepared for external users include *financial statements* which generally consist of an income statement (also called a statement of comprehensive income), a balance sheet (also called a statement of financial position), a statement of changes in equity and a statement of cash flows. These are often called **general purpose financial statements** because they provide general information for use by all external users.

General purpose financial statements are designed to meet the information needs of a wide range of users who are unable to command the preparation of reports tailored to satisfy their individual specific needs for information. Figure 1.3 illustrates the relationship between financial statements/reports and users of accounting information.

FIGURE 1.3 Financial statements and users



LEARNING CHECK

- ☐ Internal decision makers — managers — require special purpose financial statements to help in planning and controlling the operations of an entity.
- ☐ External decision makers — creditors, investors, customers, employees, unions, government agencies — receive general purpose financial statements to obtain information about an entity. These are designed to meet the information needs of a wide range of users who are unable to command the preparation of statements tailored specifically for their needs.

1.6 Using information in economic decisions

LEARNING OBJECTIVE 1.6 Apply information to make basic economic decisions.

Economic decisions are made in business every day. To illustrate, consider the following business scenario.

Cynthia loves beauty therapy. After several years in retail as a sales assistant, she decides to accept a redundancy package from her employer and take on a new career. She now has the opportunity to work in her own beauty business. On investigation, she finds there is an opportunity to set up such a business to service a number of local suburbs in her area.

First she will need to invest in some equipment. The required items are listed below with their estimated costs.

Second-hand van	$32 000
Massage tables	2 500
Manicure tables and chairs	1 950
Booking information system	2 600
Facial skin machine	2 150
Manicure and pedicure machines	1 600
Waxing pots	1 700
Uniforms	2 000
Towels	2 400
Robes	1 800
Cash register	1 850
	52 550

Therefore, Cynthia needs approximately $53000 in cash to establish the business.

She is unsure about the running costs of the business, but expects the cost of power, beauty products and laundry to be about $320 per week. She is hoping to be able to provide services to about ten clients per day, and to work for 6 days each week. She wants to work only 48 weeks of the year and have 4 weeks holiday. Furthermore, she intends to pay $150 per week to her boyfriend, Fred, for keeping the records, doing the banking, and helping with some of the maintenance duties. (For the time being, we are ignoring employer superannuation payments, workers compensation and insurances, but in reality these would need to be taken into account.) Thus, running costs per week are estimated to be as follows.

Power, beauty products and repairs and maintenance	$320
Part-time employee (Fred)	150
	470

Initially, Cynthia expects to have the following numbers of clients for the various services she intends to provide the following.

Waxing (under a regular program)	42
Facials, manicures and pedicures (under a regular program)	12
Spray tans (as requested)	24

Based on this client list, each day she plans to perform waxing services on seven clients, and facials, manicures and pedicures on two clients. She expects that the waxing will take, on average, 30 minutes per client; facials, manicures and pedicures will take 1 hour per client; and spray tans will take about 15 minutes per client. The cost of each of the services is as shown.

Waxing	$40
Facials, manicures and pedicures	80
Spray tans	10

In each week, the approximate amount of cash received, ignoring spray tan activities which are requested on an irregular basis, is expected to be as follows.

7 waxes for each of 6 days at $40 each	$1 680
2 facials, manicures and pedicures for each of 6 days at $80 each	960
	2 640

This means that her gross annual turnover for the year's work of 48 weeks is equal to $2640 × 48 = $126 720, plus spray tan revenue. Because her annual turnover is greater than $50 000, her accountant tells her that she will have to get an Australian business number (ABN) from the Australian Taxation Office (ATO) and that she will be required to collect goods and services tax (GST) from each of her clients and forward the GST to the ATO at regular intervals. Also, the cost she will pay to her accountant for preparing the annual tax return and GST documents is $1632. On a weekly basis over 48 weeks, this adds $34 per week ($1632 ÷ 48) for accounting services to the $470 per week calculated previously, a total of $504 per week. (Detailed consideration of the GST is covered in other chapters. It is assumed in this chapter that the figures quoted include the GST where applicable.)

Therefore, the expected weekly cash flow, excluding spray tanning revenue, is $2640 less the weekly costs of $504, equalling $2136. Since Cynthia is so enthusiastic about owning her own beauty salon, after consultation with Fred she decides to proceed with the business. Thus, a decision is made after considering how much money she will need to contribute to set up the business (financing activity), the equipment she will need to buy (investing activity), the running costs of the business and the weekly cash inflow (operating activity).

Note that the decision is based on the steps illustrated in figure 1.1 — establishing goals (earning a living while working as a beauty therapist), collecting information about the proposed business, and considering the future consequences of conducting such a business. Of course, many of the factors considered in making such a decision are estimates of future events and, hence, there is a need to proceed with caution. Cynthia would be very wise to keep a careful eye on how well these cash flow estimates approximate reality.

Particularly important are the financial results. Will the actual weekly performance of Cynthia's business live up to the estimated performance? How much impact does the spray tanning service have on the actual results? Is the waxing service more profitable than the facial, manicure and pedicure, or spray tan services? When does Cynthia plan to replace the assets she bought at the start? How will she account for the fact that these assets gradually wear out over time through use? And how much income tax and GST will she have to pay? Cynthia may not have considered many of these aspects in making her decision, and much of this information can be provided by an accountant.

In the next four chapters, we shall consider other examples of service businesses — Minh's TV Repairs and Intellect Management Services — and how accounting information can help in the businesses' operations and decision making. We shall also return to Cynthia's beauty business and ask further questions which accounting can help to answer.

LEARNING CHECK

- ☐ Many questions need to be asked when making economic decisions. A decision to set up a business can be made only after considering things such as how much money will be required to start (financing activity), what equipment will be needed (investing activity), the running costs of the business and the weekly net cash inflow (operating activity).
- ☐ Many of the factors considered in making an economic decision are estimates of future events, and financial results will need to be monitored to see whether the cash flow estimates approximate reality.

1.7 Accounting information and decisions

LEARNING OBJECTIVE 1.7 Describe the role of accounting information in the decision-making process.

From the example above, we can see that much financial information is needed before an economic decision is made. But how much of that information is accounting information? Since accounting is concerned mainly with identifying transactions and recording the financial history of the transactions of an entity, a major focus of accounting information is on actual financial events, not on future events. However, knowledge of information about actual events is useful in establishing relationships that are likely to hold in the future. In other words, for the purpose of decision making, past information is used often as a guide to future estimates of the consequences of different alternatives.

Accounting information is also very useful in providing decision makers with information about the outcomes or results of their decisions. Once these outcomes are known and investigated, decision makers are able to evaluate whether their decisions were correct or whether new decisions are required. The accountant can help significantly in investigating, interpreting and communicating these results for the guidance of decision makers. In this way, accountants can add value by pointing out to decision makers any areas needing attention, where new economic decisions may become necessary.

Nevertheless, the accountant in commerce is also heavily involved in the budgeting process for a business entity, and therefore in estimating the future plans for the entity. Thus, the work of the accountant in commerce is not restricted merely to recording a history of the entity's past. The accountant adds value by helping the owners and managers of a business in many ways. In some businesses, the accountant has the title 'information manager' or 'finance manager'.

The information needs of managers are quite different from those of parties external to the entity. By definition, a manager is anyone in an organisation responsible for the work of other people who report to the manager for direction and support. The managers in a given organisation are collectively called its management.

LEARNING CHECK

- ☐ A major focus of accounting information is on actual financial events, not on future events, and therefore accounting does not provide all information needed for making an economic decision.
- ☐ Accountants are often heavily involved in the budgeting process for a business entity, and in estimating the financial data for the future plans of the entity, so the accountant adds value by helping owners and managers in many ways.

1.8 Management and financial accounting

LEARNING OBJECTIVE 1.8 Compare accounting information for management and external users.

What is management accounting?

Management accounting (also referred to as managerial accounting) is that area of accounting concerned with providing financial and other information to all levels of management in an organisation to enable them to carry out their planning, controlling and decision-making responsibilities. The accountants responsible for providing this information are known as management accountants. Management accounting is used in all forms of organisations — for-profit and not-for-profit organisations; sole traders, partnerships and companies; retailing, manufacturing and service businesses; government; and charities.

Management accounting covers many activities, including cost behaviour and cost–volume–profit relationships, decision making through incremental analysis, capital budgeting, budgeting for financial planning and control, flexible budgeting for performance evaluation, the determination of manufacturing costs and costing systems, and accounting and reporting for business segment operations.

What is financial accounting?

Financial accounting is concerned with reporting information to users external to an entity in order to help them to make sound economic decisions about the entity's performance and financial position. The financial accountant is heavily involved in the determination of an entity's overall financial performance (profits or losses), its financial position, financing and investing activities (which include raising and investing money), and information as to whether the entity is complying with the requirements of the law. The financial accountant must be well trained in the regulatory arrangements affecting various entities; such regulations include accounting standards, auditing standards, the law relating to corporations and other types of organisations, and the law relating to taxation (including income tax, fringe benefits tax and GST). Through financial accounting, an entity discharges its financial reporting obligations and other corporate governance responsibilities to the community at large.

Management accounting versus financial accounting

Management accounting can be distinguished from financial accounting in a number of ways: by reference to (1) the main *users* of the reports, (2) the *types of reports* produced, (3) the *frequency of reports*, (4) the *content and format of reports*, and (5) *external verification*. Table 1.1 summarises the differences between management accounting and financial accounting.

TABLE 1.1 Differences between management accounting and financial accounting

	Management accounting	Financial accounting
Users of reports	*Users are inside the entity.* • Managers • Chief executive officers • General managers • Account managers • Sales managers	*Users are outside the entity.* • Shareholders • Lenders • Potential investors • Creditors • Customers • Government • Interest groups
Types of reports	*Special purpose financial statements for internal users.* • Financial budgets • Sales forecasts • Performance reports • Cost-of-production reports • Incremental analysis reports Do not have to comply with accounting standards	*General purpose financial statements for external users.* • Balance sheet • Income statement • Statement of changes in equity • Statement of cash flows Required by regulatory authorities; must comply with accounting standards
Frequency of reports	On-demand reports — daily, weekly, monthly — as requested by management to help with decision making.	Income tax legislation, the corporations law and securities exchange listing rules require reports at regular intervals.
Content and format of reports	• Management establishes own guidelines for structure, content and type of information (financial and non-financial); structure and classification of reports are tailored to specific needs of decisions to be made • Reports can relate to particular segments of an entity or to a particular decision	• Structure and content are largely standardised with certain disclosures dictated by accounting standards • Statements generally contain historical, verifiable data • Reflect the results of the entity as a whole, thus contain much aggregation, summarisation and restricted classification • Based on the formal double-entry system
External verification	Special purpose financial statements are not required to be audited, but management may want verification of the contents by internal auditors	General purpose financial statements must be audited by independent external auditors who verify that the statements are in compliance with accounting standards and provide a true and fair view of the performance and financial position of the entity