

FUNDAMENTALS OF ACCOUNTING AND FINANCIAL MANAGEMENT



KEN TROTMAN
VICTORIA CLOUT

KERRY HUMPHREYS
KATE MORGAN

8E

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Fundamentals of accounting and financial management

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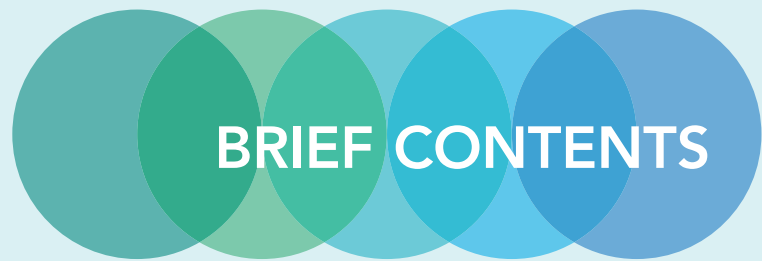
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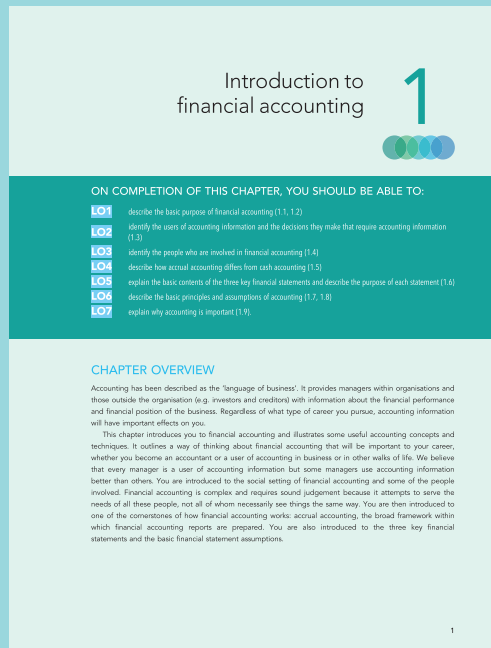
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Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of financial accounting, helping you to understand how the theory is applied in the real world.

CHAPTER-OPENING FEATURES



Introduction to financial accounting 1

ON COMPLETION OF THIS CHAPTER, YOU SHOULD BE ABLE TO:

- LO1 describe the basic purpose of financial accounting (1.1, 1.2)
- LO2 identify the users of accounting information and the decisions they make that require accounting information (1.3)
- LO3 identify the people who are involved in financial accounting (1.4)
- LO4 describe how accrual accounting differs from cash accounting (1.5)
- LO5 explain the basic contents of the three key financial statements and describe the purpose of each statement (1.6)
- LO6 describe the basic principles and assumptions of accounting (1.7, 1.8)
- LO7 explain why accounting is important (1.9)

CHAPTER OVERVIEW

Accounting has been described as the 'language of business'. It provides managers within organisations and those outside the organisation (e.g. investors and creditors) with information about the financial performance and financial position of the business. Regardless of what type of career you pursue, accounting information will have important effects on you.

The chapter introduces you to financial accounting and illustrates some useful accounting concepts and techniques. It outlines a way of thinking about financial accounting that will be important to your career, whether you become an accountant or a user of accounting in business or in other walks of life. We believe that every manager is a user of accounting information but some managers use accounting information better than others. You are introduced to the social setting of financial accounting and some of the people involved. Financial accounting is complex and requires sound judgement because it attempts to serve the needs of all these people, not all of whom necessarily see things the same way. You are then introduced to one of the cornerstones of how financial accounting works: accrual accounting, the broad framework within which financial accounting reports are prepared. You are also introduced to the three key financial statements and the basic financial statements assumptions.

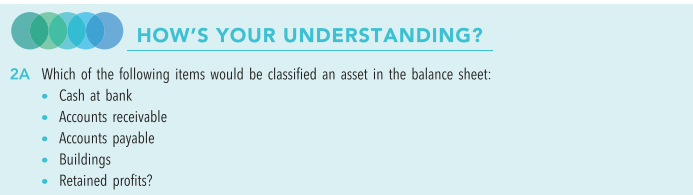
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The learning objectives and chapter overview give you a clear sense of what topics each chapter will cover and what you should be able to do after reading the chapter.

FEATURES WITHIN CHAPTERS

HOW'S YOUR UNDERSTANDING?

How's your understanding? activity questions throughout each chapter help you to reinforce your understanding of key concepts as you progress through the text, providing you with the opportunity to reflect on and revise important material.




HOW'S YOUR UNDERSTANDING?

2A Which of the following items would be classified an asset in the balance sheet:

- Cash at bank
- Accounts receivable
- Accounts payable
- Buildings
- Retained profits?

FOR YOUR INTEREST

For your interest sections present intriguing insights into the accounting profession and bring a unique perspective to the concepts covered in each chapter.



FOR YOUR INTEREST

While we have GAAP, it is very important to consider the need to fit the accounting to the circumstances of the particular accounting entity. However, if you always changed everything to suit each organisation, there would be no standards left and no comparability to other organisations. If every course in the university used a unique grading system, you couldn't compare how you did in different courses, or compute a grade-point average. Here, very briefly, are three examples of accounting difficulties that face accountants and managers.

- The ABC, as well as channels Nine, Ten and Seven, have national TV networks in Australia. The ABC is publicly owned, largely financed by the government of Australia, and is not generally supposed to be trying to make a profit, while

END-OF-CHAPTER FEATURES

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

- **Practice problems** give you the opportunity to test your knowledge and consolidate your learning.
- The **homework and discussion to develop understanding** section provides you with discussion questions, problems, and cases to help you with your revision.
- Solutions to the **practice problems** and **How's your understanding?** questions facilitate self-study and additional practice.

Financial accounting: an integrated approach

PRACTICE PROBLEMS

Solutions to practice problems can be found at the end of the chapter. These problems are intended to facilitate self-study and additional practice. Don't look at the solution for any of these without giving the problem a serious try first, because once you have seen the solution it always looks easier than it is.

PRACTICE PROBLEM A

Identify accounting transactions

The following things happened to Berlet Ltd last month. Decide if each is an accounting transaction and explain briefly why it is or it isn't.

1. A customer ordered \$6000 of products, to be shipped next month.
2. Another customer paid \$250 for some marketing advice from the company.
3. Berlet's share price went up by \$0.50. As there are 100 000 shares outstanding, this was a value increase of \$50 000.
4. Berlet ran an advertisement on TV, and promised to pay the TV station the \$2000 cost next month.
5. One of the company's employees worked overtime, earning \$120 that would be paid next pay period.
6. The company paid a teenager \$50 to compensate for a ripped shirt that occurred when the teenager tried to run away after being accused of shoplifting.
7. Berlet received a shipment of new goods for sale, paying \$1000 cash and agreeing to pay the other \$12 250 in a few days.
8. Berlet paid the other \$12 250.
9. The company made a donation to a political party of \$500. (The donation turned out later to have been against the election law, to the company's embarrassment.)
10. Grand Bank made the company a \$20 000 short-term loan.

PRACTICE PROBLEM B

Ledgers and preparation of financial statements

Go to the 11 transactions given in Newcombe Ltd Practice problem C in Chapter 3, and complete the following tasks.

1. Prepare a set of ledgers. Use the opening balances given in the balance sheet, and post each transaction to the ledger account.
2. Calculate closing balances for these accounts and prepare closing entries.
3. Based on the above ledger accounts, prepare an income statement for the month of June 2019 and balance sheet as at 30 June 2019.

PRACTICE PROBLEM C

Closing the books

The following accounts have these balances at 30 June before closing entries.

Name (debit accounts)	\$	Balance sheet accounts	\$
Revenues		Cash	25 900
Sale revenue	235 000	Accounts receivable	33 300
Interest revenue	35 000	Share capital	80 000
Expenses		Retained profits	125 900
Cost of goods sold	141 000		
Wages expense	88 000		
General expense	7 000		

CHAPTER 4 Record-keeping

1. Prepare the end-of-year journal entry to close the necessary accounts.
2. After the closing entries, what is the balance in the following accounts?
 - a. Sales revenue
 - b. Retained profits

HOMEWORK AND DISCUSSION TO DEVELOP UNDERSTANDING

This section starts with simpler discussion questions that review some of the basic concepts, which are then followed by a set of problems.

DISCUSSION QUESTIONS

1. What determines whether specific transactions are to be recorded in the accounting records?
2. What is the purpose of a journal entry?
3. What is a chart of accounts and what determines the number of account names to be included in a chart of accounts?
4. Why is it beneficial for transactions to be entered into a journal rather than being entered directly to a ledger?
5. What is the purpose of the trial balance?
6. What is the purpose of closing entries?
7. Financial statements are highly summarised documents, representing thousands of transactions. Financial newspapers and commentators produce information about companies that is even more summarised. Why would users accept, or even prefer, summarised information to detailed data? How important is it for the user to understand the procedures and assumptions behind such summarised?
8. At a recent Student Accounting Club wine and cheese party, local business people mingled with students. One small-business entrepreneur was heard to say, 'All that financial accounting information you students learn about is not relevant to me. I just started up my business. I only have five employees, four people in the shop building the product and one person in shipping/receiving. I'm out on calls, drumming up business so I have my finger on the real pulse of the firm—Dad's sales. My brother runs the bank and does the payroll every two weeks. Once in a while I write cheques too. It's all simple and smooth, so why add a lot of time-consuming, costly record-keeping to it all? All those books and financial statements are free for the big public companies. I can do without the complications.' Prepare an appropriate response to his comments.
9. Identify some differences you might expect to find between the transaction files and accounting books and records of a large corporation and those of a corner shop run by one person.
10. State whether or not you agree with each of the statements below and, in a few words, say why.
 - a. If an event satisfies all five of the transaction criteria, you can be sure it will be recorded by the entity's accounting system.
 - b. Purchases and sales by investors of existing issued shares of a company listed on the Australian Securities Exchange are not accounting transactions in the company's records.
11. Why is it essential that an accurate source document be prepared for every transaction?
 - a. it is cash payment
 - b. it is cash receipt
 - c. it is credit sale
 - d. cost of goods sold
 - e. it is purchase of inventory
 - f. the receiving of inventory

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Guide to the online resources

FOR THE INSTRUCTOR

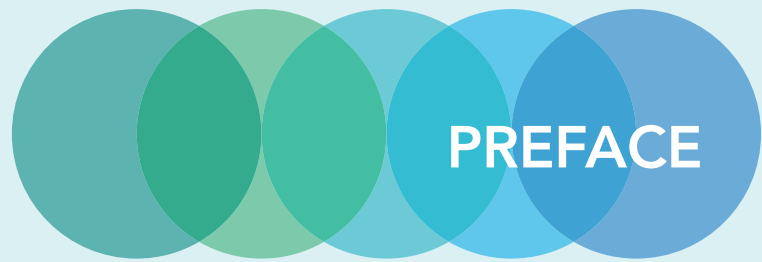
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SOLUTIONS MANUAL

The solutions manual provides solutions to discussion questions, end-of-chapter problems and case questions.

2021 WOOLWORTHS ANNUAL REPORT

An appendix containing the 2021 Woolworths Annual Report is available. Please refer to your unit outline for a link to this report.



PREFACE

One question I have been frequently asked since writing the first edition of this book is: why write an introductory accounting textbook?

First, I have been involved in teaching introductory financial accounting for over 35 years. I enjoy trying to get across the introductory concepts. Second, I have been surprised at the differences between how introductory accounting is taught in most undergraduate programs and how it is taught in MBA courses in the United States and Australia. Thirty years ago there were good reasons for the differences, as most of our first-year undergraduate students were accounting majors. This is not the case today. Third, when I ask attendees at executive education programs what their accounting background is, many respond that they did first-year accounting 10-plus years ago but found it boring! We try to change this view by continuing to illustrate the importance of accounting to the many roles our students will eventually take.

With this in mind, I tried to add to an undergraduate book some of the features that MBAs and executives seem to enjoy. We don't want our students returning in 10 years and suggesting our courses are boring! Talking about companies and relating the material to annual reports helps students to get interested.

With all of the above in mind, we set about incorporating the following in the book. First, we have tried to make clear to students the importance of accounting information by frequent reference to current material. Second, as companies are the most common business organisations in Australia today, we start by writing about companies, rather than spending many introductory chapters concentrating on sole traders. Third, to keep this book's material interesting and relevant, we have made frequent references to the content of annual reports. Students learn about real companies and can follow their performance in the newspapers or the share market if they wish. Fourth, we believe that the depth of technical knowledge in this book will challenge both accounting and non-accounting majors, but lecturers can choose to leave some sections to more advanced courses.

The first edition of this textbook was adapted from the second edition of the best-selling Canadian introductory financial accounting textbook of the same name written by Michael Gibbins. In the Australian edition, we added eight chapters as well as reorienting the material towards the Australian context.

The most attractive features of the early editions have been retained: an easy-to-read style with a wealth of extracts from company annual reports, 'How's your understanding?' activity questions throughout each chapter, questions at the end of each chapter relating to real annual reports, as well as a set of cases with questions relating to the Woolworths Limited Annual Report 2021 (appendix at the end of the book).

My co-authors for the seventh edition were Elizabeth Carson and Kate Morgan. Kate has remained on as an author of the eighth edition, while Elizabeth has now retired from academia after an illustrious research and teaching career. She made numerous improvements to earlier editions and students will still benefit from her insights. For the eighth edition, Professor Kerry Humphreys and Dr Victoria Clout have joined the author team. Kerry and Victoria have both won very important education awards as you will see from their biographies.

The eighth edition of the textbook has involved some major reconstructions. It has added a range of material on financial management, sustainability reporting and performance evaluation. The revised title is *Fundamentals of Accounting and Financial Management*. It has 17 chapters which we believe gives instructors the opportunity to choose whether to do it over two subjects or to choose the chapters they need for one subject (the publisher can arrange for the selection of chapters).

The combination of chapters of the book are used in many different combinations. Examples include:

Undergraduate first year accounting: the introductory financial accounting/financial management subject uses chapters 1–9 and the follow-up accounting subject for accounting majors uses chapters 10–17. The advantage of this is that all majors cover the basics of accounting including financial statement analysis and cash flows. The second subject then serves as the basics for accounting majors including the accounting process through to a more advanced treatment of cash flow statements.

Master of professional accounting courses: can use chapters 1–4, 10–15, 6–7 and then 16–17. This allows all of the financial analysis and cash flow material to be completed together.

Core MBA financial accounting subject: covers chapters 1–9 with an option to exclude parts of Chapter 3 (from 3.3 onwards). It would also cover Chapter 17.

All the authors are very happy to discuss these options with an instructor that would like to innovate with any of these chapters.

We trust that you will enjoy the book.

Ken Trotman



ABOUT THE AUTHORS

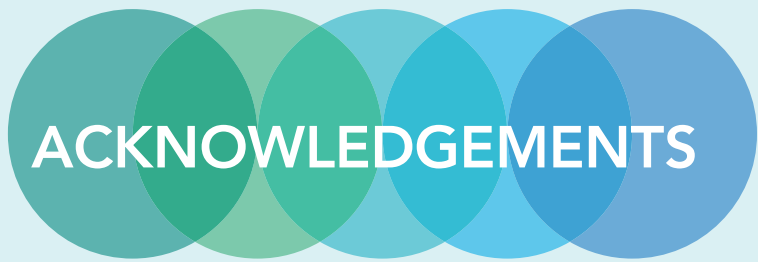
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Introduction to financial accounting

1



ON COMPLETION OF THIS CHAPTER, YOU SHOULD BE ABLE TO:

- LO1** describe the basic purpose of financial accounting (1.1, 1.2)
- LO2** identify the users of accounting information and the decisions they make that require accounting information (1.3)
- LO3** identify the people who are involved in financial accounting (1.4)
- LO4** describe how accrual accounting differs from cash accounting (1.5)
- LO5** explain the basic contents of the three key financial statements and describe the purpose of each statement (1.6)
- LO6** explain why accounting needs standards and principles, including the role of GAAP (1.7)
- LO7** describe the objective of financial reports (1.8)
- LO8** describe the basic principles of accounting (1.9, 1.10)
- LO9** outline the qualitative characteristics of useful financial information and key concepts (1.9, 1.10)
- LO10** explain why accounting and financial management are important (1.11, 1.12, 1.13).

CHAPTER OVERVIEW

Accounting has been described as the ‘language of business’. It provides managers within organisations and those outside the organisation (e.g. investors and creditors) with information about the financial performance and financial position of the business. Regardless of what type of career you pursue, accounting information will have important effects on you.

This chapter introduces you to financial accounting and illustrates some useful accounting concepts and techniques. It outlines a way of thinking about financial accounting that will be important to your career, whether you become an accountant or a user of accounting in business or in other walks of life. We believe that every manager is a user of accounting information but some managers use accounting information better than others. You are introduced to the social setting of financial accounting and some of the people involved. Financial accounting is complex and requires sound judgement because it attempts to serve the needs of all these people, not all of whom necessarily see things the same way. You are then introduced to one of the cornerstones of how financial accounting works: accrual accounting, the broad framework within which financial accounting reports are prepared. You are also introduced to the three key financial statements and the basic financial statement assumptions.

1.1 Use and preparation of accounting

LO1 Financial accounting has value because the information it produces is used in a variety of ways. Users include managers, investors, bankers, financial analysts and many others. Such people study accounting to learn how to use information effectively and to do their jobs better. For accountants, this information is essential to the services they provide.

Accounting is a complex human activity. Accounting information doesn't just happen: it is produced by a large set of people, activities and computers. To be effective users of the information, people need to know something about how and why the information is prepared. Accountants' expertise is all about the how and the why.

The demand for useful information shapes how financial accounting information is prepared; for example, when producing annual or monthly performance reports. How it is prepared shapes its use; for example, in analysis of financial statements and managerial decisions using accounting information.



HOW'S YOUR UNDERSTANDING?

Learning terminology is important. To help you with that, this book has a glossary of terms at the back. If you're not sure what a term means, look it up right away.

Accounting is a challenging discipline that involves many capabilities: assigning numbers to represent financial phenomena; providing explanations of those numbers; analysing and verifying the information prepared by others, understanding the needs of those who use accounting's reports to make decisions, communicating with the many people involved in an organisation's financial activities and maintaining judgement that is sound, objective and ethical.

Much of the challenge of accounting is in figuring out which numbers to use and deciding what the numbers tell us. Adding and subtracting the numbers is often the easy part. This makes accounting both easier and harder to learn than you might have thought. Accounting is rooted in the financial setting, and has its own vocabulary, so don't expect it all to make perfect sense at the beginning. It will take a while for you to acquire the knowledge that creates an understanding of business and accounting as they really are in our world. This understanding will be based on your knowledge of both concepts and techniques, and of the viewpoints of both accountants and the users of accounting.

The going will not all be easy, but if you give it your best effort, you may be surprised at the high level of sophistication you will reach. Here is one important suggestion. The only way to learn accounting is to do problems. It is vital that you do more than just read the examples. After reading the chapter, come back and do the examples to check your understanding. Throughout the book there are many questions called 'How's your understanding?'. Try to do the question and then look up the answer at the end of the chapter. These questions are numbered 1A, 1B, 1C, etc. where 1 indicates the chapter and the letter indicates the particular question.

1.2 Financial accounting

LO1 Accounting is a process of identifying, measuring and communicating economic information to allow informed decisions by the users of that information. Accounting systems are often described as either financial accounting systems (where periodic financial statements are provided to external decision-makers, such as investors, creditors and customers) or management accounting systems (including information for planning and performance reports to managers throughout the organisation; that is, internal decision-makers).

Financial accounting measures an organisation's performance over time and its position (status) at a point in time, and does so in Australian dollars, US dollars, yen, euros or whatever currency is judged relevant to the organisation. This measurement of financial performance and financial position is done for all sorts of organisations: large and small businesses, governments from local to national levels, universities, charities, churches, clubs, international associations and many others. The financial statements, which are financial

accounting's reports, summarise the measurements of financial performance and financial position in standard ways thought to be useful in evaluating whether the organisation has done well and is in good shape. These financial statements include notes, which contain many words (sometimes dozens of pages) of explanation and interpretation, in addition to the numbers. The statements report on the economic and financial matters and are largely for the use of people outside the organisation, such as investors, lenders, club members, regulatory agencies and taxation authorities.

In summary:

- *Financial performance* is the generation of new resources from day-to-day operations over a period of time.
- *Financial position* is the organisation's set of financial resources and obligations at a point in time.
- *Financial statements* are the reports describing financial performance and financial position (e.g. the balance sheet and the income statement).
- *Notes* are part of the statements, adding explanations to the numbers.

As we will see throughout this book, financial performance and position are highly related. Good performance is likely to lead to a healthy financial position; if a company has been making profits, it will probably build up resources. On the other hand, a healthy financial position facilitates performance; if you have lots of resources compared to obligations, the company can undertake activities that lead to good performance.

Another branch of accounting, management accounting, is oriented towards helping managers and others inside the organisation, in contrast to financial accounting's more external focus. While management accounting is not examined in this book, students interested in how financial accounting measures managerial performance will find frequent references to the relationship between managers and financial accounting. In the end, all forms of accounting exist to help people such as managers, investors, bankers, legislators and the public make financial decisions.



HOW'S YOUR UNDERSTANDING?

1A What are the two main things that financial accounting measures?

[Answers to all 'How's your understanding?' questions are at the end of each chapter. Make sure you try to answer the question prior to looking up the answer.]

1.3 Who uses financial accounting information?

This book will show you the many ways in which financial accounting has been shaped by the development of business and society. Financial accounting helps:

LO2

- stock market investors decide whether to buy, sell or hold shares of companies
- banks and other lenders decide whether or not to lend
- managers run organisations on behalf of owners, members or citizens (in addition to the help provided by management accounting and other sources of information)
- management by providing basic financial records for the purposes of day-to-day management, control, insurance and fraud prevention
- governments in monitoring the actions of organisations and in assessing taxes, such as income tax and the goods and services tax (GST)
- managers are often rewarded in the form of bonuses based on profit performances.

Whole books can be, and have been, written about each of these functions. Though this book emphasises externally oriented financial accounting for business firms, don't forget that there are many other

organisations that use, and are affected by, accounting (government departments, not-for-profit organisations including charities, sporting and cultural organisations). When words like 'organisation' or 'company' are used, the implications often go well beyond business firms.

The centre of our interest in this book – financial accounting for the organisation – operates within and serves a complex social setting. It seeks to monitor and report on financial events initiated by or happening to the organisation. While accounting tells us what is going on, in so doing it affects our decisions and actions and, therefore, also affects what is going on. For example, accounting information may determine whether an organisation hires more staff or reduces staff numbers. It will also likely affect the amount spent on contractors.

The social setting is composed of many people, including groups, companies, institutions and other parties interested in, or having an influence on, the company's financial accounting. As we will see many times in this book, these parties do not share the same interest in the company's accounting, and may even be in competition or conflict with each other. For example, management are likely to prefer higher salaries but this may or may not be in the best interest of shareholders. Most will be in the same country as the company and its management but, increasingly, companies and other organisations are operating internationally. The other groups interested in, and affecting, the company's financial accounting may be located across the globe.

Let's consider some possible users of the financial statements of a listed company:

- A company's board of directors manages the company on behalf of its shareholders. One function of the board, which involves the financial statements, is hiring the company's top operating management – especially the chief executive officer (CEO). Suppose you are a member of the board and are preparing for a discussion at the next board meeting. The board evaluates the CEO's performance continuously, which is its responsibility. The financial statements have been provided to the board prior to the meeting, and will be a major contribution to this evaluation.
- A company's shares are listed (i.e. can be bought and sold) on the Australian Securities Exchange (ASX). Suppose you are a financial analyst for an investment banker and are preparing a report projecting future earnings and making recommendations about whether the company's shares are worth buying, keeping if already held, or instead should be sold. You have the financial statements and will use them to support your report.
- A company has several hundred million dollars in bank borrowings, and lines of credit (pre-authorised borrowing capability) for millions of dollars more. Suppose you are a commercial lending officer for a bank, conducting a regular review of the company's borrowing status. You must consider the quality of the company's financial performance and assets (many of which have been assigned as security on bank loans, and therefore could be seized if the company doesn't pay its loans back on schedule). Financial performance is important because net profit generates cash to pay loans, and a good past record suggests that the company is likely to be able to earn profit in the future. You have requested the financial statements to use in your review.
- A company depends on a large number of suppliers to obtain goods and services. Suppose you are the sales manager of a stationery supplier and are considering signing a long-term contract to supply the company. You want to sign the contract because your company needs the business, but you have to be satisfied that your shipments will be paid for. More positively, you hope that if you do a good job, you will have an opportunity to grow with the company. Most of the information you need has been received already, but you have obtained the financial statements and are reviewing them as you make your final decisions about the contract.
- Management and unions often negotiate about an increase in pay rates for workers. One key input is the ability of the company to pay these increases. A company's financial statements are an important input to this decision.

In summary, these scenarios indicate the following reasons for using the company's financial statements:

- evaluation of the CEO's performance by a member of the board of directors
- preparation of 'buy', 'sell' or 'hold' recommendations by a financial analyst

- review of the company's borrowing status by a bank lending officer
- development of a supply contract with the company by a stationery supplier's sales manager
- determining pay rises by management and unions.

These scenarios have been chosen to add to your insight into the use of financial accounting information. They are not complete. In all cases, the financial statements would be only part of the information used in the decision-making process. Also, there are many other uses for financial statements, some of which might make different demands on the quality of the information from those discussed here.



FOR YOUR INTEREST

In the previous text, we noted that financial statements would be only part of the information used by various groups such as investors and management in decision-making. Another important type of information is sustainability reporting. These reports include information on economic, environmental, social and safety performance. For example, they could include information on carbon emissions, energy usage, employee safety, community involvement, etc. We introduce this material in Chapter 9, as many companies now include this information in their annual reports or in separate sustainability reports.

1.4 The people involved in financial accounting

The main participants in the art of financial accounting are:

LO3

- the information users (the decision-makers)
- the information preparers, who put together the information to facilitate the users' decision-making
- the auditors, who assist the users by enhancing the credibility of the information, providing a professional opinion about the fairness and appropriateness of the information.

Users (decision-makers)

In financial accounting, a user or decision-maker is someone who makes decisions on the basis of the financial statements, on his or her own behalf, or on behalf of a company, bank or other organisation. Ultimately, the nature and contents of financial statements are functions of the demand for decision information from users. If user demand is the fundamental reason for financial statements, understanding the demand is important.

A user's main demand is for the *credible periodic reporting* of an organisation's financial position and performance:

- *Credible* means that the information in the reports (the financial statements) appears to be sufficiently trustworthy and competently prepared for it to be used to make decisions. There is a cost-benefit issue here: huge amounts of money could be spent trying to make the reports absolutely perfect, but since that money would have to come out of the organisation's funds, spending it would make its performance and position poorer. Users, such as owners and managers, may not want that to happen, so credibility is a relative condition, not an absolute one. Accounting information has to be worth its cost.
- *Periodic* means that users can expect reports on some regular basis (such as yearly or quarterly). The longer the wait, the more solid is the information. But waiting a long time for information is not desirable: users are willing to accept some imprecision in the information in return for periodic reports with timely, decision-relevant information.

The main groups of users are as follows:

- *Owners* are individual business owners, such as proprietors, partners and other entrepreneurs; individual investors (shareholders) in shares on stock markets who can vote on company affairs; companies that invest in other companies; superannuation funds and other institutions that invest in companies; and people with quasi-ownership interests, such as members of recreation and sporting clubs or voters in

local councils. In respect of companies, shareholders own portions of the corporation – shares that can be bought and sold – but the corporation is a legal entity existing separately from its shareholder owners. Investors purchase shares in a company with the hope of gaining in two ways: receiving a portion of the company's profit in the form of dividends, and being able to sell their shares in the future at a price higher than they paid.

- *Potential owners* are people of the same sort as the owners listed previously, who do not at present have funds invested in the organisation but may be considering making such an investment. Because potential owners often buy shares from present owners – for example, by trading shares on the stock market – rather than investing directly, there is often a significant difference in outlook between present owners, who may wish to sell their shares for as much as possible, and potential owners, who would like to pay as little as possible.
- *Creditors and potential creditors* are suppliers, banks, bondholders, and others who have lent money to the organisation, who are owed funds in return for supplying something of value, or who are considering taking on such a role. Creditors do not have the legal control of the organisation that owners have, but they often have a large say in organisation decisions, especially if the organisation gets into financial difficulty. In cases of extreme difficulty, creditors may have the right to take over control of the organisation from the owners. Creditors need to decide whether to supply goods or services to the firm on credit.
- *Managers* are those who run the organisation on behalf of the owners. They have a great interest in the way accounting reports on their activities and results. They use the information for planning, controlling and organising the activities of the entity. Often managers' salaries and bonuses, and the likelihood of staying in their jobs, are directly affected by the contents of the financial statements. In small businesses in particular, the owner may also be the main manager.
- *Employees and their unions or other associations* are interested in the organisation's ability to pay wages, maintain employment levels and keep such promises as paying superannuation contributions. Financial information can be used to assess job security.
- *Regulators and other government bodies and agencies* are groups that may use the financial statements as a basis to evaluate whether the organisation is following various rules and agreements.
- *Financial and market analysts* are people who study companies' performances and prepare reports for others by analysing those companies. Analysts often make recommendations about whether to invest, sell shares or do neither.
- *Competitors* may use the financial statements to try to understand the organisation's operations for the purpose of better understanding what their competitors will do in the future and, therefore, what decisions they should make. Sometimes, for example, managers are reluctant to disclose information to shareholders, because competitors can then also obtain it and act to reduce the organisation's prospects. For example, large retailers may disclose profit by state but it is unlikely they will do this for each store location, as competitors may use this information to decide what locations are most profitable and set up competitive stores in those areas.
- *Accounting researchers* are people – mostly university academics, but also some based in accounting firms and other organisations – who study accounting with the objective of understanding it and contributing to its improvement.
- *Customers* need to consider if the entity is financially sound. This is particularly important when customers are required to pay amounts in advance, such as on a building contract. It is also important if customers rely on the warranties for repairs provided by the entity.
- *Miscellaneous third parties* are various other people who may get access to an organisation's financial statements and use them in various ways. Once statements have been issued, many people may make use of them. For example, politicians may make judgements about industry efficiency or taxation levels, journalists may write stories about employment practices, and judges may evaluate the organisation's ability to pay if it loses a lawsuit.

Think about all these users and decisions! It is a great challenge to develop one set of periodic financial statements for an organisation so that it can be useful for all. Perhaps you will not be surprised to know that there is much controversy about whether financial statements do this well, and whether financial accounting methods serve some users or decisions better than others.

How likely is it that you, the reader, will use accounting information in the future?

If you plan to be an accountant, the value of studying financial accounting is clear. It may not be so clear, however, if you have other plans, such as a career in management, marketing, engineering, law, human resources or production. To provide some perspective to those of you not planning an accounting career, and to help you understand the managers you will work with if you do become an accountant or auditor, comments will be made frequently about managers and financial accounting.

Financial accounting is directly relevant to managers because it reports on the managers' performance as decision-makers, caretakers of the organisation, representatives of the owners, legal officers of the organisation, and so on. Any manager cannot help but be interested in how her or his performance is being measured and in how that performance is analysed, projected and otherwise evaluated. Managers' bonuses, promotions, dismissals, transfers and other rewards and penalties are often directly based on the numbers prepared by accountants. Every manager should have an intimate understanding of how accounting is measuring his or her performance and should be able to conduct a 'reasonableness check' of the information being provided. It is critical for managers to understand the impact of every decision they are making on accounting numbers as these numbers will measure their performance.

Here are a few examples of how non-accounting managers may use accounting information:

- Marketing managers need to understand the financial statements of potential customers to determine which customers to focus on and which ones to extend credit to. They also need to know the profitability of individual products.
- Purchasing managers need to understand suppliers' financial statements to make sure they have the capacity to supply in the long term.
- Human resources managers use accounting information in salary negotiations.
- Information systems designers need to include the accounting information system in their design.

If you are extremely talented and have decided to make your fortune as a sports star or musician, you still need to know about accounting. We suggest that understanding the financial statements of the Sydney Cricket Ground or the Opera House would be of benefit in negotiating with those organisations.



FOR YOUR INTEREST

Over the last few years there have been major negotiations between football (various codes) and cricket players and administrators over how total revenues of the sports should be shared between players and other stakeholders. That is, the players, their representatives and the administrators are using the information in the financial statements of the sporting bodies as part of the negotiations over salaries and other benefits.

Preparers (decision facilitators)

Two main groups are responsible for the information in the financial statements:

- *Managers* are responsible for running an organisation, including issuing accounting and other information, and controlling its financial affairs. The fact that managers are also users, and are vitally interested in the results, has created a fundamental conflict of interest for them and has led to the development of the auditing function (see the next section). Managers are often referred to, as a group, as management.
- *Accountants*, who are part of the senior management team, have the job of shaping the financial statements by applying the principles of accounting to the organisation's records, under the direction of management. Many accountants are members of professional bodies, such as CPA Australia and Chartered

Accountants Australia and New Zealand. Accountants and their professional bodies also often have auditing experience and interests, and sometimes auditing roles, but the task of preparing the financial statements is quite different in principle from the task of verifying those statements once they are prepared.

Auditors (credibility enhancers)

Auditors report on the credibility of the organisation's financial statements, on behalf of owners and others. Auditors have the job of assisting the users by verifying that the financial statements have been prepared fairly, competently and in a manner consistent with accepted accounting principles. The auditing role is a very old one, arising because users demanded some assurance that managers' reports on their performance were not self-serving or biased. This book refers frequently to external auditors, who report on the financial statements on behalf of external users, but there are also internal auditors, who work within the organisation to support the credibility of information being used by management. External auditors provide an opinion on the truth and fairness of the financial statements. While external auditors may be asked for advice in preparing the statements, especially for small companies, they must avoid responsibility for the statements because their role is to scrutinise the preparation process. They cannot credibly audit statements they have prepared!

The external auditors are formally appointed by the owners; for example, at the annual shareholders' meeting. But an organisation's external auditor is not permitted to be an owner or manager of the organisation. For example, they cannot own shares in the company and they cannot act as a director or manager of the company, even for a small part of the year. This is to ensure that the auditor is financially and ethically independent and can therefore be objective about the organisation's financial affairs. Independence and objectivity are fundamental ideas that you will encounter frequently in this book.

External auditors may work alone or in partnership with other auditors in accounting firms. Some of these firms are very large, having thousands of partners and tens of thousands of employees, and offices in many cities and countries. Accounting firms offer their clients not only external auditing but also advice on income tax, accounting, computer systems and many other financial and business topics. However, if they conduct the audit there are rules in place about what other services they can provide, as auditors cannot be involved in auditing their own work, or creating any conflict-of-interest problems. Managing this requires considerable professional skill and attention to the ethics and rules of professional conduct. Whether this is being done successfully is a matter of much controversy at present. In Australia, as well as in many overseas countries, there has been additional regulation aimed at improving the independence of auditors. The large accounting firms annually spend many millions of dollars on their independence and quality-control systems. In 2020 a parliamentary committee inquiry released the Regulation of Auditing in Australia report, with a range of recommendations to improve audit quality.

People and ethics

Ethics, mentioned previously, will be raised throughout this book. Ethical issues can arise in just about any area of accounting. Here are some examples, all of them real:

- An organisation has been sued by a recently fired employee who claims that the dismissal was based on the employee's age, and therefore broke employment laws. The organisation's general manager denies any impropriety. The organisation's chief accountant, who personally feels that the former employee's claim is justified, has suggested to the boss that the lawsuit should be mentioned in a note to the financial statements, so that users of the statements will know there is a potential for loss if the former employee wins. The general manager feels that the chief accountant should ignore the lawsuit in preparing the financial statements, to avoid embarrassment and the appearance of admitting guilt. The general manager fears that such an apparent admission could be used against the organisation in court and so could cause the organisation to lose the lawsuit. What should the chief accountant do?
- While doing an audit, the external auditor learns that the organisation may have been cheating one of its customers. The customer, who is unaware of this and quite happy with things, is another client of the auditor. The auditor, who is bound by rules of conduct designed to protect the confidentiality of

information gained during the audit, knows that saying anything to anyone could result in major lawsuits. Should the auditor just keep quiet about what was found?

- A third organisation's senior managers are paid a bonus each year, calculated as a percentage of profit. Management is considering a proposed change of accounting methods that will reduce expenses this year and therefore raise accrual profit and increase bonuses. Should senior management refuse to implement the accounting change, request that the bonus calculation ignore the change, or just go ahead and enjoy the higher bonus?

These illustrative problems do not have easy answers, so none are offered here. They are dilemmas for the chief accountant, the auditor and the general manager. This book will address ethical issues from time to time, helping you to sharpen your ethical sense along with your accounting knowledge – the two are inseparable.

1.5 Accrual accounting

Financial accounting's task of producing financial statements is a complex one. For even a small business, thousands of events (transactions) have to be recorded and their financial effects evaluated. For large corporations such as BHP, Lend Lease, Rio Tinto, Woolworths, AMP, Qantas and Westpac, or organisations such as the University of New South Wales, Brisbane City Council or the Red Cross, the number of annual transactions runs into the millions or billions. Frequently, when the time comes to prepare the financial statements, some transactions have not been completed, are in dispute or have an otherwise unclear status.

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To cope with these complexities, financial accounting for most businesses and organisations uses the accrual accounting approach. Under an accrual accounting system, the impact of transactions on the financial statements is recognised in the time periods during which revenues and expenses occur, rather than when the cash is received or paid. Formal definitions of revenues and expenses can be quite complicated, and are left to Chapter 2. At this stage, we will provide examples of the main types of revenues and expenses.

The main form of revenue is usually the sale of goods or services; for example, the sale of machines for \$45 000 each, carrying out the installation of a new computer system for \$300 000 or providing consulting advice for \$40 000. For Woolworths, the sales could be a trolley of groceries. Other revenues include interest on investments held, dividends received on shares and rent from premises owned by the company.

Consider the main revenues and expenses for a coffee cart you see on campus or in the city. The main revenue will come from coffee sales. If all sales are cash sales it would be the cash received for the coffees sold. But note most customers use their credit card (where it may be days/weeks before the cash is received) or that some customers may have an account where all coffees sold to them are recorded and then they pay the whole amount the following month on receipt of an invoice. Note that under accrual accounting it is the delivery of the service (i.e. handing over the cup of coffee) that results in revenue being recognised.

Expenses include the costs of services and resources consumed in the process of generating revenues. Examples of costs incurred are wages, electricity, travel and rent. An example of resources consumed is depreciation. Organisations depreciate the cost of an asset (such as a motor vehicle or a printing machine) over the useful life of the asset; that is, each year a percentage of the cost of the asset becomes an expense. These assets are helping in generating revenue; therefore, a share of the cost should be treated as an expense in each accounting period during which the asset helps generate revenue.

Why do we depreciate the cost of an asset over its useful life rather than treat the cost of the asset as an expense in the first year? The reason is that the asset is used over many years and helps generate revenue over many periods. This depreciation expense is matched to the revenues earned during the period. Note that estimates need to be made. For example, a printing machine that cost \$480 000 would have annual depreciation of \$120 000, \$96 000 or \$80 000, depending on whether its estimated life is four, five or six years; that is, the judgement on the useful life of the machine has an impact on profit each year.

Now consider the main expenses of the coffee cart mentioned previously. Likely expenses include:

- the cost of coffee
- the cost of cups