CONTEMPORARY ACCOUNTING

A STRATEGIC APPROACH FOR USERS

10E

YUP THIS ONE'S A KEEPER
LOCAL CONTENT RELEVANT TO YOU

PHIL **HANCOCK**
PETER **ROBINSON**
MIKE **BAZLEY**

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

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Preface

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

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

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

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

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

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

A new approach

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

The main changes to each chapter are outlined as follows:

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

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

Additional resources included in the textbook are as follows:

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

Guide to the text

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

PART OPENING FEATURES

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

Practitioner Perspective

Lawrie Tremaine

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

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

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

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

the confidence to invest and to minimise the cost of the invested capital to the company.

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

For these reasons, public companies must ensure that published Financial Statements

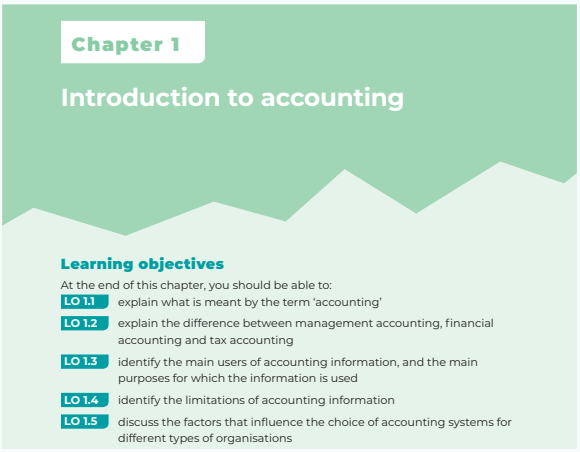
cases, the efficiency of decision making is dependent on the quality of the underlying financial information.

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

Contemporary Accounting: a Strategic Approach for Users is

CHAPTER OPENING FEATURES

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



Chapter 1

Introduction to accounting

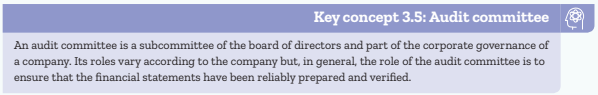
Learning objectives

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

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

FEATURES WITHIN CHAPTERS

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



Key concept 3.5: Audit committee

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

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

Stop and think 1

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

FEATURES WITHIN CHAPTERS

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

Worked example 4.1: Alexia

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

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


Scott Kozakiewicz

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

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

Case study 9.1

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

Commentary

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

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

Appendix 1

Extracts from Woolworths Ltd 2018 Annual Report

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

Auditor's Independence Declaration

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

20 August 2018

Dear Board Members

Woolworths Group Limited

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

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

(i) the auditor independence requirements of the *Corporations Act 2001* in relation to the audit; and
(ii) any applicable code of professional conduct in relation to the audit.

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

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

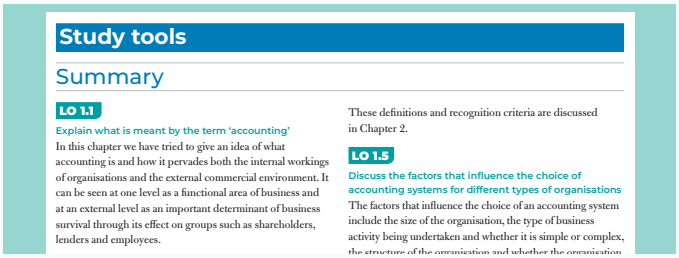
There are also issues relating to the ways in which a business is perceived and the v
management wishes the business to be perceived. Research has shown that managers,
managers of smaller entities, believe bankers are interested in the amount of assets availa
for a loan or overdraft. There is therefore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

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

END-OF-CHAPTER FEATURES

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

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



Study tools

Summary

LO 1.1

Explain what is meant by the term 'accounting'

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

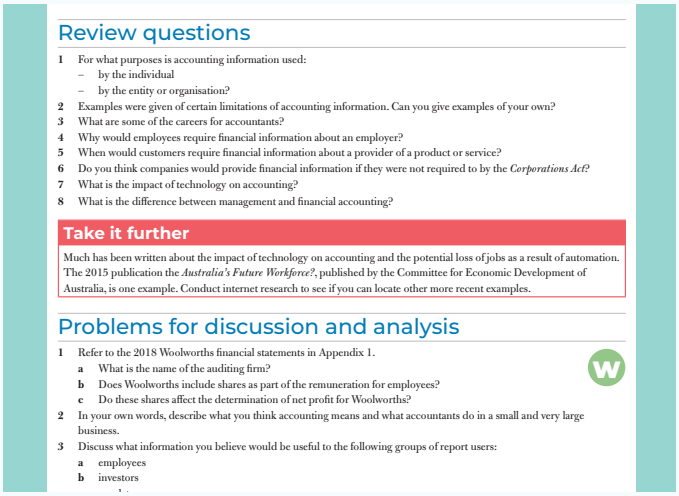
These definitions and recognition criteria are discussed in Chapter 2.

LO 1.5

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

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

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



Review questions

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

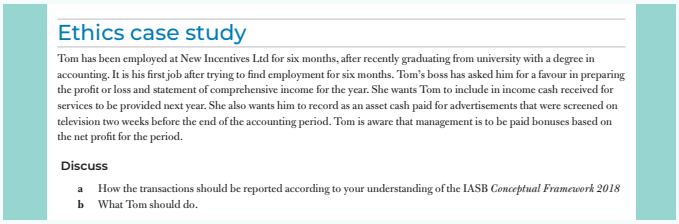
Take it further

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

Problems for discussion and analysis

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

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



Ethics case study

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

Discuss

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

Guide to the online resources

FOR THE INSTRUCTOR

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SOLUTIONS MANUAL

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

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ARTWORK FROM THE TEXT

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FOR THE STUDENT

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About the authors

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

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

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

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

Acknowledgements

We acknowledge our debt to Aidan Berry and Robin Jarvis, the authors of *Accounting in Business Context* published in the UK. This book was originally based on the British text, although the two books are now significantly different. Responsibility for the opinions expressed and for any errors in this book is entirely our own.

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Peter Robinson
Faculty of Arts, Business Law and Education
The University of Western Australia
Mike Bazley

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- Dr Graham Ray (Southern Cross University)
- Erwei (David) Xiang (Edith Cowan University)

Part 1

Financial Accounting

Practitioner Perspective

Lawrie Tremaine

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

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

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

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

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

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

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

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

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

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

Chapter 1

Introduction to accounting

Learning objectives

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

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

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

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

LO 1.4 identify the limitations of accounting information

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

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

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

LO 1.8 identify career opportunities for accountants.

Introduction

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

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

Figure 1.1
What is accounting?

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

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

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

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

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

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

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

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

1.1 What is accounting?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Key concept 1.1: Accounting

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

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

1.2 For what purpose is accounting information used?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LO 1.3

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

1.3 Who uses accounting information?

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

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

Internal users

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

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

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


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

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

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

Stop and think 1

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

Table 1.1

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

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

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

External users

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

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

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

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

Owners and shareholders

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

Key concept 1.2: Financial accounting

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

As the entity grows, however, it is likely that the owners will become divorced from its immediate and routine operations. Therefore, the owners will not have access to the management accounting information, which in any case may be too detailed for their requirements. This is the case in organisations listed on a **stock exchange**. (A listed or quoted organisation is one whose shares are traded in an open market where demand and supply govern the price of the share.) It is also the case in a number of other types of entities, such as public sector and not-for-profit entities, where the functions of management are carried out by people on behalf of the major stakeholders/owners.

stock exchange
(Chapter 1) A market for the buying and selling of stocks and shares in which supply and demand govern price.

In all these cases, the owners/major stakeholders need to know:

» whether the entity has done as well as it should have done
» whether the managers have looked after, and made good use of, the resources of the entity.

In order to evaluate whether the entity has done well and whether resources have been adequately used, it is necessary to compare the results of different entities. Information of this type is normally based on past results, and under certain conditions it can be provided by financial statements.

Owners/major stakeholders also need to know how the entity is going to fare in the future. Financial accounting is unlikely to provide this information for a variety of reasons, in particular because it is largely, if not exclusively, based on the past. Past results may be taken into account as one piece of information among many when one is trying to predict the future, but in a changing world it is unlikely that past results will be repeated because conditions will have changed.

Although there are limitations concerning the usefulness of the information in annual reports, they are often the only form of report available to an owner/major stakeholder who is not involved in the day-to-day activities of the business. Such users therefore have to base their decisions on this information, despite its inadequacies. For example, students can study the financial statements of various universities to see how much money they spend on resources such as the library and computing before deciding which university to choose for their courses.

In practice, the shareholder's involvement in this process of making comparisons (in the case of a listed organisation) is likely to be fairly indirect. This is because most of the information contained in the annual report has already been looked at by the owner's professional advisers – accountants, stockbrokers or financial analysts. The investor and owner are likely to base their decision on the professional advice they receive, rather than relying upon their own interpretation of the information. This is not to say that they will rely exclusively on expert information or that they will not use the information provided in the annual reports to assist with their decision. The reality is likely to be a mixture, the balance of which will depend on the degree of financial sophistication of the shareholders or owners. The less sophisticated they are, the more reliance they will have to place on their expert advisers. For example, a shareholder – who is, after all, a part-owner – may seek accounting advice when attempting to understand the accounting information contained in the annual report, to decide whether to sell his or her shares.

Lenders

People and organisations lend money in order to earn a return on that money. They are, therefore, interested in whether the entity is making sufficient profit to provide them with their return (usually in the form of **interest**). This information is normally provided in the statement of **comprehensive income** or an **income statement**. Lenders are also interested in ensuring that the entity will be able to repay the money it has borrowed; therefore they need to ascertain what resources an entity controls and what it owes. This information is normally provided in the statement of financial position (also called the **balance sheet**).

interest
(Chapter 1) A charge made for the use of money.

comprehensive income
(Chapter 1) The sum of profit for the year and other comprehensive income.

income statement
(Chapter 1) A financial report listing the income, expenses and net profit or net loss of a business (entity) for a time period.

balance sheet
(Chapter 1) A statement that shows all the resources controlled by an entity and all the obligations due by the entity at one point in time.

Research has shown that, in practice, bankers use a mixture of different approaches to arrive at a lending decision. The choice of approach is related to the size of the entity. In the case of smaller entities, the security-based approach predominates. This approach emphasises the availability of economic resources to

meet repayments in the event of business failure, and the emphasis is clearly on the statement of financial position or balance sheet. However, with very large businesses the approach towards a lending decision is more likely to be the 'going concern' variety where the emphasis is on the profitability of the entity.

Suppliers of goods

Goods can either be supplied on the basis that they are paid for when they are supplied, or that they will be paid for at some agreed date in the future. In each case the supplier will be interested to know whether the entity is likely to stay in business and whether it is likely to expand or contract. Both these needs relate to the future; therefore, they can never be adequately met by information in the annual report because this relates to the past.

Suppliers of goods who are not paid immediately will be interested in assessing the likelihood of getting paid. This assessment is partially helped by the annual report: the balance sheet shows what resources are controlled by the entity and what is owed, and also gives an indication of the **liquidity** of the controlled resources. However, the balance sheet has limited usefulness for predicting the future. Often the information is many months out of date by the time it is made public, because in most cases it is only published annually.

liquidity
(Chapter 1) The ability of a business to satisfy its short-term obligations. Liquidity refers to the ease with which assets can be converted to cash in the normal course of business.

Customers

Like suppliers, customers are interested in an entity's ability to survive and, therefore, carry on supplying them with goods. For example, if you are assembling cars you need to be sure that the suppliers of components are not about to go bankrupt. The importance of this has increased with the introduction of techniques such as **just-in-time management**. (Briefly, this means that inventories of parts at the production centre are kept to a minimum, reducing the cost of storage space and parts. Parts are delivered to the production centre just in time, before the inventories run out.) We discuss inventories in more detail in Chapter 8. The customers in this situation need to see that the entity is profitable, that it has sufficient resources to pay what it owes, and that it is likely to remain in business and supply components efficiently and on time. Some of these information needs are met, at least partially, by the financial statements.

just-in-time management
(Chapter 1) A management technique designed to lower the costs of holding high levels of stock.

Employees

Employees depend on the survival of the entity for their wages and therefore are interested in whether the entity is likely to survive. In the long term, an entity needs to make a profit in order to survive. The statement of comprehensive income or income statement may assist the employee in assessing the future viability of the organisation. The employee may also be interested in ascertaining how well the entity is doing, compared with other similar entities, for the purposes of wage negotiations – although the accounts are only useful for this purpose if certain conditions are met (these are explored later in this book). The accounts can also be used internally for wage negotiations because they provide evidence of the organisation's level of profitability and ability to pay.

The government

The government uses accounting information for a number of purposes, the most obvious of which is the levying of taxes. For this purpose it needs to know how much taxable income has been made. The profit an organisation reports to shareholders in its statement of comprehensive income or income statement is based on the application of GAAP, which we will discuss in Chapter 7. However, the profit upon which an organisation is assessed for tax purposes is based on the application of the tax rules and regulations and is the domain of tax accounting. While these rules are often identical to accounting rules, there are instances

where they differ. For example, a government may exempt certain income from taxation as an incentive to participants in that industry. This was the case with the gold industry in Australia for many years. Exempt income was not included in gold producers' calculations of their **taxable income**; however, as it was still income, it was included in their income statements for reporting to shareholders. The government also uses accounting information to produce industry statistics for purposes such as regulation.

taxable income *(Chapter 1)* The amount of profit, as determined by the Taxation Commissioner, on which the current income tax liability is calculated.

In certain cases, the government is both owner and customer (e.g. some state energy commissions) or public watchdog (e.g. the Environmental Protection Authority). It can combine any one of these roles with other roles, such as regulatory authority (e.g. Australian Securities and Investments Commission). The government uses accounting information for all these purposes.

The general public

The general public requires many different types of information about entities in both the public and private sectors. Much of this information is not supplied directly by financial statements. For example, the public might be interested in a organisation's environmental performance, which we expand upon in the next section, or its stance on fair trade issues.

This summary shows that the users of accounting information and the uses to which it can be put are many and varied. It is clear that accounting information has effects both within organisations and in the wider commercial environment in which entities operate and in which we live. It should also be clear that this wider environment can use accounting as a tool for entity control. Before going on to consider in detail the impact of accounting upon the commercial environment and vice versa, we should first consider the limitations of accounting information in order to put its potential impact in context.

Figure 1.2 Why external users might use accounting information

Stop and think 2

Who are the main external users of accounting information? What are some of the main purposes for which that information is used and which accounting reports are they likely to use?

LO 1.4
Identify the limitations of accounting information.

1.4 Limits on the usefulness of accounting information

It has to be stressed that accounting is only one of a number of sources of information available to decision makers. Other sources of information might be just as important as, if not more important than, the information contained in the accounts that are available to decision makers – for example, integrated and sustainability reports, discussed in Chapter 3.

To give you a flavour of what we are talking about, research into bankers' lending practices (referred to earlier) shows that a banker's personal interview with a client is as important as financial information. This is probably because accounting generally reports only on financial items (i.e. those items that can be expressed in financial, or monetary, terms) whereas the information that bankers are trying to derive from the interview is more **qualitative** (i.e. an impression of the ability of the applicant to run a successful business). It is also possible that the information that accounting provides is only of secondary importance; this would be the case where new technology has made the precise costing of a product irrelevant because the product is obsolete due to the change in technology.

qualitative
(Chapter 1) The nature or characteristics of information.

How useful is past information? In general, financial accounting information relates to the past, whereas the decisions that need to be taken normally relate to the future. Therefore, unless the past is a reasonable predictor of the future, financial statements will have some (albeit limited) value for this purpose. In the real world, because of the impact of such factors as changes in technology, innovations, fashions and inflation, the past is unlikely to be a very good predictor of the future. Of course, we are not referring here to management accounting, which as we will see in Chapters 12 to 18 is very much focused on improving the future performance of an organisation.

What value is included? Besides these problems, there is also the question of what is and what is not included in the financial accounts. For instance, some items (which it is generally agreed should be included in financial reports) are difficult to measure with any accuracy; therefore, the figures become subjective. A good example of this problem is an unfinished building. How do we decide on a figure to represent something that is only half-complete? Another example is the problem of deciding how long something is going to last. A car, for instance, loses value the older it gets. A business might decide that a car ceases to be useful to it after four or five years, but this is to some extent an arbitrary decision because there are many older cars that still serve a useful purpose.

What items are included? In addition to the problem of deciding how long things will last or what stage of completion has been reached, certain items are difficult to quantify in terms of value and are not easily included in financial reports. For example, the value of a football club is dependent on its ability to attract supporters; this, in turn, is dependent on its ability to succeed, which is dependent on the abilities of the players, and so on. However, it is difficult to decide what value to place on a player because this value will vary according to, for example, the player's fitness. Even so, football clubs in the Australian Football League do attempt to quantify the value of their players. In the United Kingdom, Europe and the United States, basketball, baseball, soccer and gridiron teams also follow this practice.

What about the impact of economy-wide issues? In addition to the questions raised above, there are many factors concerned with the natural and commercial environment that need to be taken into account but cannot be adequately included in accounts, although they may be quantifiable in monetary terms. Examples are the potential market for the product, tariff restrictions, export subsidies and environmental issues. If information about these factors were included in the annual reports of a business, a loss of competitive advantage could result.

What about inflation? Finally, we have to deal with the fact that accounting information is expressed in monetary terms and assumes that the monetary unit is stable over time. This is patently not the case. Although there has been much discussion of the problems of accounting in times of inflation, no agreed solution has yet been found.

We can conclude that, while accounting provides some information that is useful to decision makers, it is important to bear in mind that:

» the information is only a part of that which is necessary to make effective decisions
» accounting is an inexact science and depends on a number of judgements and estimates
» the end result of the accounting process can only be as good as the inputs, and in times of rising prices some of these inputs are of dubious value
» accounting systems can be counterproductive; for example, the maximisation of a division's profit may not always ensure the maximisation of the profit of the entity.

Nevertheless, it is clear that accounting is vital to the running of a healthy and prosperous entity and, arguably, it is also an essential prerequisite for a prosperous economy. It will therefore be useful to look at accounting in the wider context of an entity and its regulatory environment. We will now examine how the accounting function interacts with and is different from other business functions. We will also examine the various factors that influence the choice of an accounting system – including regulatory and environmental considerations.

Stop and think 3

What are the limitations of accounting information?

Accounting as a business function

Theoretically, the accounting department, like the personnel department, operates in an advisory capacity only – providing information for managers to make decisions. In practice, however, the financial elements controlled by the accounting function and the information it generates are so central to the operation of the entity that the influence of accounting is often pervasive. Although accounting is essential to the smooth running of the business, it does not have as direct an impact as, for example, the buying department or the production line. Its effects are generally subtler, although they may in certain instances be very obvious. For example, if the accounting information indicates that **expenses** are too high, this may have dramatic repercussions in other functional areas. Training and recruitment **budgets** may be immediately frozen, affecting the work of the personnel department and other operating departments, and possibly reducing both staffing and skills. Alternatively, a decision may be taken to stop expenditure on a current advertising campaign, therefore having a direct effect on the work of the marketing department.

Accounting can have unintended effects, too. For example, if sales representatives are judged solely on their sales, this may lead them to sell goods to customers who are unlikely to pay in order to achieve the sales targets that have been set. It can also be a very dangerous tool if used in the wrong way. For example, targets could be set to achieve cost savings on a production line with no account taken of the effect on quality or employee safety.

The importance of accounting within a business should not be underestimated. It provides the basic information by which managers and owners can judge whether the business is meeting its objectives. Its importance is shown by the high salaries that accountants can command and by the prevalence of accountants on the boards of directors of our major public organisations.

Accounting is also different from other business functions in that it is not only a function but also an industry. The accounting industry sells accounting and other advisory services to other businesses and is itself a major employer of graduate labour.

expenses
(Chapter 1) Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. (IASB *Conceptual Framework*, para. 4.69)

budgets
(Chapter 1) A short- and long-term plan of action, expressed in monetary terms, for the future operating activities of a business.

LO 1.5

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

1.5 Choice of accounting systems

Accounting is used within business to evaluate alternative strategies – such as making a component or buying it in from a supplier. Therefore, it shapes business plans and activities. At the same time, accounting is itself a function of the type of activity that a business engages in and of the strategies a business adopts. In other words, the accounting system not only influences business strategies but is itself influenced by the goals, size and structure of the organisation. For example, the accounting system that is appropriate for a local builder who does one job at a time and who can clearly identify the amount of time and materials being used on that job is not appropriate for a manufacturing plant that uses one building and many machines to produce multiple products all at the same time. In the latter case, a much more sophisticated system of accounting is required to identify the materials used and the labour inputs for a specific product. Accounting systems are variable and depend on the type of activities a business engages in, and on the levels of activity.

Organisation goals Clearly, the organisation's goals will have a major impact on the accounting system it uses. For example, developing an accounting system with the primary purpose of measuring profit would be wholly inappropriate for a not-for-profit entity such as a government or public sector entity. Similarly, the requirements, in terms of accounting reports, will be very different in the cases of a workers' cooperative, a profit-oriented organisation and the Department of Education and Training. The cooperative's members are likely to be more interested in their pay and their share of the surplus generated than in the entity's profitability. Shareholders in an organisation, on the other hand, are likely to be more interested in judging overall profitability and comparing that with alternative investments. In the case of the Department of Education and Training it may be that the owners, that is, the general public, are primarily interested in the service they have received rather than the department's profitability.

Organisation structure Furthermore, the way in which an organisation is structured determines the type of accounting system that is needed. If a brewery operates all of its hotels by putting managers into them, it will need an accounting system that allows for the payment of regular salaries and bonuses based upon achieving preset targets. These targets are normally set in terms of barrelage so the brewery will need to know what the normal barrelage of each hotel is, the mark-up on items such as spirits and soft drinks and the approximate mix of sales in order to ensure that its managers are not misappropriating the profits. If, though, it establishes its organisation so that each publican is a tenant of the brewery, a different accounting system will be required, because the publicans are not paid a salary or bonus – their remuneration comes from the profits they make from selling the beers, wines and spirits.

Organisation size We have already alluded to the effect the size of an organisation has on its accounting system. The larger and more disparate the organisation is, the greater the need for organisational controls. These are achieved through a system of accountability that makes managers responsible for the performance of their divisions and provides reports that can be used by senior managers to evaluate the performance of their subordinates and of the organisation as a whole.

As we have already mentioned, it is vital that the accounting system is tailored to the needs of the organisation. If it is not, management may be unable to control the organisation and may have dysfunctional effects. Frequently, in the case of a small business, little accounting information is available on a day-to-day basis. This may be because the operations are sufficiently simple not to warrant much information, but is more likely to be because the owner does not have the skills to produce the information, and the costs of hiring the necessary expertise are perceived as outweighing the potential benefits. It is often the case in small businesses that the only time detailed accounting reports are produced is at the end of the financial year to meet the needs of the tax collector or when the bank demands them as a prerequisite to granting a loan or extending an overdraft.

1.6 Regulatory and environmental considerations

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

In general, the environmental aspects of a business that interact significantly with accounting are the state, technology and labour. Accounting is also affected by, and affects, the economy. For example, a country such as Zimbabwe, which suffers from hyperinflation, out of necessity uses costs other than original costs in its accounting reports because the value of the monetary unit in which accounting information is expressed changes so quickly. We have already discussed the potential uses of accounting information by employees and their organisations, such as trade unions. We have also mentioned different forms of organisations such as not-for-profit organisations. In the case of most small not-for-profit organisations, there is no requirement for the publication of accounting information, whereas for organisations, the form and content of their annual reports is laid down by legislation in the *Corporations Act 2001*.

The *Corporations Act* specifies Australian Accounting Standards (referred to as **AASB Accounting Standards**) for organisations that are reporting entities; the setting of these standards is discussed in Chapter 2. All public sector reporting entities must also comply with all Australian Accounting Standards, except in cases where the Treasurer's Instructions vary or amend a standard. A similar situation prevails in most Western countries, although the importance of legislation in relation to accounting standards varies from country to country. Similarly, reporting requirements are different in non-capitalist countries where the importance afforded to the income statement is considerably less.

AASB Accounting Standards
(Chapter 1) The standards issued by the Australian Accounting Standards Board.

Developments in technology have also had a major impact upon the function of accounting. These have allowed accountants to free themselves from the mundane tasks of recording and to become more involved in decision support and strategic issues. At another level, new technology has imposed and is still imposing challenges to accounting thought. Systems that were appropriate in a labour-intensive environment are found to be lacking in the age of flexible manufacturing systems, such as just-in-time management and computer-controlled manufacturing environments. In its 2015 report, *Australia's Future Work Force*, the Committee for the Economic Development of Australia estimated there was a 94 per cent chance that the position of accountant won't exist in 2030. This is based on the impact of outsourcing and technology taking over basic bookkeeping functions. However, this is strongly disputed by the professional accounting bodies. While the role is evolving, there will still be a need for professionals to interpret the accounting numbers and provide advice as many accounting firms now do.

1.7 Economic consequences of accounting information

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

The development of accounting standards is the responsibility of the appropriate accounting standard-setting board. We discuss the development of accounting standards in Chapter 2. The selection of appropriate accounting policies for an entity is the responsibility of management. Where an accounting standard exists, the policies must comply with the standard. In some cases the standard allows a choice of policies and in other cases no standard exists. In these instances, the management of an entity can choose the most appropriate accounting policy.

As we will see in Chapter 2, the primary objective in selecting particular accounting standards is to provide useful information to the users of financial statements. As preparers of financial statements incur

costs in complying with accounting standards, the standard setters attempt only to impose requirements where the expected benefits exceed costs.

Managers do not necessarily adopt the same objectives when they select appropriate accounting policies for their organisation. Earlier in this chapter we commented that there would be chaos if all the people who bought shares in Woolworths tried to take an active part in the day-to-day running of that business. Instead, these owners or shareholders delegate the authority for the day-to-day running to a group of directors and managers through contractual arrangements. Jensen and Meckling (1976) believe that contracts between two parties (such as shareholders and management) result in an **agency relationship**. They define an agency relationship as 'a contract under which one or more (principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent' (Jensen and Meckling, 1976, p. 309). Thus, in a contract between shareholders and managers, shareholders are the principals and managers are the agents.

agency relationship *(Chapter 1)* A contract under which one or more principals engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.

Many of these contracts are written. They include formal contracts between equity (or share) holders and the organisation's management (e.g. the memorandum and articles of association, management compensation schemes and employee share ownership schemes), debt holders and management (e.g. debenture trust deeds) and less formal contracts in the form of the organisation's business structure (e.g. the hierarchical managerial chain of command and creating divisions serve to define the nature of interactions between managers). While all types of contracts are vital to the survival of an organisation, the contracts between shareholders and managers and debt holders and managers/shareholders have attracted the most attention in the accounting research literature and can affect the wealth of managers and organisations through:

- compensation plans
- debt contracts
- political costs.

Compensation plans

Many entities reward their managers through a fixed salary and an annual bonus. The bonus may be determined as a percentage of net profit. The bonus scheme, it is argued, provides an incentive to managers to increase net profit. Increases in net profit are in the best interests of shareholders. Therefore, the bonus scheme is intended to align the interests of managers more closely to those of shareholders.

However, a consequence of the bonus scheme is that managers may also be motivated to increase reported profit by the appropriate selection of profit-increasing accounting policies. Therefore, this strategy may increase reported profit when the underlying profitability of the entity has not increased. This has been described as a cosmetic increase in profits rather than a real increase in profits.

Some spectacular corporate collapses – such as Gourmet Food Holdings (including the Rosella brand) and the Hastie Group in Australia, and Lehman Brothers and Enron in the USA – raised considerable public outcry about many issues including the use of share options as part of the remuneration packages for corporate executives. The 2008–9 Global Financial Crisis (GFC) saw a number of banks collapse amid allegations of excessive lending motivated by greed. There is a view that the use of share options creates incentives for managers to do almost anything to keep reporting large profits so that the price of the organisation's shares continues to rise. In turn, this increases the value of the manager's share options. Such high-profile corporate collapses have led to considerable debate about the appropriateness of using share options as part of executive remuneration, given the highly publicised impact of such a policy on financial reporting. At the G20 meeting in London in April 2009, finance ministers and central bank governors expressed a view that there should be some regulation of executive compensation.

In Australia, listed organisations have to submit a remuneration report that key executives convey to the Annual General Meeting of shareholders. In 2011, the 'two strike' rule was introduced into law in Australia. The rule allows shareholders to vote to 'spill' the board if the remuneration report receives a 'no' vote of 25 per cent or more two years in a row. In May 2018 at the AMP meeting, 61.5 per cent of shareholders voted against the remuneration report, which was one of the highest for an ASX 200 company since the two-strike rule was introduced. If more than 25 per cent vote against the remuneration report in 2019, there would be a spill of the board at the annual meeting. This would mean an election of new directors. There has been no case of two strikes being recorded since the legislation was introduced in 2011.

Debt contracts

Many lenders require a contract before lending money to a borrower. Such contracts may impose certain restrictions on the borrower. For example, a new loan contract may contain a clause stating that if the borrower's debt exceeds a certain level, the loan must be immediately repaid in full. The measurement of the level of debt may be based on the total liabilities figure as reported in the borrower's statement of financial position or balance sheet. Another common clause in debt contracts relates to the number of times the net profit covers interest expense. We will look at these and other ratios in Chapter 10.

These clauses in the debt contracts are based on accounting numbers as reported in the organisation's financial statements. Therefore, if an entity is approaching the limits of a clause in a debt contract, there are incentives for managers to select accounting policies that allow the entity to avoid being in violation of the debt contract.

Political costs

Political costs refer to the costs imposed on an entity by regulation, taxation and closer public scrutiny of its affairs. Some accountants argue that bigger organisations, like News Corporation, are subject to more political costs. Size is often measured in terms of net profit, total assets and total sales. These are all numbers determined by the application of accounting policies. Therefore, there are incentives for managers of large entities to select profit-decreasing accounting policies.

Another argument suggests that incentives exist for other types of businesses, such as telephone or electricity organisations, to choose profit-decreasing accounting policies. This choice is made at a time when the organisation wishes to increase the charges for its service. It is politically more acceptable to increase charges when reported profits have decreased.

Therefore, political costs create incentives for managers of large organisations to select accounting policies that decrease reported profits. This is clearly the reverse of the argument under compensation plans, in which the manager's self-interest prevails. With political costs, the interests of the organisation prevail. Ultimately, if the large organisation attracts lower political costs, its managers will be rewarded.

The dual reason for selection of accounting policies

The selection of appropriate accounting policies may be based on the objective of providing useful information to users, or it may be based on **economic consequences**. These two objectives need not be mutually exclusive and, as you read the following chapters, you should consider the role of both these objectives in the selection of accounting policies. Shareholders and lenders may initiate strategies to

economic consequences *(Chapter 1)* The impact of accounting policy changes on the economic position of various parties affected by the change.

mitigate the incentives for managers to select accounting policies based on economic consequences. In this event, the selection of accounting policies is more likely to be based on the objective of providing useful information to users.

In the next section we briefly discuss the important issue of ethics in business and accounting.

Case study 1.1: SIA profit due to depreciation

By Paul Thompson

Laurent Fievet/AFP/Getty Images

I REFER TO your article 'SIA hints net profit may be above $200m' by Andrea Tan (*BT*, April 20). First, may I say that, for the sake of the hardworking staff, I certainly hope it is true. They would then stand a good chance of getting previously implemented wage cuts restored. Second, may I bring to investors' attention – if they are not already aware – that SIA is engaging in earnings management, much like their peers in Europe and North America.

SIA's earnings management makes it difficult for me to get excited about the mildly bullish sentiment surrounding SIA. While things are indeed looking up for SIA, it is worth noting that the primary reason it stands any chance of making any profit at all for the year ended March 31, 2002 boils down to what some might call an accounting sleight of hand.

I hold SIA in high regard. SIA is a high-flier in the world of aviation. It offers impeccable service, far better than any other flag carrier I have flown in. It is also one of the world's most profitable airlines and, unlike many like the big US flag carriers and British Airways, it appears to have avoided a free fall into financial losses – and it has averted slashing staff numbers (the latter achievement is especially commendable).

The main reason, however, it has managed to steer clear of reporting losses for the past financial year (announcement is due in early May but SIA, for sure, already knows the score) is through a timely change in its accounting policy on the depreciation of fixed assets.

Depreciation is a major expense for airlines whose balance sheets are bulging with an expensive aircraft fleet. In its half-year report issued last October, soon after the terrorist attack on the World Trade Center, SIA said: 'Commencing this financial year, the company changed its depreciation rate for passenger aircraft, spares and spare engines from 10 years to 20 per cent residual value to 15 years to 10 per cent residual value. This is to bring it more in line with airline industry practice. Aircraft depreciation charge was $133 million lower as a result.'

In other words, SIA's policy change for the six months to Sept 30, 2001 caused expenses to be lower by $133 million and hence profit higher by the same figure. For the full year, the effect is likely to be double – that is, a boost to profits by some $266 million.

I do not doubt SIA when it says that this policy change aligns itself with industry practice. In fact, in 1999, I compared the depreciation policy of SIA with BA and found it to be more conservative. But the fact remains that had it not made this change, SIA would almost certainly be reporting a loss for the year to March 31, 2002 in the next few weeks.

Paul Thompson, *Business Times Singapore*, 25 April 2002.

Commentary

Although this article is not recent, it is an excellent example of the impact of accounting policy choice on an organisation's reported profits. It shows how Singapore Airlines (SIA) was able to increase reported profit by a change in accounting policy. The organisation stated that the aim of this change was not to boost earnings for the year, but rather to align its depreciation policy with those of other airlines.

A recurring theme in this book is how the choice of accounting policies will impact an organisation's reported results and may be explained by the existence of contracts, as well as the objective of providing useful and relevant information to users. By the time you complete the chapters on financial accounting, you will better appreciate how the choice of accounting policies affects an organisation's financial statements.

While SIA changed the way it accounts for the depreciation of its aircraft, the value of the aircraft did not change. Does this change in profit, resulting from a change in an accounting rule, make SIA more valuable? The answer is no, and consequently there should be no change in the value of SIA's shares based on this higher reported profit.

Stop and think 4

What are the economic consequences of accounting policy choice?

1.8 Careers in accounting

LO 1.8
Identify career opportunities for accountants.

Accountants are employed in many different areas in both the private and public sectors. This section provides only a brief overview of the different careers for accountants.

Accounting firms

Most accounting firms operate as a sole proprietorship or a partnership. The most significant firms are large firms like PricewaterhouseCoopers, Ernst & Young, KPMG and Deloitte. Large firms provide services in the areas of **auditing** and assurance services, tax, management advice, and insolvency and administration.

Accountants in accounting firms work in public accounting. They are members of Chartered Accountants Australia and New Zealand, CPA Australia or the Institute of Public Accountants.

auditing
(Chapter 1) The examination of a company's general-purpose financial statements by an independent external observer (the auditor) to ensure that they present a 'true and fair' representation of the company's financial status. The auditor's findings are presented in the auditor's report.

Industry and commerce

All organisations, both large and small, employ accountants to perform many different duties. These duties include the preparation of financial statements for external reporting purposes. Large and medium-sized organisations also employ accountants in internal auditing. The internal auditor's role is to ensure that the **internal controls** in the organisation are adequate to safeguard the organisation's assets. Large and medium-sized organisations also often employ tax accountants to do all the work involved with income tax, payroll tax, GST and other indirect taxes. They also employ cost accountants, whose job is to generate information about the behaviour of costs, to help establish budgets and to generally assist management in controlling costs and establishing appropriate prices for the organisation's products.

internal controls
(Chapter 1) The procedures and processes in place within a business to safeguard all assets including cash.

Not-for-profit entities

The not-for-profit (NFP) sector includes all levels of government, health, education, social services, culture and recreation, charities, business and professional associations, and others such as religious groups. Excluding the government sector, the NFP sector in Australia represented $43 billion to the gross domestic product (GDP) in 2006–7, which is the latest available figure (http://www.acnc.gov.au). As a result of its size, this sector employs many accounting graduates. Accounting for profit and NFP entities is very similar, although the absence of a profit motive does result in some differences.

The government employs many accountants, who work in all areas at the local, state and federal levels. Accountants can be found doing similar work to their private sector counterparts: preparing financial reports, auditing, tax work and cost accounting. Departments such as Treasury and the Auditor-General's Office employ many accountants, and all departments employ some accountants to carry out all types of accounting work.

Professional membership

The two major professional accounting bodies are Chartered Accountants Australia and New Zealand (CA ANZ) and Certified Practising Accountants Australia (CPAA). The Institute of Public Accountants (IPA) is another professional organisation in Australia, for accountants 'recognised for their practical, hands-on skills and a broad understanding of the total business environment' (www.ipaa.com.au).

The three bodies have different categories of membership. University graduates are initially admitted as associates. They must then complete a professional program and have three years' practical experience before advancing in their membership. Finally, a public practice certificate is required for all principals in public accounting firms.

Study tools

Summary

LO 1.1

Explain what is meant by the term 'accounting'

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

LO 1.2

Explain the difference between management accounting, financial accounting and tax accounting

Management accounting is prepared for internal users and is largely unregulated. Financial accounting results in financial statements prepared for external users in accordance with GAAP. Tax accounting involves the preparation of tax returns where the objective is to report the activities of the organisation in compliance with the tax rules so that the organisation pays the minimum amount of tax to the government.

LO 1.3

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

There are many users of accounting information and they include internal users (managers) and external users (shareholders, lenders, suppliers, customers, employees, government and the general public). We have shown that there is no perfect accounting report that will meet the needs of all users, and that the needs of users vary. For example, in the case of a small business the owner may wish to show a low profit to reduce the potential tax bill, but may need to show a high profit in order to persuade a banker to lend the business money.

LO 1.4

Identify the limitations of accounting information

We have shown that accounting will be useful only if it is used correctly and if its limitations are understood. Financial accounting is based on past information and only includes those elements that meet the definition and recognition criteria for assets, liabilities, income, expenses and equity. These definitions and recognition criteria are discussed in Chapter 2.

LO 1.5

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

The factors that influence the choice of an accounting system include the size of the organisation, the type of business activity being undertaken and whether it is simple or complex, the structure of the organisation and whether the organisation is for-profit or not-for-profit.

A failing business will still fail even though it has an excellent accounting system; on the other hand, potentially successful businesses have been allowed to go bankrupt because the accounting system did not give any warning signs or gave them notice too late to allow management to take action to rectify the situation.

LO 1.6

Demonstrate an understanding of the regulatory and environmental considerations that can influence accounting decisions

The *Corporations Act* influences the financial reporting of companies and other entities required to register with ASIC. Developments in technology and outsourcing certain procedural bookkeeping tasks have also had a major impact upon the function of accounting.

LO 1.7

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

The economic consequences of accounting policies can influence a manager's choice of accounting policies. Accounting numbers are used in various contracts and this, it is argued, creates incentives for managers to choose accounting policies based on their impact on the numbers in the contracts. Managerial compensation and debt contracts create incentives for managers to favour profit-increasing accounting policies. Political costs create incentives for managers of large organisations to favour profit-decreasing accounting policies.

LO 1.8

Identify career opportunities for accountants

Accountants work in many areas and in many types of organisations. Accountants work in public accounting firms providing various services including audit and assurance, taxation, an advisory service, and insolvency and administration. Accountants work in large, medium and small organisations preparing financial statements and all types of information for internal decision making by managers. Accountants also work in not-for-profit entities, which include all levels of government and other areas such as health, education and social services.

Review questions

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

Take it further

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

Problems for discussion and analysis

1 Refer to the 2018 Woolworths financial statements in Appendix 1.
   a What is the name of the auditing firm?
   b Does Woolworths include shares as part of the remuneration for employees?
   c Do these shares affect the determination of net profit for Woolworths?
2 In your own words, describe what you think accounting means and what accountants do in a small and very large business.
3 Discuss what information you believe would be useful to the following groups of report users:
   a employees
   b investors
   c regulators
   d suppliers of goods and services
   e customers.
4 If you work for an accounting firm, whose perspective should you take – the firm's, the client's, the user's or your own?
5 You own and run a small supermarket. What accounting information do you need, and how often?
6 You are the manager of a small local band which are offered $1000 for a three-hour performance. What financial (accounting) issues do you have to consider before accepting or rejecting the offer?

7 It was pointed out that accounting information is only a part of the input to the decision-making process. In order to expand your understanding of the role of accounting information, for the situation outlined below, identify:

a the accounting information that would be relevant

b any other information that would be relevant.

Head & Co. is in the business of making navigation equipment and wishes to diversify into the production of hang-gliders. The business is based in Sydney but the owners may be willing to move. The owners have little knowledge about the market for hang-gliders, but feel that there is money to be made in that field.

8 You are considering buying a small retail store selling electrical equipment. The selling agent is very enthusiastic. What non-financial information should you be requesting?

9 'Automation and artificial intelligence will mean there will be little demand for accountants in the future.' Critically review this statement.

10 'Looking at an organisation's financial statements is like looking in the rear view mirror when driving a car.' Discuss this statement and explain why such a statement would be made. Do you agree?

Note to instructors: The following problems are considered more suitable for use in postgraduate courses. However, undergraduate courses may also find them useful.

11 Tom was left some money in his mother's will and decided that he should give up his job and go into business for himself. While the lawyers were still sorting out his mother's estate, he started looking around for a suitable business. After a short time, he identified a small boat-building business that he felt was worth investing in. He was still uncertain about how much his mother had left him but thought that it was probably between $80 000 and $100 000. The boat-building business was for sale for $200 000 and so, assuming that he could finance the remainder, he engaged an accountant to check the books of the business and report back to him. As proof of his good faith, he deposited $2000, which he had in savings, with the business agents.

The report from the accountant confirmed his initial impression that the business was worth investing in, so he paid the accountant's modest fee of $1000 in full. At this stage he discussed his plans more fully with his bank manager, who was duly impressed with the professional approach taken by Tom.

The bank manager pointed out that Tom had no business experience and, therefore, was a high risk from the bank's point of view. However, in view of their long-standing relationship, the bank was prepared to take a chance and said that it would lend Tom 40 per cent of the purchase price.

On the basis of this, Tom signed a conditional agreement to buy the boat-building business. A short time after this he received a letter from his lawyers stating that his inheritance from his mother amounted to only $60 000. He could not raise the additional finance to purchase the boat-building business and so withdrew from the agreement, recovered his $2000 deposit and purchased a yacht with the intention of doing charter work to the Caribbean.

Required

Discuss the point at which, in your opinion, the accounting process should begin, giving reasons for your point of view. Pay particular attention to the dual needs of Tom as an owner and as a manager.

12 The No-Returns Rubber Company is considering setting up a new manufacturing plant that will produce rubber arbuthnots to be used in the manufacture of nuclear-powered frisbees. Discuss what information the managers are likely to require in order to make an informed decision about the viability of this project. Factors to be taken into account should include financial issues, health and safety considerations, and also the possible social and legal issues that may arise from the manufacture of non-biodegradable substances, such as rubber arbuthnots and nuclear items. Discuss how you think these considerations can be incorporated into a costing of the project.

13 Scasboro Beach is a beautiful beach in Bondavia. The surrounding residential area is very attractive because of the beach and the lovely views out to the ocean. After a great deal of negotiation, the Coastal Development Company obtained a permit from the local shire council to erect a 12-storey five-star hotel, which would encroach onto the lovely beach and sand dune area. Prior to this approval, the highest building permitted at Scasboro Beach was three storeys.

Construction began immediately. At this time a legal challenge to the hotel was lodged by a local ratepayers' association and environmental groups. They wanted the permit declared void because the planned structure would obstruct the views of existing property owners and cause damage to sand dunes in the area.

After the Coastal Development Company had invested $500 000 in the Scasboro Hotel project, a court hearing was held with the plaintiffs, which ordered demolition of the site as well as total restoration of the area. This would cost approximately $200 000. The company lost an appeal to a higher court.

Required

a Discuss how you might measure the economic value (using your understanding of what economic value means) of the project before the decision of:
- **i** the lower court
- **ii** the higher court.

b What problems do you envisage in making such measurements?

c What losses were sustained and who sustained the losses in this case?

(Adapted from R.G. May, G. Mueller and T.H. Williams, *A New Introduction to Financial Accounting*, Prentice-Hall, 1975, Chapter 1, Exercise 1–2.)

14 At the beginning of time there was a small dwelling of cave men and women who elected themselves a leader called Ugg. Ugg's responsibilities were to restore peace and order in the dwelling, which had become unsettled due to a recent outbreak of stealing.

Ugg was a very intelligent cave man and he began thinking that if every cave person accounted for their belongings, then less stealing would happen. Furthermore, if cave people paid him some kind of 'due' in respect of their belongings, thieves would be deterred because the more belongings a cave person had, the more in dues he or she would have to give Ugg. Ugg decided to call this due the 'rock tax'.

The next day Ugg announced the rock tax to the dwelling. He explained to the cave people his thoughts from the previous day and asked for grunts of approval for the rock tax. These outweighed the grunts of disapproval so he then proceeded to outline the rock tax guidelines. These were:

1. one large brown fur equalled 50 morsels of meat
2. one small brown fur equalled 30 morsels of meat
3. one large black fur equalled two large brown furs
4. one small black fur equalled three small brown furs
5. for every 10 morsels of meat, one large rock had to be given to Ugg, which would help to build a wall around the whole dwelling. The tax would be paid once every 300 days commencing from the next day.

Ugg also said that he would personally check every cave to make sure truthful accounts were given.

Two of the oldest members of the dwelling, Thug and Olga, thought Ugg's rock tax was the best announcement they had ever heard and proceeded to add up their furs and morsels. Thug calculated he had six large brown furs, two small brown furs and five small black furs in addition to the 34 morsels of meat he had stored in his rock-fridge. Thug had exchanged three small brown furs for his rock-fridge some 400 days ago. Olga counted two large brown furs, 10 large black furs and nine small black furs in her rock-cabin. She also counted 22 meat morsels in her rock-fridge. Olga had exchanged one large black fur for the rock-fridge 200 days ago.

Required

Imagining you lived in this dwelling, calculate:

a the amount of tax that Thug and Olga should give Ugg

b how Thug and Olga would pay their tax to Ugg.

Cool Value Cinemas

Go to the online case and answer the questions related to Chapter 1.

Suggested answers to stop and think exercises

1 Identified in the text is the need for information to enable management to carry out its duties and responsibilities in terms of stewardship, planning, control and decision making. The second part of the question should provoke a number of different answers, perhaps related to the market for the internal user's product, competition or the economic situation. We have found that by encouraging the students to think about the alternative information needs, and the sources from which information can be derived, they are better able to see accounting in a wider context.

2 In general, for external users, the accounting reports that are normally used are the annual report or statements. Where specific reports, such as the balance sheet or income statement, are mentioned in the body of the text, these are shown below.

3 The limitations are as follows:

- **a** The information is only a part of that which is necessary to make 'effective decisions'.
- **b** Accountancy is, as yet, an inexact science and depends on a number of judgements, estimates, etc.
- **c** The end result of the accounting process can only be as good as the inputs, and in times of rising prices some of these inputs are of dubious value.
- **d** Accounting systems can be counterproductive; for example, the maximisation of a division's profit may not always ensure the maximisation of the entity's profit.

4 Economic consequences refer to the financial impact on an organisation from a particular accounting policy. For example, an accounting policy that requires all mining organisations to expense all exploration and development expenditure incurred would result in large losses for organisations not yet in production. Hence, this may make it difficult to attract investors to buy the organisation's shares, despite its future prospects.

Management	Various reports including specialist reports to help run the business profitably
Owners	Annual report to help assess if management is doing a good job and protecting their investment
Lenders	Statement of comprehensive income, income statement and statement of financial position or balance sheet to assess if the loan can be repaid and, in the event of loan repayment problems, if there is adequate security
Suppliers	Statement of comprehensive income, income statement and statement of financial position or balance sheet because they are interested in issues that are similar to those of lenders
Customers	Statement of comprehensive income, income statement and statement of financial position or balance sheet to determine if the entity will continue to operate – particularly if the customer has a long-term contract
Employees	Profitability, therefore statement of comprehensive income and income statement to help assess ability of the entity to continue to operate
Government	Statement of comprehensive income and income statement to assess payment of taxes
The public	Annual report to assess the entity's impact on areas like the environment and to assess the entity's social policies and so on.

Chapter 2

Business structures and financial reporting

Learning objectives

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

LO 2.1 identify three forms of business structures, the main characteristics of each structure and the major differences between their financial statements

LO 2.2 identify the main characteristics of the financial statements of a public company and the role and meaning of consolidated financial statements

LO 2.3 explain the current framework for standard setting in Australia and the influence of accounting standards, the *Corporations Act 2001* and the Australian Securities Exchange Listing Rules on financial reporting requirements

LO 2.4 explain what is meant by, and the role of, a conceptual framework and explain the major concepts

LO 2.5 appreciate the role of the external audit function.

Note to instructors: Instructors who defer consideration of this chapter until later in the course should be aware that the following terms, defined in this chapter, are used throughout the text: 'assets', 'liabilities', 'expenses', 'income', 'revenue' and 'equity'. These terms are restated in Chapters 5 and 6.

Introduction

In Chapter 1 we discussed the objectives of accounting and the influences of users on financial reporting. We also discussed the limitations of accounting information and the role of accounting in business, its effect on business and some of the factors that influence accounting. The impact of accounting policies on management compensation and debt contracts was also mentioned. In this chapter we plan to provide you with an understanding of the terms accountants use, such as assets, revenue and consolidated financial statements, so that you will begin the journey toward a better understanding of financial statements!

The types of financial statements prepared by entities will depend on a number of factors, including the type and size of the organisation. At the simplest level a small sole trader and the local football club may well only prepare a statement of cash receipts and payments with a statement of the bank balances at year end. For large public companies like Woolworths there are four main financial statements, as listed below:

» Single statement of profit or loss and other comprehensive income **or** the statement of profit or loss **and** the statement of comprehensive income – the statement of profit or loss reports income and expense items and profit or loss for a period of time. Income and expenses are determined using accrual accounting, which is explained later in this chapter but for now we can say income and expenses may not equal cash received and paid. Large entities like Woolworths also have to report items of other comprehensive income, which are added to profit (loss) to determine total comprehensive income for the same period. These statements are explained in detail in Chapter 6.

» Statement of financial position (balance sheet) – this statement reports the assets, liabilities and equity at a point in time. It is like a snapshot of a business at a point in time. It is also based on accrual accounting and is explained in detail in Chapter 5.

» Statement of changes in equity – this statement reports the total changes to the equity for a period of time which arise from transactions with owners, such as when a company pays a dividend to shareholders, and is explained in detail in Chapter 6.

» Statement of cash flows – as the first statements are based on accrual accounting, this statement reports all the inflows and outflows of cash for a period of time. This statement is explained in detail in Chapter 7.

In this chapter we consider different forms of organisations. We then examine the financial reporting framework that influences the preparation of financial statements for different types of organisations. The most extensive regulations exist for companies – in particular for listed public companies. Their financial reports must comply with various professional, statutory and securities exchange requirements. Other types of business organisations – such as not-for-profit and public sector entities – may be subject to various regulatory requirements, and in some cases must also comply with accounting standards. Organisations such as small private companies, partnerships or sole proprietorships are subject to much less regulation.

We also examine the process used for the establishment of accounting standards and the parties involved in the standard-setting process. The objective of financial reporting and the **qualitative characteristics of financial information** are also considered. We explain the definitions of key terms such as 'assets', '**liabilities**', '**equity**', '**income**', 'revenue' and 'expenses' from the **International Accounting Standards Board (IASB)** revised *Conceptual Framework for Financial Reporting (RCF)* published in March 2018 are explained. Finally, the role of the external auditor in financial reporting is discussed.

qualitative characteristics of financial information
(Chapter 2) If financial information is to be useful it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. (IASB *Conceptual Framework*, para. 2.4)

liabilities
(Chapter 2) Liabilities are defined as a present obligation of the entity to transfer an economic resource as a result of past events. (IASB *Conceptual Framework*, para. 4.26)

equity
(Chapter 2) The residual interest in the assets of an entity after deduction of its liabilities. (IASB *Framework*, para. 4.63)

income
(Chapter 2) Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. (IASB *Conceptual Framework*, para. 4.68)

International Accounting Standards Board (IASB)
(Chapter 2) The body responsible for the development of International Accounting Standards.

LO 2.1

Identify three forms of business structures, the main characteristics of each structure and the major differences between their financial statements.

2.1 Types of business structures

Organisations can be classified as either for-profit entities or not-for-profit entities. Common types of for-profit entities are sole proprietorships, partnerships and companies.

There are also not-for-profit (e.g. charities) and public sector organisations. In addition, there are other, less common forms such as cooperatives, friendly societies and provident societies. Each of these organisational forms requires slightly different accounts. This is because the needs of the users are slightly different or because of other factors, such as the requirements of legislation or other regulations (e.g. those imposed by a stock exchange). Rather than attempting to deal with all the different forms of organisation, we concentrate our discussion on simple forms of organisation: the **sole trader**, the **partnership** and the limited **company**.

sole trader
(Chapter 2) A one-owner business.

partnership
(Chapter 2) The relationship which exists between persons carrying on a business in common with a view to profit. (*Partnership Act 1891*, section 1(1))

company
(Chapter 2) An entity incorporated, or taken to be incorporated, under the Corporations Act (*Corporations Act 2001*, section 9). It is recognised as a separate legal entity

There are distinct differences in the presentation of financial accounts, relating to the structure, size, patterns of ownership and goals of an organisation. These influences operate at the organisational level, as explained in Chapter 1. Other influences that operate in the commercial context are legal requirements such as the reporting requirements of the *Corporations Act*, the *Partnership Act* and case law. These will be discussed in some detail here. Other influences, such as stock exchange listing requirements, are briefly discussed later in this chapter. We begin by discussing the smallest and most common form of business organisation: the sole trader.

The sole trader

A one-owner business is a common form of business organisation, and is simple to set up. All that is required is a business bank account. Because it is so simple and because it has no recognition in law, there are no formal guidelines for the format of the accounts. The fact that the business and the owner are not seen as separate legal entities can be a problem if the business gets into difficulties: the owner is liable for all the debts of the business and might have to sell personal possessions, such as the family home, to meet them. In addition, this form of organisation relies heavily on the owner for finance and this can cause problems if the business expands. Owners tend to have limited funds at their disposal. These problems can be alleviated or solved by, for example, introducing a partner into the business. Alternatively, the owner may set up a company, which limits his or her liability.

Financial statements of a sole trader

A sole trader is not required to prepare all four financial statements but if the business did prepare a profit or loss statement and a balance sheet, the following **Tables 2.1** and **2.2** are examples of how they might look.

Table 2.1

Phil's Business
Profit and loss statement for the year ending 30 June 20X9

	$	$
Sales		45 000
Cost of goods sold		31 000
Gross profit		14 000
Rent	1 200	
Van expenses	1 000	
Van depreciation	1 000	3 200
Profit for the year		10 800

Table 2.2

Phil's business **Balance sheet as at 30 June 20X9**				
	$	$	$	$
Assets				
Current assets				
Cash	14 500			
Prepaid	300			
Inventory	4 000			
Total current assets		18 800		
Non-current assets				
Van (at cost)	5 000			
Less Accumulated depreciation	(1 000)			
Total non-current assets		4 000		
Total assets			22 800	
Liabilities				
Current liabilities				
Accounts payable	2 000			
Total current liabilities		2 000		
Non-current liabilities	NIL	NIL		
Total liabilities			2 000	
Net assets				20 800
Equity				
Capital	10 000			
Profit and loss	10 800			
Total equity				20 800

Partnerships

A partnership is a relationship that exists between two or more people to carry on a business in common with a view to profit. As an organisation, a partnership offers certain advantages and disadvantages compared to the sole trader. A partnership is not regarded as a legal entity separate from the partners who comprise it.

Advantages

The advantages of forming a partnership include the following.

» *Ease of formation*. A partnership can be easily formed between two or more persons: all they have to do is agree to form a partnership. The partnership agreement is usually in writing, although a verbal agreement can be sufficient to constitute a partnership.

» *Limited rules and regulations*. Unlike a company, a partnership is not subject to the requirements of the *Corporations Act*. The partners are not required to prepare financial statements which comply with

accounting standards unless the partnership is a reporting entity. Therefore, the partnership only prepares an income statement and not a statement of profit or loss and other comprehensive income.

» *Provision of capital and expertise*. A partnership is often formed to raise more capital than is possible for a sole trader. It may also be formed to bring together the different skills of the partners; for example, an accountant and an engineer.

» *Income tax*. There may be income tax advantages in forming a partnership since it is not a separate legal entity. A partnership is not taxed, as is the case for a company. However, the individual partners pay income tax on their share of partnership profits.

Disadvantages

Disadvantages of the partnership form of organisation include the following.

» *Limited life*. A partnership can end at any time through, for example, the death of a partner, withdrawal of a partner, bankruptcy of a partner, incapacity of a partner or admission of a new partner. However, the end of the partnership does not signify the end of the partnership business: it may continue under a new partnership for many years.

» *Unlimited liability*. As each partner is personally liable for all debts of the partnership, there is unlimited liability with all partnerships. Partners in accounting firms normally purchase professional indemnity insurance because of this risk.

» *Mutual agency*. As each partner is an agent of the partnership, he or she has the authority to enter contracts on behalf of the partnership provided such contracts are within the scope of normal operations.

Financial statements of a partnership

A partnership is not likely to prepare all four financial statements as most partnerships are not required to, hence they also have a great deal of flexibility in how they prepare their financial statements. Let us now look at a profit or loss statement and a balance sheet for a partnership (**Table 2.3**).

Table 2.3

ADAM & SMITH Partnership
Profit or loss statement for the year ended 30 June 20X9

	$	$
Sales		100 000
Cost of goods sold		60 000
Gross profit		40 000
Expenses		20 000
Profit		20 000
Distributions		
Salary		
Adam	6 000	
Smith	4 000	10 000
		10 000
Profit share		
Adam	5 000	
Smith	5 000	10 000

A comparison of the profit and loss statement of the sole trader, Phil, with that of the partnership reveals that the main difference is the distribution statements for the partnership. This statement shows that Adam and Smith were each paid a salary for services provided to the partnership, and the remaining profit was then shared equally (see **Table 2.4**).

StockLite/Shutterstock.com

Table 2.4

ADAM & SMITH Partnership
Balance sheet at 30 June 20X9

	$	$	$	$
Assets				
Current assets				
Cash	10 000			
Inventory	10 000			
Total current assets		20 000		
Non-current assets				
Land and building	100 000			
Total non-current assets		100 000		
Total assets			120 000	
Liabilities				
Current liabilities				
Accounts payable	20 000			
Total current liabilities		20 000		
Non-current liabilities	NIL	NIL		
Total liabilities			20 000	
Net assets				100 000
Partners' equity				
Capital accounts				
Adam	40 000			
Smith	40 000			
Total capital accounts		80 000		
Current accounts				
Adam	11 000			
Smith	9 000			
Total current accounts		20 000		
Total partners' equity				100 000

account
(Chapter 2) A device used to provide a record of increases and decreases in each item that appears in a firm's financial statements.

A comparison of the balance sheet of Phil the sole trader with that of Adam and Smith reveals a difference in the equity part of the statements. The balance sheet for the partnership shows a balance for each partner under the headings of capital and current accounts. The current **account** reveals the partners' entitlement to profit, salary, interest, drawings and other, more short-term transactions. The capital account records the capital contributed by the partners. As current and capital items might be treated differently for legal purposes, it is useful to record them separately in the accounts.

Companies

Unlike the partnership and the sole trader, a company is recognised as a separate legal entity quite distinct from its owners. The debts incurred in the normal course of business are those of the company. In the case of a default in payment, it is the company that is sued rather than the owner. The fact that the owners might also be the managers and the only employees is irrelevant: in the eyes of the law all these roles are different.

Companies can be:

- private (proprietary)
  - limited by shares
  - unlimited with share capital
- public
  - limited by shares
  - limited by guarantee
  - unlimited with share capital
  - no liability.

Limited-by-shares companies

This class of company restricts the liability of members (shareholders) to a specified amount. For a limited company, the shareholders' liability is restricted to the amount paid for the share. Limited-by-shares companies include those found in the following list.

- *Proprietary companies or private companies*. These must have a minimum of one shareholder and normally have a maximum of 50 shareholders. A proprietary company must have the word 'Proprietary' or 'Pty' before the word 'Limited' or 'Ltd' as part of its name. These companies are often family companies and have fewer legal formalities than public companies, but they are unable to approach the general public to raise money.
- *Small or large proprietary companies*. A small proprietary company is one that meets at least two of the following criteria:
  - sales of less than $25 million
  - assets of less than $12.5 million
  - fewer than 50 employees.

  A small proprietary company does not generally have to prepare audited financial statements. All other proprietary companies are large and are required to lodge audited financial statements with the Australian Securities and Investments Commission (ASIC), unless granted an exemption.
- *Public companies*. A public company must have at least 50 non-employee shareholders and there is no maximum number for its shareholders. Usually, ownership of these companies is widespread. A public company can invite the public to subscribe to its shares or **debentures** and can be listed, which means that its shares are traded on a stock exchange, or unlisted. A public company must have the word 'Limited' or 'Ltd' as part of its name and is subject to many more rules and restrictions under the *Corporations Act* than are proprietary companies.

debentures
(Chapters 2 and 9) The term given to a secured transferable loan instrument that can be listed on the stock exchange. Debentures can be secured over specific assets, or by way of a floating charge over all assets.

Companies limited by guarantee

Companies that are limited by guarantee are public companies whose shareholders undertake to provide a guaranteed amount of money in the event of the company being liquidated. This type of company does not have share capital and, as such, does not raise initial capital. It is not, therefore, suitable for trading purposes. This form of company is often used for sporting clubs and not-for-profit charitable organisations.

Unlimited liability companies

Shareholders of an unlimited liability company are liable for all the debts of the company. For this reason such companies are not common in Australia, although some mutual funds are organised in this way. An advantage of this type of company is that there are no restrictions on the return of capital to shareholders.

No-liability companies

This category is restricted to mining companies. The words 'No Liability' or 'NL' must be part of the company's name. Shareholders in these companies are not required to contribute the unpaid value of shares if the company is liquidated.

Advantages of companies

The advantages of the company form of organisation are:

- *limited liability*: shareholders are liable only for the value of their shares
- *more capital*: a company has the potential to raise substantial amounts of capital, which is not possible for sole traders or partnerships
- *ease of transfer of ownership*: shareholders can buy and sell shares without affecting the operations of the company
- *no mutual agency*: shareholders cannot enter into contracts that would bind the company
- *professional management*: a company is managed by a **board of directors** and a managing director, while the shareholders maintain ownership. It is therefore possible to hire the best managerial talent available
- *continuous existence*: a company has an indefinite life and does not cease to function each time a shareholder sells shares, dies or goes bankrupt
- *separate legal entity*: unlike a sole trader or a partnership, a company is a separate legal entity. Therefore it can buy and sell property, sue and be sued, enter into contracts, hire and dismiss employees, be responsible for its debts and pay tax.

board of directors
(Chapter 2) The board is an important corporate governance mechanism. Its role is to represent shareholders and create value for shareholders.

Disadvantages of companies

Disadvantages of the company structure include the following.

- *Taxation*. A company is a separate legal entity and is required to pay company tax, which is not the case for a sole trader or a partnership. However, provided shareholders receive their profits as **franked dividends**, the taxing of companies might not be a significant disadvantage, and, depending on income levels, could be an advantage.
- *Regulation*. A company is subject to more government intervention in the form of rules and regulations. This is particularly true for public companies. For example, they are required to produce accounts annually and to have them audited by a recognised firm of auditors, which can be expensive. A copy of the audited accounts must be lodged with ASIC, where it is available for inspection by the public. The form of these accounts is also subject to the *Corporations Act*, which requires that a company's

franked dividends
(Chapter 2) Dividends paid by a company which have been subject to company taxation.

directors' report *(Chapter 2)* A report required by the *Corporations Act 2001*, prepared by a company's directors and included with the company's financial statements, providing information including the directors' names, activities of the company, profit or loss for the year, amount of dividends, review of operations and many other matters in relation to the company.

auditor's report *(Chapter 2)* A report required by the *Corporations Act 2001*, prepared by an auditor and included with a company's financial statements, stating whether the company's financial statements comply with the requirements of the *Corporations Act*, whether they provide a true and fair view of the state of affairs of the company, and whether they are in accordance with applicable accounting standards.

directors' statement/declaration *(Chapter 2)* A statement required by the *Corporations Act 2001*, signed by at least two directors and included with a company's financial statements, outlining whether, in their opinion, the income statement and the balance sheet present a true and fair view, whether the company will be able to pay its debts as they fall due, and whether the financial statements comply with applicable accounting standards.

accounts should consist of the company's balance sheet, the company's statement of profit or loss and other comprehensive income (or statements of profit or loss and comprehensive income), the **directors' report**, the **auditor's report** and a **directors' statement**. In addition to these general requirements, there are detailed requirements, particularly in accounting standards, covering the content of the actual accounts. Such requirements are more onerous for companies that are required to prepare general-purpose financial reports.

» *Limited liability*. While generally an advantage, it may be a disadvantage for a small company if its ability to borrow money is restricted by the fact that its members have limited liability.

» *Separation of ownership and control*. This can also act as an advantage or a disadvantage. Managers might have incentives to make decisions that are not in the best interests of all shareholders. The *Corporations Act* contains provisions intended to discourage managers from behaving in this manner.

Stop and think 1

Explain the differences between a partnership and a company. Under what circumstances would you expect either to be used?

Worked example 2.1: Financial statements of a private company

Unlike the sole trader or a partnership, a large private and all public companies are required to prepare all four financial statements, and many companies like Woolworths must also comply with all accounting standards. We only illustrate the statement of profit or loss and other comprehensive income and the balance sheet.

Jack Pty Ltd
Statement of profit or loss and other comprehensive income for the year ending 30 June 20X9

	Notes	20X9		20X8	
		$000	$000	$000	$000
Sales	1		60 000		45 000
Cost of sales			40 000		30 000
Gross profit			20 000		15 000
Distribution costs	2	3 000		2 500	
Administration costs	2	11 000	14 000	9 000	11 500
Profit before taxation			6 000		3 500
Taxation	3		2 600		1 400
Profit after taxation			3 400		2 100
Other comprehensive income					
Unrealised gain (loss) on revaluation of properties			15 000		6 000
Total comprehensive income for the year			18 400		8 100

Jack Pty Ltd
Balance sheet at 30 June 20X9

	Notes	20X9	20X8
		$000	$000
Assets			
Current assets			
Cash at bank		3 500	2 000
Debtors		11 000	4 000
Inventory	7	10 000	7 000
Total current assets		24 500	13 000
Non-current assets			
Equipment	5	10 000	11 000
Land and buildings	6	70 000	56 000
Total non-current assets		80 000	67 000
Total assets		104 500	80 000
Liabilities			
Current liabilities			
Creditors		4 000	3 000
Taxation	3	2 600	1 400
Dividends	4	1 600	1 100
Total current liabilities		8 200	5 500
Non-current liabilities			
Total liabilities		8 200	5 500
Net assets		96 300	74 500
Capital and reserves			
Share capital	8	70 000	64 000
Retained profits	9	5 300	4 500
Reserves	10	21 000	6 000
Total capital and reserves			74 500

Clearly, to go through these requirements in great detail is outside the scope of an introductory text. Instead we have included in the previous section the statement of profit or loss and other comprehensive income and a balance sheet for Jack Pty Ltd, a private company. (The financial statements for Woolworths, a publicly listed company, are in Appendix 1.) The financial statement highlights areas of difference between the accounts of the limited company and those of the other forms of organisation considered (see the accounts for Phil's business on pages 30–31 and Adam and Smith's partnership on pages 32–33).

Statement of profit or loss and other comprehensive income

The first difference is in the title of the statement: the fact that Jack is a proprietary limited company must be stated, and the new title does this. In addition, the statement contains comparative figures for the previous year, as well as references to a number of notes. These notes contain greater detail than can be shown on the face of the statement, and so are an integral part of the analysis of the accounts of a company. This will be discussed in more detail in Chapter 10. We can see that down to 'Gross profit' the format is familiar. However, we then find that expenses are classified into broad categories. These categories are laid down in AASB 101 *Presentation of Financial Statements*. The other difference is that the statement is called a statement of profit or loss and other comprehensive income. We discuss statements of financial performance in detail in Chapter 6.

It is from the point at which the profit is shown that the real differences arise. The most striking of these is that taxation is included in the statement of profit or loss and other comprehensive income. This is because the company is recognised as a separate entity for legal and tax purposes and its profits are liable to company tax. In contrast, the sole trader and the partnership are not separate legal or taxable entities: their profits are not taxed as such, but only as they form part of the income of the owner.

Balance sheet

We now look at the balance sheet of a proprietary limited liability company and the differences that arise.

The format uses the current/non-current classification. AASB 101 allows companies to choose an alternative format in which assets and liabilities are listed in order of liquidity. Most banks list assets and liabilities in order of liquidity and do not use the current/non-current classification. We discuss balance sheets in detail in Chapter 5.

As you can see, the top part of the balance sheet is similar to those we have encountered before, except for the inclusion of dividends and taxation and the fact that a lot of the detail is included in the notes to the statements. For example, Note 6 would contain details of non-current assets bought and sold during the year, as well as the depreciation to date, and that charged during the year.

The lower part of the balance sheet is somewhat different in that the owners' equity is referred to as share capital. This might consist of different types, each carrying different voting rights, and so on. This would only be apparent if we looked at the detail contained in the notes. Similarly, there may be different types of **reserves**, such as a revaluation reserve for revalued assets such as land and buildings. Jack has a revaluation reserve and more details are provided in the statement of changes in equity.

reserves
(Chapter 2) Amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist at the date of the balance sheet. Reserves do not equal cash.

controlled entity
(Chapter 2) An entity which is controlled by a parent entity.

LO 2.2
Identify the main characteristics of the financial statements of a public company and the role and meaning of consolidated financial statements.

2.2 Financial statements for a public company

The statements presented for Jack Pty Ltd above are for a private company and are simpler than those for a public company. Woolworths is a public company and its financial statements illustrate the usual format of each statement. Refer to the Woolworths financial report in Appendix 1. Note that the statements are headed 'consolidated'.

Most major companies, such as Woolworths, operate in a parent–subsidiary (or **controlled entity**) relationship for a variety of reasons. In fact, such companies often control many companies. For example, Woolworths has over 70 wholly owned subsidiaries, including Cellarmasters and Safeway.

Consolidated financial statements report the results and financial position of the combination of the **parent entity** and the other entities it controls. The preparation of these accounts is called consolidation, and the terms '**group**' and 'consolidated' accounts are used and are interchangeable. In these accounts, the parent entity and its controlled entities are grouped to constitute an economic entity. It does not have the status of being a legal entity; it does not have the legal rights and obligations of a company. The following figure illustrates some of the many different business structures that exist.

parent entity
(Chapter 2) One which controls another entity.

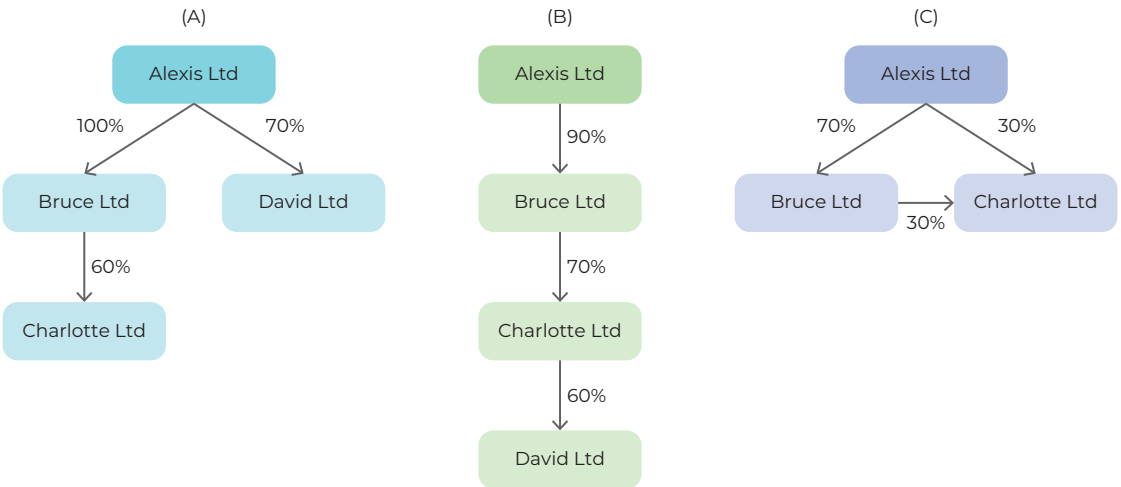

Figure 2.1
Alternative company structures

In the **Figure 2.1** (where the percentages represent ownership of voting ordinary shares) each of the three structures represent a group, with Alexis Ltd the parent in each group. In the first group, Alexis owns all the shares in Bruce Ltd, 70 per cent of the shares in David Ltd and so controls Bruce and David. Alexis Ltd also controls Charlotte Ltd as Alexis Ltd can direct Bruce Ltd on how to vote in the affairs of Charlotte Ltd. Hence, Alexis Ltd does not own any shares in Charlotte Ltd but has control. The middle structure is also a group with Alexis Ltd the ultimate parent as Alexis controls Bruce which in turn controls Charlotte which in turn controls David. The final structure is also a group with Alexis Ltd controlling both Bruce Ltd and Charlotte Ltd. Alexis has 30 per cent of the shares in Charlotte Ltd and can control how Bruce Ltd votes with its 40 per cent shares and so Alexis Ltd effectively controls 70 per cent of the voting shares in Charlotte Ltd.

group
(Chapter 2) The term applied to a parent company and its controlled entities for which consolidated financial statements are prepared. The group is an economic entity and not a legal entity.

The purpose of consolidated financial statements is to give a view of the parent entity and its controlled entities as if they were one entity – the economic entity – so that, on the balance sheet, the accounts receivable represent the customers of the parent entity and all its controlled entities. Similarly, the consolidated statement of profit or loss and other comprehensive income shows total revenue from sales made by the parent entity and all its controlled entities. In preparing consolidated financial statements, similar accounts from the individual statements of the parent entity and its controlled entities are combined. However, some accounts result from transactions between the parent entity and a controlled entity. If consolidated financial statements are to represent the position and results of an economic entity as a whole, then any transactions between members within the economic entity must be eliminated.

Consolidated financial statements are useful to the management and shareholders of the parent entity in judging how well the parent has achieved its goals. They are also critical in reporting the financial position of the economic entity. For example, the collapse of Enron revealed billions of dollars in debt hidden in 'special purpose entities'. It is important that users are fully aware of all the debts of an entity

when assessing issues like solvency and the 'going concern' test. The collapse of Enron also caused losses for many employees who may have made different decisions about investing in the company they worked for had they been aware of its level of debt.

The consolidated financial statements are prepared by combining similar accounts from the separate statements of the parent entity and its controlled entities after elimination of all transactions between members of the economic entity.

In many cases, a parent entity owns 100 per cent of all its subsidiaries. However, there are also many instances when a parent entity will own enough to gain control of another entity, but not 100 per cent. For example, if a parent only owns 90 per cent of a controlled entity it means that other shareholders own 10 per cent of the shares in that controlled entity. Such shareholders are described as non-controlling interest' in accounting standards as they are shareholders outside the shareholders of the parent entity. Non-controlling interests are reported in consolidated financial statements based on their interest in the relevant controlled entity or subsidiary. For example, in the above case the non-controlling shareholders represent 10 per cent of the net assets of the controlled entity at balance date. The non-controlling interest is also entitled to 10 per cent of the profit/loss of the controlled entity for the period. Non-controlling interest is not a liability in the consolidated statements but represents part of the equity of the net assets of the economic entity.

Key concept 2.1 : Consolidated financial statements

Consolidated financial statements provide information about the performance, financial position and cash flows of an economic entity.

An examination of the Woolworths financial report shows that all the statements have the word 'consolidated' in the title representing the economic entity of Woolworths Limited and all its subsidiaries as listed in the annual report.

An examination of Note 5.4 of the Woolworths financial statements (available at www.woolworthslimited.com.au) reveals information for the parent entity Woolworths Limited. This information would only be of use to users like creditors and lenders who deal with the parent entity, and the accounts show these are not large items.

Lenders to Cellarmaster Wines Pty Ltd have a claim against Cellarmaster, even though it is a 100 per cent controlled entity of Woolworths Limited. However, the existence of a cross guarantee of the debts of Cellarmaster as detailed in the Woolworths accounts means such creditors are interested in the financial position of the Woolworths group as revealed in the consolidated statements.

Not-for-profit entities (NFPEs) operate in many areas in our society, including education, health, community services, leisure, religion and charities. The aim of a NFPE is to use its resources in an efficient manner to best achieve the objectives for which it was formed, rather than pursuing a profit for its owner(s).

In this book we concentrate on accounting from the viewpoint of private sector, for-profit companies. However, much of what is covered in the book is also relevant for entities in the not-for-profit (NFP) sector. In some chapters we also include examples from the NFP and public sectors. The remainder of this chapter examines the various influences that affect the preparation of financial reports for companies. The factors that may influence and regulate the preparation of the financial statements for most companies are accounting standards, accounting concepts and the *Corporations Act*. The Securities Exchange Listing Rules impose additional reporting obligations for listed public companies.

2.3 The framework for setting accounting standards

LO 2.3

Explain the current framework for standard setting in Australia and the influence of accounting standards, the *Corporations Act 2001* and the Australian Securities Exchange Listing Rules on financial reporting requirements.

Accounting standards have a major influence on the financial statements that companies must prepare. The **Australian Accounting Standards Board (AASB)** sets accounting standards that must be applied in all **general-purpose financial statements** for both the private and public sectors in Australia. Australia has sector-neutral accounting standards, which means there is only one set of accounting standards for both the for-profit and not-for-profit sectors. We will talk more about this later.

Financial Reporting Council

The standard-setting arrangements also involve the Financial Reporting Council (FRC) which has oversight responsibility for the AASB and the Auditing and Assurance Standards Board (AUASB). There are eight members of the FRC (plus the chairperson) comprising key stakeholders from professional accounting bodies, the business community, government and regulatory agencies such as the Australian Securities and Investments Commission (ASIC). Members are appointed by the federal Treasurer.

Australian Accounting Standards Board

There are 11 members of the AASB, including a full-time chairperson. The AASB's responsibilities, as specified in section 227(1) of the *Australian Securities and Investments Commission Act 2001*, include the following:

- to develop a **conceptual framework**, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards
- to develop and issue accounting standards that have the force of law
- to formulate accounting standards for other purposes
- to participate in, and contribute to the development of a single set of accounting standards for worldwide use.

The AASB follows **due process** in the development of accounting standards and holds in public all meetings that relate to technical matters. The AASB has its own dedicated technical staff responsible for the preparation of papers for the AASB to consider as it develops accounting standards.

Compliance with accounting standards

In accordance with the *Corporations Act*, compliance with the accounting standards and interpretations issued by the AASB is mandatory for all companies preparing general-purpose financial statements. Other jurisdictions such as state governments may also adopt AASB standards and make compliance with such standards mandatory. The Australian Securities and Investments Commission (ASIC) is responsible for enforcing compliance with the *Corporations Act*.

The political nature of accounting standard setting

In Chapter 1 we discussed the choice of accounting policies and their economic consequences. The standard-setting body selects accounting standards based on the objective of providing useful information to the

AASB (Australian Accounting Standards Board)
(Chapter 2) The body responsible for setting accounting standards in Australia.

general-purpose financial statements (GPFS)
(Chapter 2) The set of financial statements according to AASB 101 intended to meet the information needs that are common to users who are unable to command the preparation of financial statements so as to satisfy, specifically, all of their needs.

conceptual framework
(Chapter 2) A set of interrelated concepts which define the nature, subject, purpose and broad content of general-purpose financial statements.

due process
(Chapter 2) The process designed to allow all interested parties maximum opportunity to comment on proposed accounting standards.

users of financial statements. Managers, however, may choose accounting policies based on the economic consequences for themselves and their organisations.

The due process used by the AASB provides managers with an opportunity to lobby the standard setters. They can attempt to influence its deliberations, particularly with reference to standards that are relevant to their company. The Group of 100 is an association of the chief financial managers from Australia's 100 largest companies. The group is active in making submissions to the standard setters. The decision by the FRC that forced the AASB to adopt International Financial Reporting Standards means that Australians who want to influence the standard-setting process now need to influence the deliberations of the IASB. Given the size of the Australian capital market, this is a difficult task.

The Group of 100's agenda for lobbying the standard setters may be to ensure that financial statements provide useful information. Alternatively, its reasons could be motivated by contracts like bonuses for senior management that are dependent upon achieving certain accounting numbers, as discussed in Chapter 1.

In any event, this interest in the standard-setting process means that standard-setting bodies have to achieve their stated objectives within a process that is quite political.

International Accounting Standards

The International Accounting Standards Board (IASB) consists of members from a number of countries. It is based in London and began operations in January 2002, replacing the International Accounting Standards Committee (IASC). All standards issued by this board prior to 2002 are referred to as International Accounting Standards (IAS). All new standards issued by the IASB from January 2002 are called International Financial Reporting Standards (IFRS).

The term 'International Financial Reporting Standards' includes:

- **International Financial Reporting Standards**
- **International Accounting Standards**
- interpretations issued by the International Financial Reporting Interpretations Committee or the former Standing Interpretations Committee.

International Financial Reporting Standards *(Chapter 2)* Standards issued by the IASB from January 2002. An IFRS includes all new IFRSs, previously issued IASs and interpretations of these standards.

International Accounting Standards *(Chapter 2)* Standards issued by the IASB prior to January 2002.

The mission of the IASB is to 'develop in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general-purpose financial statements (GPFS)'. The 15 board members are selected on their technical skills and accounting knowledge rather than on country or regional representation. One of the members, Professor Anne Tarca, joined the Board from the University of Western Australia. Anne is only the second Australian to join the IASB.

Although such standards do not override national standards, the IASB hopes that its activities will result in more uniform worldwide accounting standards. Where a country does not have a standard-setting authority, it can adopt the IAS (IFRS). From 1 January 2005, Australia adopted the IFRS. As a result, Australia has now issued all IASB standards, but only after subjecting them to due process. The impact of this decision means that Australia is now locked into IFRS and any changes that the IASB makes to IFRS must be replicated in Australia.

To allow users to distinguish the previous IAS from new IFRS, the following numbering system has been adopted by the AASB.

- AASB 1 = IFRS 1, AASB 2 = IFRS 2, so the same number applies to the new standards issued by the IASB
- AASB 101 = IAS 1, AASB 102 = IAS 2, so the original number of the IAS plus 100 allows users to identify AASB standards that are equivalent to IASC standards.

The same numbering policy applies to the adoption of Interpretations of IFRS and IAS for application in Australia.

In addition, some original Australian accounting standards like AASB 1051 *Land Under Roads* have been retained for use because there is no equivalent IFRS or IAS. These standards are identified with numbering from 1000. It is estimated that in 2013 over 150 countries were using IFRS in some ways. There is a view that international harmonisation of accounting standards will facilitate the flow of capital across national borders. This has potential benefits for investors and for companies wishing to list their shares in other countries.

reporting entities (*Chapter 2*) Entities (including economic entities) for which there are users who rely on the financial statements as their major source of financial information about the entity. (AASB *Framework*, para 8)
2) A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.(IASB Conceptual Framework para 3.10)

The Corporations Act

It is not our intention in this section to cover the requirements of the *Corporations Act 2001* in detail. They are dealt with in courses on company law and company accounting.

Most companies are required to prepare financial statements in accordance with applicable accounting standards. These statements must show a true and fair view of the company's financial position and results for the period. Compliance with applicable accounting standards issued by the AASB is mandatory for all companies that are **reporting entities** under section 298 of the *Corporations Act 2001*.

The *Corporations Act 2001* also requires the following to be included with a company's financial statements:

» the directors' report
» the directors' statement
» the auditor's report.

See **Table 2.5** below for more information.

Table 2.5

Corporations Act requirements	
Statement/report	**Content**
The directors' report	The directors' report must include information such as directors' names, activities of the company, profit or loss for the year, amount of dividends, review of operations and other matters in relation to the company.
The directors' statement	The directors' statement, or declaration, states whether, in the opinion of the directors: • *the FINANCIAL statements present a true and fair view* • *the company is able to pay its debts as they fall due* • *the financial statements comply with accounting standards and the Corporations Act 2001.* The reference to the ability of the company to pay its debts is an important statement about the solvency of the company and is clearly intended to reassure users such as employees, shareholders, creditors and lenders. There have been cases where directors of companies have been found guilty of making this statement when the company could not in fact pay its debts.
The auditor's report	The auditor's report is prepared by an external auditor and is meant to reassure shareholders that they can rely on the financial statements prepared by the company. The auditor is required to form an opinion about the financial statements. The auditor's report must state whether the financial statements: • *comply with the requirements of the* Corporations Act • *provide a true and fair view of the state of affairs of the company* • *are in accordance with applicable accounting standards.*


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Securities exchange influence on financial reporting

Public companies in Australia that have their shares listed on a securities exchange must comply with the listing requirements of the ASX.

The Listing Rules impose additional requirements on listed companies. These rules require companies to provide:

- half-yearly reports
- a preliminary final statement
- additional details to the annual report
- additional details for mining exploration companies.

If companies do not comply with these they are likely to be delisted, so that their shares can no longer be traded on a securities exchange.

LO 2.4

Explain what is meant by, and the role of, a conceptual framework and explain the major concepts.

2.4 The conceptual framework

Accounting standards, the *Corporations Act* and the Australian Securities Exchange Listing Rules impose certain requirements on, and provide guidance for, companies as they prepare their financial statements. Public sector and NFP entities may also need to comply with legislative requirements or Treasurer's Instructions. However, not all accounting transactions can be specifically dealt with in an accounting standard, or the law, or in the Listing Rules. Accounting standards establish procedures on how to account for certain transactions and events, as well as providing detailed disclosure requirements. For example, cash flow statements must be prepared in accordance with AASB 107 *Statement of Cash Flows*.

A conceptual framework is an attempt to develop some basic concepts of accounting to help accountants determine how transactions should be accounted for when there are no accounting standards. As we indicated in Chapter 1, the preparation of financial statements involves many decisions about how to record transactions. To assist with this process, rule-making or standard-setting bodies have been established in most Western countries – in Australia this is the AASB. Standard-setting bodies are responsible for developing standards (rules) that help accountants to record transactions that could be described as difficult.

One might expect standards to be based on an underlying theory, but in practice they were determined on an ad hoc basis until the late 1980s. In recent years, standard-setting bodies have been concerned with developing a conceptual framework to provide the theory from which accounting standards can then be developed. For example, in 1978 the Financial Accounting Standards Board (FASB) in the USA defined the conceptual framework as:

> a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function and limits of financial accounting and reporting.

The IASB revised the IASB *Conceptual Framework for Financial Reporting*, which states in SP 1.1 it is to:

> (a) assist the International Accounting Standards Board (Board) to develop IFRS Standards (Standards) that are based on consistent concepts;

(b) assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy; and
(c) assist all parties to understand and interpret the Standards.

In Australia, the due process followed for developing accounting concepts was the same as that followed for accounting standards. Four Statements of Accounting Concepts (SACs) were issued in Australia from 1990 to 1995. Because Australia issues accounting standards based on IFRS, the AASB adopted the IASB *Framework* for the preparation and presentation of financial statements, which was first issued in 1989. However, it retained SAC 1 *Definition of the Reporting Entity* because the IASB *Framework* did not deal adequately with the definition and recognition of a reporting entity. In March 2018, the IASB issued a *Revised Conceptual Framework for Financial Reporting* (RCF), which the AASB is expected to also issue in 2019 (the time of writing). The RCF is used in the 10th edition of this book. The AASB is currently reviewing the reporting entity concept, and one option favoured by the AASB would see the removal of SAC 1. We discuss this further later in the chapter. Members of the accounting profession in Australia must comply with accounting standards under the Accounting Professional and Ethical Standards (APES) 205 *Conformity with Accounting Standards*. Even though the RCF is not mandatory like accounting standards, the Framework is listed in AASB 108 *Accounting Policies*, *Changes in Accounting Estimates and Errors* as relevant in accounting policy choice and therefore has some legal status.

Key concept 2.2: The Conceptual Framework

The *Conceptual Framework for Financial Reporting*
(a) assist the International Accounting Standards Board (Board) to develop IFRS Standards (Standards) that are based on consistent concepts;
(b) assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy; and
(c) assist all parties to understand and interpret the Standards

Key concept 2.3: General-Purpose Financial Report (GPFR)

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:
(a) buying, selling or holding equity and debt instruments;
(b) providing or settling loans and other forms of credit; or
(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

Key concept 2.4: General-Purpose Financial Statements (GPFS)

GPFS include:
- a statement of profit or loss and other comprehensive income for the period
- a statement of financial position or balance sheet at the end of a period
- a statement of changes in equity for the period
- a statement of cash flows for the period
- notes to the financial statements.
- comparative information in respect of the preceding period

Therefore, the *Conceptual Framework* attempts to establish concepts or ideas that determine how financial reports are prepared for general users. It is an attempt to establish the foundations for the preparation of general-purpose financial reports. Basic questions such as those in the following list are addressed.
- What entities should prepare general-purpose financial reports?
- Who are the users of general-purpose financial reports?
- What are assets, liabilities, income, expenses and equity?
- How should these items be measured and displayed?

In the following sections of this chapter we examine the RCF and its development. The definitions of 'assets', 'liabilities', 'income', 'expenses' and 'equity' used throughout this book are also explained.

Objectives of a conceptual framework

Why develop a conceptual framework? In this section we briefly discuss some of the possible reasons for standard-setting bodies expending considerable time and resources on developing a conceptual framework (see **Table 2.6**).

standards overload *(Chapter 2)* A problem concerned with the time and costs involved in preparing general-purpose financial reports which must comply with a large number of accounting standards.

Table 2.6

Why the need for a conceptual framework?

Reason	Explanation
Fewer accounting standards	A conceptual framework enables the resolution of accounting problems without the need to issue an accounting standard every time an issue arises. This should result in fewer accounting standards and help to minimise what some see as the problem of '**standards overload**' associated with preparing general-purpose financial reports that must comply with a large number of accounting standards.
More consistency	Some new accounting standards will still be required. However, because they will all conform to the framework, there will be greater consistency.
Improved communication	The various conceptual framework projects have already led to improved communication among accountants and between the standard-setting bodies and their constituents. All parties are now using common definitions for items such as assets, liabilities, income, expenses and equity.
Defence against politicisation	A set of concise and well-defined concepts should enhance the credibility of financial reporting and enable the standard-setting bodies to defend particular accounting standards on the basis that they are consistent with the appropriate framework. The setting of accounting standards will always be a political process to some extent. However, a conceptual framework should reduce the ability of lobby groups to influence the standard-setting process to achieve objectives that are not in the public interest.

The Revised Conceptual Framework

In the next few sections we highlight major concepts from the RCF with regard to private-sector for-profit entities. You should be aware that these concepts also apply to public sector and not-for-profit entities. We use many of these concepts throughout this book.

Definition of the reporting entity

In Australia, SAC 1 deals with the issue of defining a reporting entity. As previously mentioned, the reporting entity concept is being reviewed by the AASB. From 1 January 2020 it will no longer apply to for-profit private sector entities. For these entities the definition will be the one in the RCF issued by the IASB in 2018 and included in Key Concept 2.5. At the time of preparing this 10th edition, the status of SAC 1 for not-for-profit and public sector entities had not been resolved by the AASB and so we provide both definitions in Key Concept 2.5.

Key concept 2.5: Reporting entity

SAC 1

Reporting entities are entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general-purpose financial reports for information that will be useful to them for making and evaluating decisions about the allocation of scarce resources.

(AASB *Conceptual Framework* SAC 1, 1990 para. 40)

Revised Conceptual Framework (RCF)

A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

(IASB *Conceptual Framework for Financial Reporting* 2018, para. 3.10)

There are many existing and potential investors, lenders and other creditors who cannot demand information from entities and so they rely upon general-purpose financial reports for financial information as stated in the SAC 1 definition. Of course, they would use more than general-purpose financial reports when making decisions about investing in an entity, including the state of the economy, outlook for the industry and so on. Identifying users in the SAC 1 definition is therefore critical and is considered in the next section.

When an entity is identified as a reporting entity in Australia, it is currently required to prepare general-purpose financial reports in accordance with accounting standards. However, as stated earlier, from 1 January 2020, in the case of for-profit private sector entities, the determination of which entities should prepare general-purpose financial reports will be based on the requirement of relevant regulatory bodies. This will be based on **public accountability** and so, for example, the ASX requires all listed companies to prepare general-purpose financial reports. This approach would be consistent with the definition of reporting entity in the RCF.

public accountability (Chapter 2) Applies to for-profit entities that either issue shares or debt securities to the public, or hold assets in a fiduciary capacity like a bank.

Currently in Australia, if an entity is deemed not to be a reporting entity, it does not have to comply with accounting standards when preparing financial reports. It can, of course, choose to prepare general-purpose financial reports and under the IASB RCF this would make it a reporting entity. A small family business is not likely to be a reporting entity and is therefore not required to spend money on preparing detailed general-purpose financial reports. If Mum and Dad run the family business, they normally know how the business is performing and do not require general-purpose financial reports.

The objective of general-purpose financial reporting

General-purpose financial reporting provides financial information about the entity that existing and potential investors, lenders and other creditors can use to help them make decisions about providing resources to the entity. Those decisions could involve buying, selling or holding equity instruments, and providing or settling loans and other forms of credit. This is the objective as stated in paragraph 1.2 of Chapter 1 of the IASB RCF. The analysis of financial statements is considered in Chapter 10.

Key concept 2.6: Objective of general-purpose financial reporting

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity instruments and providing or settling loans and other forms of credit.

In order to achieve the objective, financial statements must be prepared assuming a going concern and on an accrual basis, not a cash basis. 'Accrual' refers to transactions being recognised when they occur and not when cash is paid or received. Under cash accounting the trigger for entry into the accounting records is the payment or receipt of cash. With accrual accounting the trigger is the provision or receipt of goods or services. This often occurs simultaneously, like buying food at a Woolworths store. Where goods are sold on credit, accrual accounting is used to record the transaction, not cash accounting. If a business purchases a machine with an expected life of 10 years, it is an expense in the year of acquisition in cash accounting. In accrual accounting the cost is spread over 10 years.

We use the following examples in **Tables 2.7** and **2.8** to illustrate the difference between cash and accrual accounting. XYZ Ltd purchases a lease (or builds a factory on leasehold land) for $100 000, which has five years to run. The lease generates net cash revenues of $35 000 per annum for XYZ. XYZ incurs no other expenses.

Table 2.7

The results if XYZ Ltd used cash accounting for years 1–5

Item	Year 1	Year 2	Year 3	Year 4	Year 5	5-year term
Cash revenue	$35 000	$35 000	$35 000	$35 000	$35 000	$175 000
Cash expenses	($100 000)	$0	$0	$0	$0	($100 000)
Profit/(Loss)	($65 000)	$35 000	$35 000	$35 000	$35 000	$75 000
Cumulative result	($65 000)	($30 000)	$5 000	$40 000	$75 000	$75 000

Table 2.8

The results if XYZ Ltd used accrual accounting for years 1–5

Details	Year 1	Year 2	Year 3	Year 4	Year 5	5-year term
Cash revenue	$35 000	$35 000	$35 000	$35 000	$35 000	$175 000
Accrual expenses	($20 000)	($20 000)	($20 000)	($20 000)	($20 000)	($100 000)
Profit/(Loss)	$15 000	$15 000	$15 000	$15 000	$15 000	$75 000
Cumulative result	$15 000	$30 000	$45 000	$60 000	$75 000	$75 000

Accrual accounting provides a better measure of performance (but not cash flow) as the $100 000 outlay at the beginning benefits all five years and this is how it should be reported.

Key concept 2.7: Accrual accounting

The method of accounting whereby **revenues** and expenses are identified within a specified period of time and are recorded as incurred, along with acquired assets, without regard to the date of receipt or payment of cash.

Key concept 2.8: Going concern

The assumption that the entity will continue to operate into the foreseeable future and is not in the process of liquidation. Financial statements are prepared on this basis.

revenues
(Chapter 2) Income arising in the course of an entity's ordinary activities. (AASB 15 appendix A)

123RF/zagandesign

Qualitative characteristics of financial information

What qualities should financial information possess to be included in general-purpose financial reports? Paragraph 2.4 of Chapter 2 of the IASB RCF states that: 'If financial information is to be useful it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.' The fundamental characteristics are *relevance* and *faithful representation*.

Financial information is *relevant* if it is capable of making a difference to a user's decision – whether it is actually used is irrelevant. Financial information can be capable of making a difference in two main ways. It may confirm what the user expected. For example, the Reserve Bank makes decisions about the cash interest rate in Australia on the first Tuesday of each month. Investors are always predicting what the decision might be ahead of the Reserve Board's announcement. When the actual announcement is made it either confirms market expectations or, on some occasions, is contrary to market expectations. The second way financial information can make a difference is when it has predictive value. For example, the movement in the Dow Jones Index in the USA is often a predictor of what is likely to happen to the Australian share market when it commences trading on the next day.

For financial information to *faithfully represent* what it purports to, it must be *complete*, *neutral* and *free from error*. *Complete* information means that all relevant financial information that users require to understand a transaction is available. *Neutral* information is presented without bias so that it is not slanted towards a particular view that the preparer would like the user to take. For example, when a football fan is explaining why an umpire's decision was not fair they are likely to explain the event in a biased manner. *Free from error* does not mean it is perfectly accurate but rather that there are no errors in describing the transaction or in the process used to present financial information about the transaction. For example, an estimate of the fair value of an asset will faithfully represent the value if the process used to obtain the estimate, such as assumptions used, are accurately described and the limitations made clear to users.

Information must be both *relevant* and *faithfully represented* if it is to be useful to users of general-purpose financial statements. Some information, such as forecasts of future profits, may be relevant but cannot be *faithfully* represented with an acceptable degree of reliability to be included in general-purpose financial reports. Conversely, some information may be *faithfully represented*, such as the historical cost of an asset 20 years ago, but is it of relevance to users? We look at different measurement attributes in Chapter 4 and should keep in mind the qualitative characteristics when considering the advantages and disadvantages of each attribute.

materiality test *(Chapter 2)* Assesses whether omission, misstatement or non-disclosure of an item of relevant and reliable information could affect decision making about the allocation of scarce resources by the users of the general-purpose financial reports of an entity.

In addition to being a *relevant* and *faithful* representation, information must also pass the **materiality test**. This means that the information is not likely to affect the user's decision adversely, is immaterial and need not be separately disclosed in the general-purpose financial report. In other words, we can ignore it for decision-making purposes.

The RCF also states that *comparability*, *verifiability*, *timeliness* and *understandability* are qualitative characteristics that enhance the usefulness of information that is *relevant* and *faithfully represented*. As we will see in Chapter 10, when analysing financial statements it is important for users to be able to *compare* the general-purpose financial statements of different entities. It is important that independent observers are able to *verify* that the information is a *faithful* representation of the transaction. General-purpose financial statements should be prepared on a *timely* basis. It is of no use to a punter in 2019 to be told which horse won the 2018 Melbourne Cup. The same applies to financial information about a reporting entity. However, for large organisations there is inevitably a delay of two to three months from the balance date until the release of the general-purpose financial statements. The information should be *understandable* to users who have a reasonable knowledge of accounting and who are prepared to diligently study the information in financial statements. Such a user is sometimes described as a 'sophisticated' user.

Key concept 2.9: Qualitative characteristics

General-purpose financial reports should provide all the financial information that is *relevant* and can be *faithfully represented* subject to the constraint that the benefits of providing the information exceed the costs of providing the information. The information is enhanced by *comparability, verifiability, timeliness* and *understandability*.

The RCF states that *relevant* and *faithfully represented* information should be disclosed to users subject to a cost/benefit constraint. The balance between benefits and costs is difficult and requires the exercise of judgement. The intent is that entities should not be required to provide information if the costs of providing the information are expected to exceed any benefits that may flow from the provision of such information. One of the problems is that often those who enjoy the benefits do not incur the costs. However, it is a general guide to standard setters that they should consider the costs and benefits to entities before imposing additional reporting obligations on them.

Financial statements should also report the substance and economic reality of a transaction and not merely its legal form. For example, A purports to sell an item to B but at the same time enters into an arrangement with B whereby A guarantees to purchase the item back from B in one month. Furthermore, A continues to use and enjoy the benefits from the item. The form of the transaction suggests a sale, but the substance of the arrangement is that A is borrowing money from B and using the item as collateral and no sale should be recognised by A. The objective of companies that enter into transactions of this type may be to increase reported profits and so mask underlying problems.

Traditionally, accountants have tended to overstate liabilities, understate assets, recognise **unrealised losses** and defer **unrealised gains**. This approach is known as **conservatism** and the RCF does not regard conservatism as a required or appropriate qualitative characteristic in deciding the type of information to be disclosed in general-purpose financial reports.

unrealised loss
(Chapter 2) A loss which is yet to be realised by way of a transaction. For example, a decrease in the value of an asset represents an unrealised loss until the asset is sold, at which time the loss would be realised.

unrealised gain
(Chapter 2) A gain which is yet to be realised by way of a transaction. For example, an increase in the value of an asset represents an unrealised gain until the asset is sold, at which time the gain would be realised.

conservatism
(Chapter 2) The concept of conservatism applies to the practice of understatement of income or assets and/or maximum recognition of expenses or liabilities.

Definition and recognition of the elements of financial statements

Definitions and recognition criteria for assets, liabilities, income, expenses and equity are found in Chapter 4 of the RCF. Each of these elements is discussed in turn and the definitions are identified as key concepts to be used in later chapters.

Assets

Before an item qualifies for inclusion in the financial statements (in this case the statement of financial position or balance sheet) it must not only meet the definition of an asset, but must also pass certain recognition criteria. *Recognition* is the process of assigning a monetary value to the financial statement element so it can be recorded in the relevant financial statement. Only when an item satisfies the definition and meets both recognition criteria, discussed later, will it qualify for inclusion on the balance sheet.

Key concept 2.10: Assets

An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

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The essential characteristics of an asset from the above definition include the following.

» *Right*. *Rights* can arise in a number of ways but does not require ownership. Owning a car conveys to the owner the *right* to use the car and the *right* to sell the car. In this example, the *rights* are ones that do not correspond to the obligations of another party to do something. There are also *rights* where there are obligations for another party arise when one party sells goods to another party who agrees to pay in 60 days. Most *rights* arise from a contract such as a lease of a rental property for 12 months. However, where an entity creates an item of value that is not in the public domain there is no contract. Of course, if the entity patents the item, the *right* is protected by a contract.

» *Present economic resource*. An economic resource is a right that has a potential to generate 'economic benefits'. The RCF points out that there only needs to be a potential to obtain economic benefits and the potential does not need to be certain or even highly likely. The probability of the right producing economic benefits will be relevant in deciding if the right should be recognised as an asset on the balance sheet. Although an asset has value because of the potential economic benefits, it is the present right that

contains the potential and the value of the right will in part depend on the probability of the economic benefits being realised. An economic resource can arise in many ways, such as when an entity has a right to collect cash from another entity, to exchange an economic resource with another party on favourable terms or sell an item for cash. For example, it is fairly obvious that a gold mine full of unmined gold is an asset for a mining business. However, there will come a point when all the gold has been removed and all that is left is a hole in the ground. The hole in the ground no longer has potential to provide economic benefits from selling gold. Does it cease to be an asset? The answer will depend on whether there are any other uses for the land. For example, the hole in the ground may be of use to a rubbish disposal business and hence it is still a present economic resource as it can be sold, albeit at a lower value.

» *Control*. Common definitions of assets imply that in order to be an asset something must be owned. In reality, most assets are owned, but the assertion that ownership is a precondition for the recognition of an asset by an entity is not correct. The RCF defines control 'as the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it'. While control often arises from legally enforceable rights, the absence of legal ownership does not automatically deny the existence of control. An example of this is a **non-cancellable lease**, where the lessee has control over the economic benefits embodied in the goods but the lessor maintains legal title to the goods. Thus, the lessor can resume possession of the goods, but only if the lessee is unable to meet the lease payments. On the other hand, the fact that an individual or entity owns an item does not necessarily mean that there is any benefit to be obtained. For example, an old car that has been ordered off the road by the police may cease to be an asset, and in fact, unless it can be driven to the salvage yard, may become a liability.

» *Past events*. Only present abilities to control economic benefits are assets. A decision at balance date to buy a new machine next year does not itself create an asset. However, if the entity has entered into a **non-cancellable contract** to acquire the machine then a right might have been obtained and an asset created as a result of the contract. The signing of the contract is, in effect, the past event.

non-cancellable lease *(Chapter 2)* A contract which cannot be cancelled, allowing a person or entity to use or occupy property in return for rent.

non-cancellable contract *(Chapter 2)* A legal or formal agreement made between two or more people that cannot be changed without incurring significant penalties.

Case study 2.1: Accounting for the cost of football players: are they an asset or expense?

Getty Images/OLI SCARFF/Stringer

An analysis of the very long 2016 Annual Report submitted by Manchester United PLC (Public Limited Company) to the New York Stock Exchange provides a clear picture as to how players are treated in accounting terms and how they are shown as assets in the balance sheet.

Note 15 under Intangible assets reports that: 'The unamortized balance of existing registrations as of 30 June 2016 was £241.7 million, of which £110.1 million is expected to be amortized in the year ended June 30, 2017. The remaining balance is expected to be amortized over the three years to 30 June 2020. This does not take into account player additions after 30 June 2016, which would have the effect of increasing the amortization expense in future periods, nor does it consider disposals subsequent to 30 June 2016, which would have the effect of decreasing future amortization charges. Furthermore, any contract renegotiations would also impact future charges.'

(Manchester United 2016 Annual Report, page F 32)

Commentary

The case discusses the interesting question of whether a football player is an asset. Consider whether a football player meets the definition of an asset. Manchester United controls the *right* to benefit from the services of players because of the contracts it has with them. The present economic resource relates to the potential ability to obtain economic benefits from the players' services, which allow the team to win games which helps attract sponsors and to sell the club's merchandise such as shirts and hats. This is consistent with paragraph 4.16 c (i) of the RCF. Also, there is the potential for Manchester to sell the player to another club as this is part of the English football system, when transfer payments are in millions of pounds. If transfer payments did not exist, as is the case in the Australian Football League, then the potential to sell a player is removed. Of course, the value of the playing service remains. The past event would be the signing of the contract.

Before being recognised on the balance sheet, an item that meets the definition of an asset must also satisfy the recognition criteria, which we discuss later in this chapter. Essentially an asset is recognised (which means recorded on the balance sheet) when the asset can be faithfully represented and the information is relevant to users. If the club had to pay an amount to secure the services of a player, as in the case of English football, then this amount would be what could be used as a faithful representation of the value of the player. To be relevant there would need to be a reasonable probability of the economic benefits flowing to the club, which will depend on a number of issues, including a player's age, risk of injury, performance on the field and so on.

The wages paid to players – which in the UK can be thousands of pounds a week – are recorded as expenses in the same way as for other employees. While it is common practice for some sporting clubs in the UK to report players on balance sheets, it is not common practice in Australia as there are no transfer payments and it is not common with most other entities. Study the Woolworths balance sheet in Appendix 1 to see if you can locate any value for employees.

Liabilities

As is the case with assets, an item that meets the definition of a liability must also satisfy the criteria for recognition before being recorded on the balance sheet.

Key concept 2.11: Liabilities

Liabilities are defined as a present obligation of the entity to transfer an economic resource as a result of past events.

The essential characteristics of a liability from the above definition include the following.

» *Present obligation*. This means that a transaction or event in the past has created an obligation that has not yet been satisfied. As with assets, the word 'legal' is not used in the definition of a liability. The view adopted is that legal obligations alone do not give rise to liabilities. There may be other social or moral reasons that create a present obligation. For example, an entity may decide to rectify faults in one of its products even though the warranty period has expired. The entity is not legally obliged to rectify the faults, but the decision to do so imposes an obligation on the entity and the sacrifices required to honour the obligation constitute a liability. An aspect of liabilities introduced in the RCF is the concept that an obligation is a duty or responsibility that the entity has no practical ability to avoid. For example, where a company sells a product with a warranty to make good any defects for 24 months it would have no practical ability to avoid. Conversely, a company that buys an aircraft which under law must have a major overhaul every 50 000 flying hours could avoid the obligation by selling the aircraft before the 50 000 hours.

» *Transfer of an economic resource*. There must be a potential that an entity will be required to transfer an economic resource to another party. The potential to transfer an economic resource does not need to be certain or even highly likely. The probability of the need to transfer an economic resource will be relevant in deciding if the obligation should be recognised as a liability on the balance sheet. The obligation must result in the entity having to sacrifice economic benefits in the future to discharge the obligation. Examples of such obligations would be a loan from a bank or where one party buys goods from a second party and is required to pay the other party in 60 days.
» *Past events*. Only present obligations to transfer an economic resource are liabilities. An obligation that may arise in the future is not a liability. An insurance company that has sold a policy to a client to protect for loss of the client's home from storm damage would not have a liability for a storm that may strike the client's neighbourhood as the past event has not occurred. After a storm has hit the house, then a present obligation exists.

Equity

The definition of equity within the IASB RCF is similar to that adopted by the Financial Accounting Standards Board in the USA. It is a residual definition whereby the identification of equity is dependent on the recognition of assets and liabilities. Consequently, unlike the other four elements of financial statements, the definition of equity does not require recognition criteria.

Key concept 2.12: Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Expenses

Before expenses are recognised in the financial statements, they must meet the recognition criteria discussed below. We discuss expenses in more detail in Chapter 6.

Key concept 2.13: Expenses

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Income

As with the other elements, income is recognised in the financial statements only when it meets the recognition criteria discussed below. We discuss income in more detail in Chapter 6.

Key concept 2.14: Income

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

A subset of income is the important element called 'revenue.' The IASB uses the term 'revenue' in International Accounting Standard (IAS) 18 *Revenue*, as defined in Key concept 2.15, and because of the adoption of IFRS in Australia, we now use the same definition. While revenue is, in fact, a subset of income, it is not defined as a separate element in the RCF.

Key concept 2.15: Revenue

Income arising in the course of an entity's ordinary activities.

(AASB 15. Appendix A)

Key concept 2.16: The interrelationship between income, revenue and gains

In accordance with IASB definitions and terminology:
- income = revenue + gains
- revenue = inflows from ordinary activities
- gains = all other inflows that are not revenue.

Recognition of assets, liabilities, equity, income and expenses

Recognition is the term used to describe the recording of one of the elements such as an asset, liability, equity, income or expense into the financial statements. To recognise is to record an item with a description and an amount. For example, if an entity buys a new car for $50 000 and pays cash, an asset Motor Vehicle is recognised in the balance sheet, while $50 000 cash is derecognised or removed from the balance sheet. An item of income will be recognised when a company sells goods or it may also be recognised when an asset's value increases. Conversely, an expense is often recognised when an entity incurs a liability. For example, the entity's workers are owed $20 000 for work completed in the last two weeks but have yet to be paid. A decrease in an asset referred to as an impairment will also result in an expense.

The recognition criteria in the RCF require an element that meets the definition of an asset, liability, income or expense to be recognised only if it provides information that is useful. To be useful, the information must be relevant and be able to be faithfully represented in the financial statements.

Key concept 2.17: The recognition of assets, liabilities, equity, income and expenses

An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, i.e. with:
(a) relevant information about the asset or liability and about any resulting income, expenses or changes in equity (see paragraphs 5.12–5.17); and
(b) a faithful representation of the asset or liability and of any resulting income, expenses or changes in equity (see paragraphs 5.18–5.25).

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Relevant information. While information about assets, liabilities, equity, income and expenses will be relevant information, the relevance is impacted by existence uncertainty and low probability of economic benefits flowing from the asset. The existence of an asset or liabililty may be uncertain in some cases

where, for example, one party is seeking compensation for defamation by another party. Where this is being disputed in court, neither party has an asset or a liability where the outcome of the case is highly uncertain.

Conversely, where an item meets the definition of an asset or liability, the probability that economic benefits will arise or a transfer of an economic resource will be required is so low that to recognise such assets and liabilities would not provide relevant information to users. For example, continuing the defamation case above, let's assume Donald Rump has successfully won a defamation case against Joe Citizen and been awarded damages of $500 000. So Mr Rump has an asset and Joe Citizen has a liability. However, if Joe has disappeared, then the probability of Rump receiving the $500 000 is so low that it should not be recognised. Joe, of course, would also not recognise the liability.

Faithful representation. In order for an asset, liability, income or expense to be recognised in the financial statements it must be measured in dollar terms in Australia. In the previous version of the *Conceptual Framework* this criterion was the reliable measurement of a cost or other attribute. In the RCF the degree of measurement uncertainty determines how faithful the measure is as a representation of the asset, liability, income, expense or change in equity. The higher the degree of uncertainty, the less faithful is the representation. This may result in non-recognition, but disclosure of the item may still be made in the notes.

Continuing our defamation case above, let's now assume that Rump has won the case but the judge is yet to award damages. It is expected Joe Citizen will pay the damages once determined. It is expected the damages may be anywhere from $100 000 to $1 000 000. This high level of measurement uncertainty may mean there should be no recognition of an asset by Rump but a note is added to the financial statements.

LO 2.5

Appreciate the role of the external audit function.

2.5 External audits

Users of general-purpose financial statements wish to be assured that the information contained in these statements represents a true and fair assessment of the economic activities of the entity being reviewed. As mentioned earlier in this chapter, the person who audits general-purpose financial statements is the auditor. The auditor is seen as an *independent* external observer who is called upon, in the case of a company, to express an opinion that the reports provide a 'true and fair' representation of the company's financial status.

It is important to stress here that the directors of public companies, not auditors, are responsible for the preparation and presentation of a company's general-purpose financial statements. The purpose of an external audit is to add credibility to the reports presented by the directors. Most large companies also have an *internal auditor* who is responsible for making sure that correct processes are being followed. An efficient internal audit process can reduce the time required by the external auditor, thus helping to reduce the cost of the external audit.

Key concept 2.18: External audit

The external audit aims to provide assurance to **absentee owners** (shareholders) that the financial statements of the company provide a true and fair view of the company's financial position, performance and cash flows.

absentee owners *(Chapter 2)* The shareholders in large businesses.

All companies, except small private companies and some large private companies, must have their accounts audited as required by the *Corporations Act*. Other entities, such as banks, insurance companies, credit unions, building societies and some unions, are also required to be audited under separate legislation. In fact, many not-for-profit organisations, for whom there is no statutory requirement to do so, choose

to present audited accounts to show users that their accounts can be relied upon. Examples of not-for-profit organisations include sporting organisations, clubs and societies. All public sector entities have their financial statements audited by the Auditor-General's office.

The external auditor, as noted above, does not prepare general-purpose financial statements; this is the responsibility of the company's directors. The auditor's task is to review the accounting systems used to prepare the reports, to check on the accuracy of certain transactions (particularly those involving large dollar amounts), to state that the accounts have been prepared in accordance with the *Corporations Act* and applicable accounting standards and that they provide a true and fair view of the entity. For annual reports, all reporting entities are required to obtain an audit opinion as to the truth and fairness of the general-purpose financial statements. For interim reports, entities can choose whether they provide a full audit opinion or an audit review. An audit review does not involve a detailed audit, so the auditor is not able to express an audit opinion, only a statement about the general-purpose financial statements.

You should now read the independent audit report prepared by Deloitte for the Woolworths 2018 financial report (Appendix 1).

The auditor

A person who is appointed as a company auditor is required, under the *Corporations Act 2001*, to meet certain requirements. Briefly, the auditor must:

- have the appropriate tertiary qualifications and have completed a prescribed course in auditing or have other qualifications or experience that ASIC considers equivalent to both requirements
- meet one of the following practical experience requirements
  - satisfy all the components of an ASIC-approved competency standard
  - have the level of practical experience that is prescribed in the Corporations Regulations or experience that ASIC considers equivalent
- satisfy ASIC that he/she is capable of performing the duties of an auditor and is otherwise a fit and proper person to be registered as an auditor.

Shutterstock.com

The shareholders at an annual general meeting appoint the auditor, though in practice, management usually provides the name of an auditor for approval by shareholders.

The auditor is required to form an opinion on the general-purpose financial statements of a company to determine whether proper records have been kept, and to report to shareholders. The auditor must also inform ASIC of any suspected wrongdoing by management or any non-compliance with applicable accounting standards.

The auditor can be removed only by special notice, given at the annual general meeting, and ASIC must be informed. ASIC has the power to stop an auditor from resigning or being removed from office.

Besides the statutory requirements noted above, the auditor is bound by professional obligations, which cover:

- independence, integrity, confidentiality and **ethical** considerations
- conformity with accounting and auditing standards, auditing guidelines and statements of auditing practice.

ethical
(Chapter 2) Behaving in an honest and morally correct manner.

The expectation gap

As discussed previously, the directors of a company are responsible for preparing the accounts, and the auditors are responsible for seeing that those accounts have been prepared according to statutory and professional requirements. Are auditors responsible for detecting fraud or illegal acts? The law requires auditors to exercise due care when forming their opinion; it does not require them to detect fraud, though if a suspicion is aroused it must be acted upon.

During the past decade the auditing profession has been criticised for not fulfilling what is seen as its role. This criticism has arisen, in part at least, because a number of companies have failed after being given an unqualified opinion by an auditor. The difference between what an auditor is required to do and what is expected by users is known as the **expectation gap**.

expectation gap
(Chapter 2) The difference between what an auditor is required to do and what is expected by users.

The reporting of fraud and illegal acts, whether actual or suspected, is a requirement of the *Corporations Act*. The problem the auditor faces is that it is often extremely difficult to detect a well-organised fraud, particularly where more than one party is involved. An auditor does not check every transaction of a business, but instead selects a sample to test. While the sampling methods are based on statistical methodologies, the reality is that the auditor does not check every transaction. For this to happen, the cost of an audit would be prohibitively high.

Therefore, the auditor uses a sampling method to test certain transactions so that he or she can be reasonably assured that the financial statements provide a true and fair view of the entity. This is not a guarantee that every error in the financial statements of a business has been detected. This in part explains why there is an expectation gap. The audit profession continues to grapple with the problem of fraud and illegal acts, and professional pronouncements continue to be updated.

Key concept 2.19: Expectation gap

The expectation gap describes the difference between the role performed by the auditor and the role that shareholders expect of the auditor.

Independence

The *Corporations Law Economic Reform Program (CLERP 9)* included a number of changes to the *Corporations Act*, one of which related to the relationship between an auditor and his/her client and the independence of the auditor. These amendments resulted from concerns about the lack of audit independence in high-profile company failures such as Enron.

The auditor in Enron was providing a range of services to the client, not just audit. Other services related to tax, corporate finance, accounting, IT and an internal audit. In many cases like Enron, the fees received for non-audit services far exceed the audit fee. The concern here is that the auditor may be reluctant to be critical of the company because he or she relies on the other fees he/she receives. Consequently, companies in Australia are now required to disclose the fees they pay to auditors for all the services carried out in addition to the audit. They must also provide a statement as to why any additional fees have not compromised the independence of the audit. Auditors must make a declaration about their independence (see Appendix 1).

One of the other issues in the Enron case involved the appropriateness of ex-partners of Arthur Andersen (Enron's auditor) serving as directors on the Enron board. It was felt that such persons would not be truly independent directors. This also had the potential to affect the independence of the auditor because the former audit partner's firm was still engaged to do the audit. In Australia there is a two-year ban on former audit partners taking up positions as directors on the boards of former clients.

There is also a requirement for an automatic rotation of an audit partner after five years. The reason for this requirement relates to audit independence. There is a view that after being in charge of an audit for five years, the partner would be very familiar with the client and this might potentially impair his/her independence. ASIC has power to provide some relief to this requirement but only in limited circumstances. The professional accounting bodies have a professional standard that deals with professional independence. It provides a guide to issues associated with independence. This professional standard has also been revised and reissued in response to events like the failure of Enron.

Key concept 2.20: Auditor independence

Auditor independence means that the auditor must be independent of the client for whom the audit is conducted so that he/she is able to express a truly objective opinion about the financial statements.

Auditor independence *(Chapter 2)* The auditor must be independent of the client for whom the audit is conducted to be able to express a truly objective opinion about the financial statements.

It is essential that external auditors maintain independence from audit clients so that they can properly fulfil their duties and give unbiased opinions about firms' financial statements. Failure to maintain this independence, whether real or perceived, can only harm the image of the profession. It also serves to reinforce the expectation gap, as a non-independent auditor is more likely to overlook events and transactions, as was the case in Enron. Moreover, when a company fails, shareholders have the right to ask, 'How could the auditor not see that something was seriously wrong?'

Stop and think 2

Should auditors be allowed to provide non-audit services to an audit client?

Study tools

Summary

LO 2.1

Identify three forms of business structures, the main characteristics of each structure and the major differences between their financial statements.

A sole trader is a business run by one person and a partnership involves two or more parties. Neither of these forms of business is a separate legal entity. A company, however, is a separate legal entity. A one-owner business is a common form of business organisation, and is simple to set up. All that is required is a business bank account. Because it is so simple and because it has no recognition in law, there are no formal guidelines for the format of the accounts, except in the situation where the sole trader is a reporting entity.

The advantages of forming a partnership (as a form of organisation) are:

- ease of formation
- limited rules and regulations
- provision of capital and expertise
- more favourable tax position.

The disadvantages of a partnership include:

- limited life
- unlimited liability
- mutual agency.

The advantages of companies as a form of organisation are:

- separate legal entity
- limited liability
- ease of transfer of ownership
- no mutual agency
- professional management
- continuous existence.

Disadvantages of the company structure include:

- taxation
- regulation
- limited liability
- separation of ownership and control.

There are many differences between the financial statements of a company and either a partnership or a sole trader. For example, the balance sheet for a company contains shareholders' equity, which includes paid-up capital, retained profits and reserves. A sole trader or partnership does not need to prepare a statement of profit or loss and other comprehensive income but a partnership may prepare a statement of partners' capital accounts. In addition, unlike a partnership or a sole trader, a company is required to pay taxation.

LO 2.2

Identify the main characteristics of the financial statements of a public company and the role and meaning of consolidated financial statements

Public companies prepare financial statements that have a shareholders' equity section, and many prepare consolidated financial statements that report the results and financial position of the combination of the parent entity and the other entities it controls.

LO 2.3

Explain the current framework for standard setting in Australia and the influence of accounting standards, the *Corporations Act 2001* and the Australian Securities Exchange Listing Rules on financial reporting requirements

The FRC has oversight responsibility for both accounting and auditing standards in Australia. It is responsible for the appointment of all members (except the chairperson) to the AASB and the AUASB. The AASB is responsible for establishing accounting standards in Australia. The AUASB is responsible for establishing auditing standards.

The government-appointed AASB produces accounting standards that, under the *Corporations Act*, are mandatory for all companies that are reporting entities. The AASB sets accounting standards for all entities in both the private and public sectors. These standards are now the equivalent of IFRSs. The AASB has a full-time chair and employs a number of technical staff.

In addition to accounting standards, interpretations and accounting concepts also influence the preparation of external financial reports. The external financial reports prepared by companies are also influenced by certain requirements within the *Corporations Act*. In particular, the requirements of AASB standards, the directors' report, the directors' statement and the auditor's report influence the external financial reports prepared by companies. For this reason, a number of companies expend considerable resources to provide input to the standards-setting process.

For listed public companies, the Listing Rules of the Australian Securities Exchange require companies to present half-yearly reports, preliminary final statements and additional details in their annual reports. Under the *Corporate Law Reform Act 1994*, disclosing entities are also required to prepare yearly and half-yearly accounts and comply with continuous disclosure requirements.

LO 2.4

Explain what is meant by, and the role of, a conceptual framework and explain the major concepts.

A conceptual framework is a series of concepts or ideas that determine how financial reports are prepared for general users. It is an attempt to establish the foundations for the preparation of general-purpose financial reports.

The proposed benefits of having a conceptual framework include:

- a reduction in the number of accounting standards required
- more consistency in accounting standards
- improved communication among parties involved in the preparation of general-purpose financial reports
- the provision of a defence against the actions of lobby groups.

In SAC 1, a reporting entity is an entity for which it is reasonable to expect the existence of users dependent on general-purpose financial reports for information that will be useful to them for making and evaluating decisions. In the RCF a reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity is not necessarily a legal entity.

General-purpose financial statements must include:

- a statement of profit or loss and other comprehensive income for the period
- a statement of financial position (balance sheet)
- a statement of changes in equity
- a statement of cash flows
- notes to the financial statements.

The two principal qualitative characteristics are *relevance* and *faithful representation* of the information. *Verifiability*, *timeliness*, *understandability* and *comparability* enhance the relevance and faithful representation of information. The qualitative characteristics are subject to a cost/benefit constraint.

The objective of general-purpose financial reporting is defined as providing information to assist users in making decisions about the resources of the entity.

- An asset is a present economic resource controlled by the entity as a result of past events.
- A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
- Equity is the residual interest in the assets of the entity after deducting all its liabilities.
- Income is increases in assets, or decreases in liabilities, that result in increases in equity other than those relating to contributions from holders of equity claims.
- Revenue is defined in AASB 118 as the same as income except the inflows are from an entity's ordinary operations. Thus, income includes revenues and other gains.
- Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

All elements are recognised on the financial statements when the information is relevant and the element can be faithfully represented on the financial statements.

LO 2.5

Appreciate the role of the external audit function.

Auditors are there to give some assurance as to the truth and fairness of financial statements but cannot guarantee that they are absolutely correct and free of errors. They provide an audit opinion in the case of annual reports or an audit review in the case of half-yearly reports. The expectation gap describes the difference between the actual

and the perceived role of the auditor and the audit process. Audit independence is concerned with ensuring that auditors are able to give an independent opinion with regard to the financial statements of an audit client.

The concern is that auditors may be reluctant to be critical of clients when they rely on other fees that are received from them or they have a close relationship with a client's management.

Review questions

1 Why is it advantageous to set up a business as a limited company?
2 What are the differences between a sole trader and a limited liability (limited by shares) company?
3 Discuss the various influences on external financial reporting for companies in Australia.
4 What are consolidated financial statements? What is their purpose?
5 Explain what is meant by the term 'controlled entity'.
6 What is a conceptual framework of accounting?
7 Discuss who uses general-purpose financial statements and why they require such statements.
8 Discuss the difference between control and ownership in terms of the definition of an asset.
9 What is the purpose of an external audit?
10 What is meant by the expectation gap in relation to auditing?
11 Do you think that public financial statements would present a 'true and fair' view if they were not audited?
12 You are considering investing in two similar types of private companies. One has an unqualified audit report and the other has no audit report. How important is this to you in making your decision?

Take it further

Critically review the role of the auditor Deloitte in the collapse of Dick Smith in 2016.

Problems for discussion and analysis

1 Refer to the Woolworths financial report for 30 June 2018 in Appendix 1.
   a On what basis are the accounts prepared?
   b Who are the auditors of Woolworths Limited?
   c How much does Woolworths pay for the audit and for other services? Is there an issue for audit independence? (You will need to access the entire annual report to answer this question. Go to www.woolworthslimited.com.au.)

2 Partners Mike and Phil share profits and losses in proportion to their fixed capital balances. The following balances were taken from the partnership's books as at 30 June 20X9:
   a On the basis of the above figures, calculate the profit for the period.
   b What was the amount of profit/loss allocated to each partner?

	$
Cash	3 000
Accounts receivable	12 500
Inventory	8 400
Plant	100 000
Accumulated depreciation	3 000
Creditors	8 600
Capital: Mike	36 320
Capital: Phil	54 480
Sales	210 000
Cost of goods sold	163 000
Selling expenses	7 316
Depreciation expense	4 322
Financial expenses	1 827
General expenses	12 035

3 Steve Hill and Lee Down formed a partnership, investing $250 000 and $200 000 respectively. Determine their participation in the year's profit of $150 000 under each of the following independent assumptions:
   - **a** no agreement concerning division of profit
   - **b** profit to be divided in the ratio of original capital investment
   - **c** interest at the rate of 10 per cent allowed on original investments and the remainder divided in the ratio of 2:3
   - **d** salary allowances of $65 000 and $70 000 respectively, and the balance divided equally
   - **e** allowance of interest at the rate of 10 per cent on original investments, salary allowances of $65 000 and $70 000 respectively, and the remainder divided equally.

4 Andrew Glen and Norman Dale have decided to form a partnership. They have agreed that Glen is to invest $150 000 and Dale is to invest $220 000. Glen will work full-time in the business, and Dale is to work half-time. The following plans for the division of profit are being considered:
   - **a** equal division
   - **b** in the ratio of original investments
   - **c** in the ratio of time devoted to the business
   - **d** interest of 10 per cent on original investments and the remainder in the ratio of 5:3
   - **e** interest of 10 per cent on original investments, salary allowances of $110 000 to Glen and $40 000 to Dale, and the remainder equally
   - **f** plan (e) except that Glen is also to be allowed a bonus equal to 20 per cent of the amount by which profit exceeds the salary allowances.

Required

For each plan, determine the division of the profit under each of the following assumptions:
   - **i** Profit of $276 000
   - **ii** Profit of $162 000.

Present the data in table form, using the following column headings:

	$276 000		$162 000	
Plan	Andrew Glen	Norman Dale	Andrew Glen	Norman Dale

5 ABC Ltd is being sued by a client for $100 000. The company's legal advisers say that there is only a 35 per cent chance of an unfavourable outcome. At the end of the financial year, the case has still to go to court. Should the $100 000 be reported as a liability? Would the answer change if there was a 75 per cent chance ABC would lose the case?

6 Vanessa raised a $15 000 000 loan to fund the exploration that led to the discovery of a deposit of silver.
   - **a** Does the deposit of silver meet the definition of an asset to Vanessa according to the RCF? Why?/Why not?
   - **b** Under what circumstances may the deposit of silver be recognised in the balance sheet of Vanessa according to the RCF?
   - **c** Does the loan meet the definition and recognition criteria of a liability to Vanessa during the term of the loan, according to provisions of the RCF?

7 **a** Refer to Case study 2.1. Do you agree that a football player should be recognised as an asset on Manchester United's balance sheet? What about a player who plays for the local community football club?
   - **b** Go to the website for the Liverpool Football Club at https://www.liverpoolfc.com/welcome-to-liverpool-fc. Review the club's annual report and explain how the club accounts for its players.

8 Most of the major airlines offer 'frequent traveller' specials where travellers can receive free flights, upgrades from economy to first or business class, or free accommodation packages. Some airlines have been trying to gain more market

share by giving double-kilometres credit for each flight. How should the airlines account for frequent flyer points that have been issued to travellers but not yet redeemed? Are they a liability?

9 Why do you think companies take an active interest in the standard-setting process of the accounting profession?

10 Given that general-purpose financial reports are aimed at providing information that is 'useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity', discuss to what extent these users are represented in the due process.

11 Discuss and explain the different reporting requirements for public and private companies. Why do you think some private companies are exempted from regulatory standards?

12 In note 3.9 of the 2018 *Annual Report,* Woolworths states: 'The provision for self-insured risks primarily represents the estimated liability for workers' compensation and public liability claims.' Discuss what is meant by self-insured risks and if this meets the definition and recognition criteria for a liability.

13 Very few people attend meetings of local councils so why do you think they are required to prepare general purpose financial statements and have them audited?

14 You are discussing the financial position of a company with a friend. The friend is considering buying shares in the company and comments, 'I can't rely on the audit report as it does not guarantee the financial statements are correct'. Your friend knows you have just completed an accounting subject and asks you for your opinion about the value of the audit report. What would you say to your friend?

15 Roy Dorro is running a small accounting practice with annual fees of $100 000. He is approached by the CEO of a company that has just established premises in Roy's area. The CEO wants Roy to conduct the annual audit for the company and has indicated that a fee of $50 000 would be provided for the audit. Should Roy have any concerns about audit independence if he were to accept the engagement?

16 Examine the following cases for Ruliable Ltd and indicate whether you believe the company should recognise a liability.

- **a** Potential costs due to the discovery of a possible defect related to one of its products. It is probable that claims will be made and the costs can be reliably estimated.
- **b** There is a potential claim for damages to be paid from a lawsuit filed this year against another company. It is probable that the proceeds from the claim will be paid by Ruliable next year.
- **c** The company has a policy whereby it overhauls its major machinery every five years. This has been its practice for the last 25 years. At the balance date, the machinery had been overhauled three years previously.

17 For the current year ended 30 June, the results of operations of Hawkeye Corporation and its wholly owned subsidiary, Radar Enterprises, are as follows:

	Hawkeye Corporation		Radar Enterprises	
	$	$	$	$
Sales		8 150 000		750 000
Cost of inventory sold	5 000 000		440 000	
Selling expenses	800 000		75 000	
Administrative expenses	600 000		35 000	
Interest expense (revenue)	(30 000)	6 370 000	30 000	580 000
Profit		1 780 000		170 000
Other comprehensive income		0		0
Total comprehensive income		1 780 000		170 000

During the year, Hawkeye sold inventory to Radar for $80 000. The inventory was sold by Radar to non-affiliated companies for $120 000. Hawkeye's interest revenue was realised from a long-term loan to Radar.

a Determine the amounts to be eliminated from the following items in preparing a consolidated statement of profit or loss and other comprehensive income for the current year:

i sales

ii cost of inventory sold.

b Determine the consolidated profit.

18 Given the simplified balance sheet of Bazz Ltd and Lee Ltd, prepare a worksheet for the consolidation of the accounts of the parent company (Bazz Ltd) and its subsidiary (Lee Ltd). From your worksheet, prepare the consolidated balance sheet.

The following items need to be taken into consideration:

– Bazz Ltd acquired all the shares of Lee Ltd for $320 000 on the morning of 30 June 20X1.
– All assets and liabilities are stated at their fair values.
– Lee Ltd owed Bazz Ltd $10 000 for goods purchased on 15 June 20X1.

Bazz Ltd Lee Ltd
Balance sheet at 30 June 20X1

	Bazz Ltd	Lee Ltd
	$	$
Assets		
Current assets		
Bank	180 000	50 000
Accounts receivable	100 000	150 000
Total current assets	280 000	200 000
Non-current assets		
Plant and equipment (net of depreciation)	300 000	300 000
Investment in Lee Ltd	320 000	–
Total non-current assets	620 000	300 000
Total assets	900 000	500 000
Liabilities		
Current liabilities		
Accounts payable	400 000	180 000
Total liabilities	400 000	180 000
Net assets	500 000	320 000
Equity		
Paid-up capital	400 000	300 000
Retained profits	100 000	20 000
Total equity	500 000	320 000

19 Bev and Daniel want to buy a business of their own. Bev is a schoolteacher and Daniel has worked in the public service and has a degree in commerce. They decide to buy a delicatessen, and choose one close to their home. The shop has been there for several years, but has not been a great success. Bev and Daniel will have to borrow a large amount of money to finance the purchase.

Required

You have been asked to advise the following:

a What form of organisation should they adopt for the business, a partnership or a company?
b Will the choice of organisation affect the availability of finance for their business? Explain.
c What skills will Bev and Daniel need to manage the business?
d How can they raise the required finance? What security do you think they will need to provide?

(Adapted from R. Craven, I. Urquhart and R. Woolley, *Case Studies in Accounting*, 3rd edn, VCTA Publishing, 1985, Case 3–3 and p. 36.)

20 The Magic Lawn Corporation is a family-owned company that produces and sells lawn care products. The company has recently developed a new product that enhances the water retention properties of all types of lawn. The potential for this product is unlimited, but in order to capitalise on its potential, the company needs a substantial injection of cash into the business. At present, the family owns all 10 000 shares of $1 value that have been issued. The shareholders' section of the most recent balance sheet is as follows:

	$
10 000 $1 value shares fully paid	10 000
Retained profits	2 990 000
	3 000 000

Following are the options that are being considered by the family in order to raise the additional cash:

a a five-year bank loan for $3 million – interest rate 10 per cent, payable annually in arrears; principal to be repaid at the end of five years
b converting to a public company and issuing 600 000 shares at an estimated market price of $5. Family members will have priority in the purchase of shares
c the issue of 600 000, 6 per cent, $5 cumulative preference shares to an investment company. The shares will be redeemable at the discretion of the Magic Lawn Corporation.

There are two important issues for the company:

i The company has always been family owned and the family are concerned about losing control of the company.
ii The company has always had cash flow problems. Options (a) and (c) both involve regular cash payments for interest or dividends.

Write a report to the family outlining the advantages and disadvantages of each option. The tax rate for companies is 30 per cent. Interest is tax-deductible but dividends are not.

21 Bob Strongarm and Phil Hannock are partners in a consulting business. In the last three years, Bob's share of partnership profits has been $15 000, $20 000 and $30 000. He has been offered $80 000 for his share of the partnership. Bob decides that if his total share of profits over the next three years is less than $100 000 he will sell. The following schedule sets out some estimates of profits for the next three years:

Schedule			
Total partnership profits			
	Year 1	Year 2	Year 3
Optimistic estimate	75 000	85 000	95 000
Most probable estimate	55 000	65 000	75 000
Pessimistic estimate	45 000	55 000	65 000

Bob and Phil currently share profits as follows: Bob receives a salary of $20 000, Phil's salary is $15 000, and the remainder is split with Bob getting 60 per cent.

Required

Calculate Bob's share of the profits over the next three years if his optimistic estimate is correct.

a Calculate Bob's share of the profits over the next three years if his most probable estimate is correct.

b Calculate Bob's share of the profits over the next three years if his pessimistic estimate is correct.

c If the probabilities are 20 per cent that
the optimistic estimate will be correct, 60 per cent that the most probable estimate will be correct, and 20 per cent that the pessimistic estimate will be correct, should Bob sell for $80 000?

d Discuss the other factors Bob should consider when deciding whether or not to sell.

Ethics case study

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

Discuss

a How the transactions should be reported according to your understanding of the IASB *Conceptual Framework 2018*

b What Tom should do.

Cool Value Cinemas

Go to the online case and answer the questions related to Chapter 2

Suggested answers to stop and think exercises

1 A company allows funds to be raised from members of the public. Therefore, it provides greater access to funds than a partnership. However, companies are subject to more rules and regulations and these rules are increasing in the wake of the collapse of companies like HIH, Enron and WorldCom. Shareholders in a limited company are only liable for the amount paid on their shares, whereas partners may be jointly and severally liable for all partners' debts. A company is a separate legal entity, whereas a partnership is not.

2 This is a difficult and controversial question. In the USA the *Sarbanes-Oxley Act 2002* places restrictions on the type of services, other than auditing, that an audit firm can provide to an audit client. The approach in Australia involves some restrictions and more disclosure about the fees an auditor derives from the provision of other services to an audit client. The real issue is auditor independence, and some argue that an auditor can provide other services and still be independent due to professionalism. Others disagree and, partially as a result of what happened with Enron, argue for restrictions on the amount and type of other services an auditor can provide to audit clients.