

CHAPTER 7

INTRODUCTION TO ACCOUNTING

LEARNING OBJECTIVES

When you have completed your study of this chapter, you should be able to:

- L01** Explain the nature and role of accounting
- L02** List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information
- L03** Compare and contrast financial and management accounting
- L04** Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk-return relationship
- L05** Provide an overview of the main financial reports prepared by a business
- L06** Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context
- L07** Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting, including current thinking on ethics in business
- L08** Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting
- L09** Identify the learning outcomes associated with the Australian Learning and Teaching Council's Academic Standards Statement for Accounting: namely judgement; knowledge; application skills; communication and teamwork; and self-management; and examine how these compare with characteristics of successful business people.

People need economic information to help them make decisions and judgements about businesses. Whether we are talking about a business manager making decisions about the most appropriate level of production, a bank manager responding to a request from the business for a bank loan or trade unionists deciding how much pay increase to seek for their members, accounting information should help them with their decision.

In this opening chapter, we begin by considering the roles of accounting. As we shall see, accounting can be a valuable tool in the decision-making, planning and control process. We shall identify those people who are the main users of accounting and financial information, and discuss the ways in which this information can improve the quality of decisions that they make. In subsequent chapters, we develop this decision-making theme by considering in some detail the kinds of financial reports and methods used to aid decision-making.

Since this book is mainly concerned with accounting and financial decision-making for private-sector businesses, we shall devote some time to examining the business environment. We shall, therefore, consider the key financial purpose of a private-sector business, the main forms of business enterprise and the ways in which a business may be structured, organised and managed. These are all important as they help to shape the kind of accounting and financial information that is produced.

Finally, we shall consider how business is changing and identify key issues regarding stakeholder interests, ethics and sustainability. These issues have considerable implications for the public perception of business, for businesses themselves, and for accountants and their measurement and reporting systems. Some of these issues are difficult and not easily resolved, but they are issues that you need to be aware of.

ACCOUNTING AND YOU



MAKING DECISIONS

So how do you make decisions?

- What kind of decisions do you need to make?
- How important is economic information in your decision-making?
- How do you deal with numbers and quantitative information?
- Are you comfortable with these areas, or are there areas with which you are uncomfortable?

Let us consider the kind of decisions that are commonly made at some stage of our lives.

- Keeping expenditure in line with income—something just about every student will wrestle with.
- Buying new things—these might include buying simple things like a new mobile phone, or a new vehicle, whether an old banger or a new BMW, or a really major decision, such as buying a home.
- Starting a new business venture, either on your own or in collaboration with others.
- Investing for the future in shares or government bonds.

All of these decisions will require you to collect information, much of which can be classified as economic. Economic information is largely quantitative. The typical economic decision involves choosing the best outcome for you, given that your resources are scarce.

None of what has been said to date should imply that decisions are made solely on economic lines. Many decisions are based on things such as personal preference, family considerations, a sense of duty or aesthetics, with a few people even using the stars to assist! However, many decisions have a clear economic orientation, and accounting can help with these decisions.

So what information do you need to keep your expenditure in line with income? You will probably need a clear understanding of your income, its amount and nature. You will also need to have a clear understanding of your spending patterns, and you will almost certainly need to differentiate between ongoing regular expenditure and one-off expenditure.

Decisions to buy new things may be relatively easy, such as buying a new phone, which may well be bought out of normal spending. Decisions about major assets, such as the purchase of a home, will require much more careful information gathering and analysis. This analysis will probably include ideas around how the asset will be funded.

Decisions regarding potential business ventures also require substantial data collection and analysis. Your future lifestyle is likely to be substantially influenced by the success or failure of a venture of this type. The analysis will need to contain information about markets and competition, as well as specifics regarding the particular business.

Decisions regarding the possible purchase of new shares or bonds will require the collection of relevant data. In the case of shares, this will probably mean detailed information about the past performance of the company and estimates of its future prospects.

Clearly, any decision that has an economic element will require substantial economic information. Basically, the role of the accounting system is to provide much of that information. The system cannot and does not attempt to cover all economic input, but essentially focuses on the collection, recording and reporting of key economic data as they relate to a particular individual or entity. Just what information is covered is the subject of this book.

You may not be comfortable with numbers and quantified information. However, it is difficult for an entity to be successful without having someone who does understand and can communicate such information. So good luck with your studies.

Class discussion points

- 1 If you were to consider starting a business, what information would you be seeking before commencing?
- 2 Who might you want to work with and in what capacity?
- 3 How important is teamwork and good communication in decision-making? Do you see any particular issues that might arise with the people identified above?
- 4 How comfortable are you likely to be in a team where expertise in a particular area is held by only one team member?

NATURE AND ROLE OF ACCOUNTING

Accounting is concerned with the collection, analysis and communication of economic information. Such information can be used as a tool of decision-making, planning and control. This is to say that accounting information is useful to those who need to make decisions and plans about businesses, and for those who need to control those businesses.

Examples of the kind of decisions for which the managers of businesses may need accounting information include the following:

- decisions to develop or terminate new products or services
- decisions to change the price or quantity of existing products
- decisions to borrow money to help finance the business
- decisions relating to the scale of the business, and
- decisions to change the methods of purchasing, production or distribution.

You might spend a few moments reflecting on the implications of some of these. Some decisions have far-reaching consequences; for example, moves to take activities offshore have the potential to impact substantially on the business, its workforce, and the local and regional communities.

Although managers working in a particular business are likely to be significant users of accounting information, they are by no means the only people who are likely to use accounting information about that particular business. People outside the business (whom we shall identify later) may need information to help make decisions such as whether to invest in the business—as owner or lender, whether to grant credit for goods provided or whether to enter into a major contract with the particular business.

It is generally recognised that accounting fulfils two distinct roles: a ‘stewardship’ role and a ‘decision-usefulness’ role. Traditionally, accounting focused more on providing a stewardship, or accountability, report on the status of transactions for the period; that is, what was the position at the beginning of the period, what happened during the period and what the position was at the end of the period. More recently, accounting has been seen as a way of assisting a wide range of users to make informed choices about the allocation of scarce resources. Sometimes, the impression



Explain the nature and role of accounting

accounting

The process of identifying, measuring and communicating information to permit informed judgements and decisions by users of the information.

is given that the purpose of accounting is simply to prepare financial reports on a regular basis. While it is true that accountants do this kind of work, it does not represent an end in itself. The ultimate purpose of accountants' work is to discharge the accountability function of management and to influence the decisions of those who use the information produced. This decision-making perspective of accounting is central to the theme of this book and shapes the way we deal with each chapter.

Accounting as a service function

Accounting can be seen as a form of service. Accountants provide financial information to their 'clients'. These clients are the various users identified in the next main section of the chapter. The quality of the service provided will be determined by the extent to which it meets the information needs of the various user groups. To be useful to users, the information must possess certain qualities. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. These two qualities, which are regarded as **fundamental qualities**, are covered in more detail below.

fundamental qualities

These are the two most important qualities which underline the preparation of accounting reports namely relevance and faithful representation.

relevance

A quality that states that, in order to be relevant, accounting information must be able to influence decisions.

materiality

The quality of information which has the potential to alter the decisions that users make.

faithful representation

A quality that says that accounting information should represent what it is supposed to represent—it should be complete, neutral and free from error.

- **Relevance.** Accounting information must be able to influence decisions—otherwise, there really is no point in producing it. To do this, it must be relevant to the *prediction of future events* (such as estimating next year's profit) or to the *confirmation of past events* (such as establishing last year's profit), or to both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

To be relevant, accounting information must cross a threshold of **materiality**. A key question to be asked is whether its omission or misrepresentation would alter the decisions that users make. If the answer is no, the information is not material. This means that it should not be *separately* included within accounting reports, as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret them. All figures need to be included in the accounts: the question is whether a particular figure needs to be separately identified or whether it can be included elsewhere, under a more general heading. The threshold of materiality will vary from one business to the next. To identify the threshold, the nature of the information and the amounts involved must be considered within the context of the accounting reports of the particular business.

- **Faithful representation.** Accounting information should represent what it is supposed to represent. This means that it should be *complete*, by providing all of the information needed to understand what is being portrayed. It should also be *neutral*, which means that it should be presented and selected without bias. Finally, it should be *free from error*. This is not the same as saying that it must always be perfectly accurate; this is not really possible. Estimates may have to be made which eventually turn out to be inaccurate. It does mean, however, that there should be no errors in the way in which these estimates have been prepared and described. In practice, a piece of information may not perfectly represent these three aspects of faithful representation. It should try to do so, however, insofar as possible.

Note that accounting information must satisfy both fundamental qualities of relevance and reliability if it is to be useful. There is little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, but which is faithfully represented.

Further qualities

Where accounting information is both relevant and faithfully represented, there are other qualities that, if present, can enhance its usefulness. These are comparability, verifiability, timeliness and understandability. Each of these qualities is now considered.

- **Comparability.** This quality helps users to identify similarities and differences between items of information. It may help them, for example, to identify changes in the business over time (such as the trend in sales revenue over the past five years). It may also help them to evaluate the performance of the business in relation to similar businesses. Comparability is enhanced

comparability

A quality which helps users identify similarities and differences between items of information.

by treating items that are basically the same in the same manner for accounting purposes. It is also enhanced by making clear the policies that have been adopted in measuring and presenting the information.

- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.
- **Timeliness.** Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later accounting information is produced, the less useful it becomes.
- **Understandability.** Accounting information should be set out as clearly and concisely as possible. It should also be able to be understood by those at whom the information is aimed.

verifiability

Something that can be checked and verified.

timeliness

Being available early enough to be of use to users.

understandability

Clearly set out to facilitate understanding.

ACTIVITY 1.1

Do you think that accounting reports should be understandable by those who have not studied accounting?

Despite the answer to Activity 1.1, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible for non-accountants.

It is worth emphasising that the four further qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented. It is also worth noting that the qualitative characteristics may conflict.

Costs and benefits of accounting information

In addition to the characteristics described above, there is also a seventh key characteristic which is at least as important as any of these six. In theory, a particular piece of accounting information should be produced only if the cost of providing it is less than the benefits, or value, to be derived from its use. This cost–benefit issue will limit the amount of accounting information provided. In practice, however, these costs and benefits are difficult to assess.

To illustrate the practical problems of establishing the value of information, let us assume that someone has collided with our car in a carpark, dented one of the doors and scraped the paintwork. We want to have the dent taken out and the door resprayed at a local service station. We know that the nearest service station would charge \$700, but we believe that other local service stations may offer to do the job for a lower price. The only way of finding out the prices at other service stations is to visit them, so that they can see the extent of the damage. Visiting the service stations will involve using some fuel and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local service stations? The answer, as we have seen, is that, if the cost of discovering the price is less than the potential benefit, it is worth having that information.

To identify the various prices for the job, there are several points to be considered, including:

- How many service stations shall we visit?
- What is the cost of fuel to visit each service station?
- How long will it take to make all the visits?
- At what price do we value our time?

The economic benefit of having the information on the price of the job is probably even harder to assess. The following points need to be considered:

- What is the cheapest price that we might be quoted for the job?
- How likely is it that we shall be quoted a price cheaper than \$700?

As we can imagine, the answers to these questions may be far from clear—remember that we have only contacted the local service station so far. When assessing the value of accounting information we are confronted with similar problems.

Producing accounting information can be very costly. The costs, however, are often difficult to quantify. Direct out-of-pocket costs, such as salaries of accounting staff, are not usually a problem, but these are only part of the total costs involved. There are other costs, such as the cost of user's time spent on analysing and interpreting the information provided.

There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some 'science' to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, which have been discussed above, are summarised in Figure 1.1.

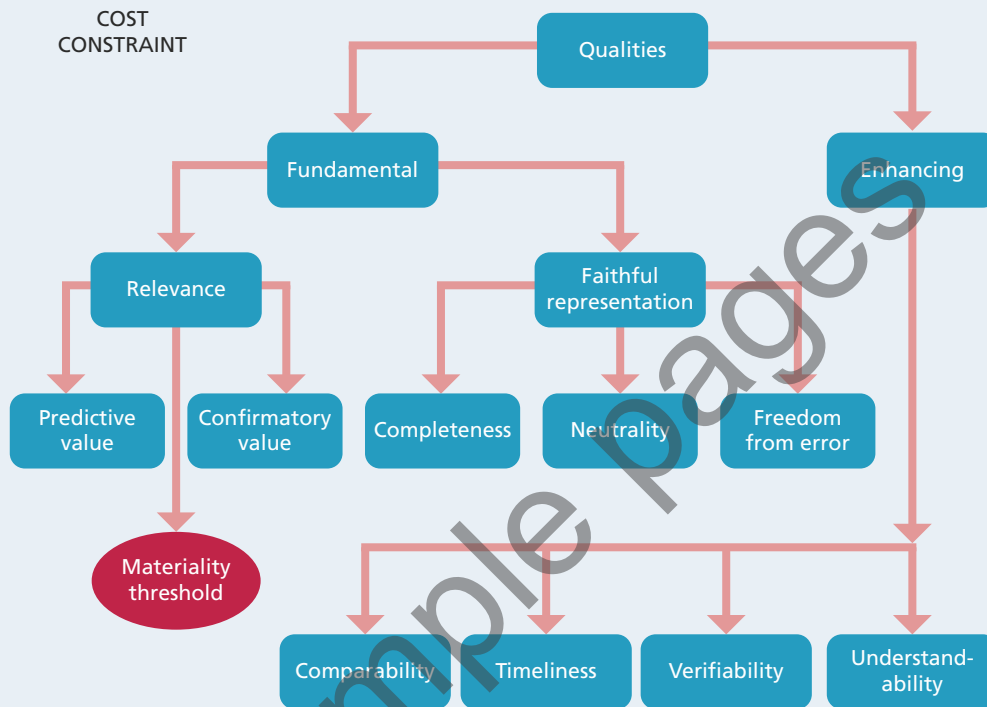


FIGURE 1.1

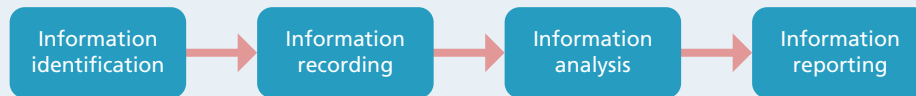
The characteristics that influence the usefulness of accounting information

Two fundamental qualities determine the usefulness of accounting information. In addition, four qualities enhance the usefulness of accounting information. The benefits of providing the information, however, should outweigh the costs.

Accounting as an information system

Accounting can be seen as an important part of the total information system for a business. Users, both inside and outside the business, have to decide how to allocate scarce economic resources. To try to ensure that these allocation decisions are efficient and effective, users require economic and other information. It is the role of the accounting system to provide much of that information. Thus, we can view accounting as an information-gathering, processing and communication system. The accounting system will involve the following four stages shown in Figure 1.2:

- 1 identifying and capturing relevant economic information
- 2 recording the information collected in a systematic manner
- 3 analysing and interpreting the information collected
- 4 reporting the information in a manner that suits the needs of users.

**FIGURE 1.2****The accounting information system**

The figure shows the four sequential stages of an accounting information system. The first two stages are concerned with preparation, and the last two stages are concerned with using the information collected.

Given the decision-making emphasis of this text, we shall primarily concentrate on the final two elements of the process—the analysis and reporting of financial information. We are concerned with how information is used by, and is useful to, decision-makers rather than with how it is collected and recorded. However, in Chapters 4 and 5 we will provide a brief overview of data collection and recording for those who are interested or need a foundation for more detailed work on these two aspects of accounting.

Concept check 1

The purpose of accounting is to:

- A** Provide information to assist users' decision-making
- B** Report on the status of transactions for the period
- C** Prepare financial reports on a regular basis
- D** Provide financial information to clients
- E** None of the above are true.

Concept check 2

The two most important qualities for accounting information are:

- A** Relevance and materiality
- B** Relevance and accuracy
- C** Faithful representation and relevance
- D** Completeness and relevance
- E** Freedom from error and relevance.

Concept check 3

The usefulness of accounting information is increased by:

- A** Not being overly complex
- B** Being provided on schedule (e.g. not late)
- C** Being supported by reasonable evidence
- D** All of the above
- E** None of the above.

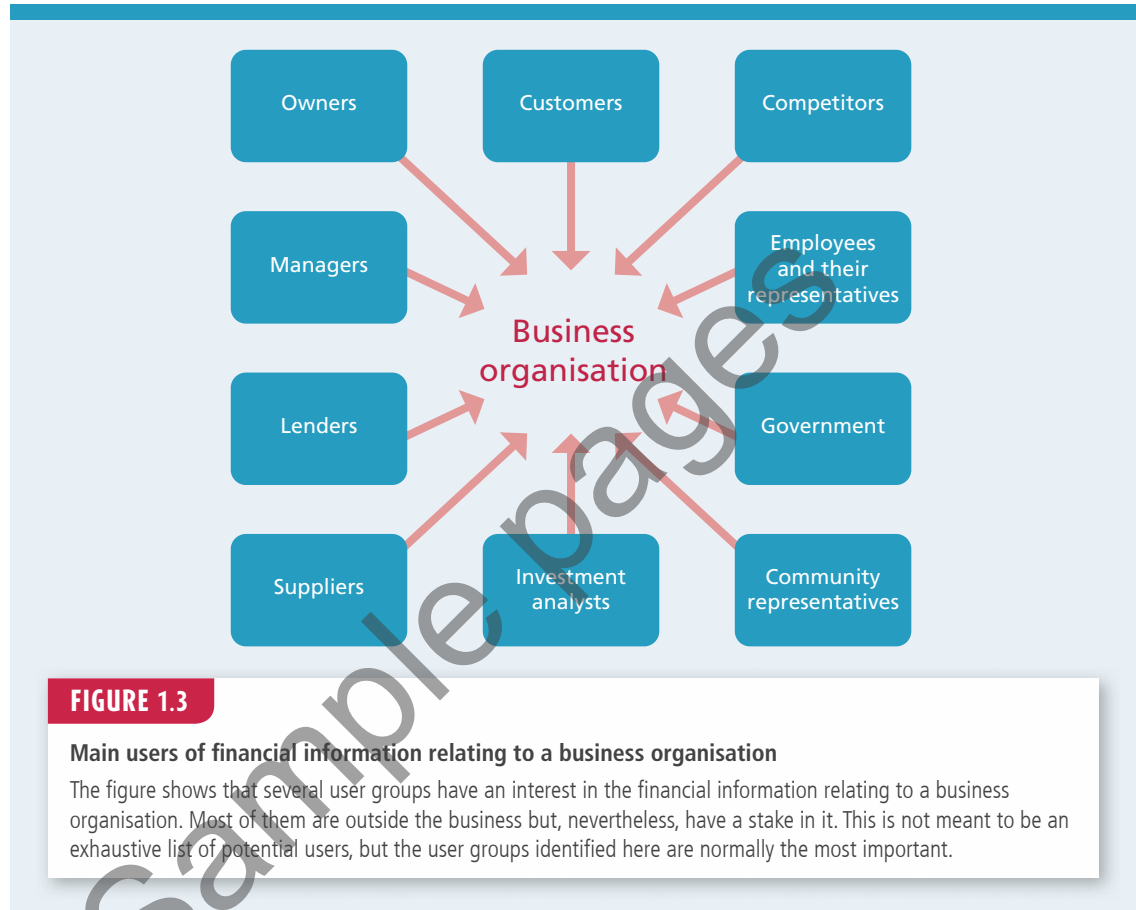
L02

List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information

USERS OF ACCOUNTING INFORMATION

Accounting seeks to satisfy the needs of a wide range of users. In a particular business, there may be various groups who are likely to have an interest in its financial health. (Although the points made in this chapter and throughout this book may apply to a variety of organisations—such as public-sector business enterprises, local authorities and charities—we concentrate on private-sector businesses.)

The major user groups for a business organisation are shown in Figure 1.3.



ACTIVITY 1.2

Ptarmigon Insurance Ltd (PI) is a large motor insurance business. Taking the user groups identified in Figure 1.3, suggest, for each group, the sorts of decisions likely to be made about PI and the factors to be taken into account when making these decisions.

Activity 1.2 illustrates that each user group looks at the business from a different perspective and has its own particular interest. Inevitably there will be occasions when these perspectives and interests may clash. One of the more likely causes relates to the way in which the wealth of the business is generated and distributed. Recent years have seen considerable debate as to the salary level of management teams, especially that of the chief executive officer (CEO). High bonus payments in a year in which performance has not been judged to be good do not sit well with investors. Another area of potential conflict is likely to be between investors and lenders, with lenders wishing to be sure that the money lent has been invested appropriately and with due regard to their interests, while borrowers are likely to want to be able to have maximum flexibility.

Stakeholder theory uses a similar approach to that set out above, but additionally provides some useful insights into just what makes a successful business, and illustrates how the various

stakeholder theory

A theory which argues that organisations have a variety of interested parties and that these interests need to be considered and incorporated in a harmonised manner, in order to achieve the best overall outcomes.

user groups can interact. User groups can clearly be thought of as stakeholders in a business. Stakeholder theory was effectively introduced by R. Edward Freeman in 1984 in his book, *Strategic Management: A Stakeholder Approach*. Freeman's main point was that, at that time, business pretty much saw managerial self-interest and shareholder profit as the driving force of business. Freeman argued that this wasn't the view of the people who actually did business. They had other motivations and responded to other people—employees, customers, suppliers, regulators, industry bodies, trade unions, community groups—which Freeman called stakeholders. We shall come back to stakeholder theory later in the chapter.

Concept check 4



Accounting seeks to satisfy the needs of which of the following users?

- A** Shareholders
- B** Prospective shareholders
- C** Government (e.g. ATO)
- D** Stakeholders
- E** Creditors.

Concept check 5



Stakeholder theory:

- A** Recognises that organisations have a variety of interested users
- B** Attempts to meet the needs of the primary users
- C** Was introduced by R.E. Freeman in 1986
- D** All of the above
- E** None of the above.

FINANCIAL AND MANAGEMENT ACCOUNTING

In providing information for the various user groups identified, accounting has divided into two main areas: management accounting and financial accounting. **Management accounting**, as the name suggests, is concerned with providing managers with the information they require for the day-to-day running of the organisation. **Financial accounting** is concerned with providing the other users with useful information.

The main differences between the two types of accounting reflect the range of recipients, as follows:

- **Nature of the reports produced.** Financial accounting tends to produce general-purpose financial reports; that is, they contain financial information that will be useful for a broad range of users and decisions. Management accounting reports, on the other hand, are often specific-purpose reports, designed with a particular decision or manager in mind.
- **Level of detail.** Financial accounting reports provide users with a broad overview of the position, performance and cash flows of the business for a period. As a result, information is aggregated and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular decision.
- **Restrictions.** Financial reporting for many businesses is subject to legal and accounting regulations that seek to ensure that specified content is presented in a fairly standard form.

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Compare and contrast financial and management accounting

management accounting

An approach which aims to provide managers with the information they require to run the organisation.

financial accounting

Financial accounting provides general-purpose financial information for a variety of users, with the information being of a general-purpose nature.

Because management accounting reports are for internal use only, there are no restrictions on the form and content of the reports.

- **Reporting interval.** For most businesses, financial accounting reports are produced on an annual basis. However, large companies may produce half-yearly reports and a few produce quarterly reports. Management accounting reports may be produced as frequently as required by managers. In many businesses, managers are provided with certain weekly or monthly reports to allow them to check progress on a regular basis. In addition, special-purpose reports will be prepared when required (e.g. to evaluate a proposal for a piece of equipment).
- **Time horizon.** Financial accounting reports reflect the performance and position of the business to date. In essence, they are backward-looking. Management accounting reports, on the other hand, often provide information on expected future performances as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release forecast information to other users in order to raise capital or to fight off unwanted takeover bids. Even preparation of the routine financial reports typically requires making some judgements about the future, as we shall see in Chapter 3.
- **Range of information.** Financial accounting reports concentrate on information that can be quantified in monetary terms. Management accounting produces such reports, too, but is also more likely to produce additional reports on non-financial matters, such as measures of physical quantities of inventory (stocks) and output. Financial accounting places greater emphasis on objective, verifiable evidence when preparing reports. Management accounting reports intended for managers may use information that is less objective and verifiable, but which nevertheless provides managers with the information they need. So the basic accounting statements will be used historically by the financial accountant, where the emphasis is on information which is as reliable and as objective as possible, whereas the management accountant may well use the same format to assist in some decisions, but will inevitably also use estimates which are clearly less reliable. This does not detract from the usefulness of the forecasts.

We can see from the above list that management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of reliability. The only real test of the value of the information produced for managers is whether or not it improves the quality of decisions made.

ACTIVITY 13

Can you think of any areas of overlap between the information needs of managers and those of other users? (Think about the time orientation and the level of detail of accounting information.)

The distinction between the two areas reflects, to some extent, the differences in access to financial information. Managers have much more control over the form and content of the information they receive. Other users have to rely on what managers are prepared to provide or what the financial reporting regulations state must be provided. Although the scope of financial accounting reports has increased over time, fears over loss of competitive advantage and fears of user ignorance about the reliability of forecast data have led businesses to resist making information available to users other than managers.

There is little doubt that in the past financial accounting has been the dominant partner, and many of the ground rules reflect this. However, modern accounting systems typically are developed in a manner that enables both the specific external reporting requirements to be fulfilled and relevant management accounting reports to be prepared. Financial accounting and management accounting should not be seen as two different topics, but rather different perspectives reflecting the justifiable needs of users.

Concept check 6



Which of the following is true?

- A** Financial accounting provides greater detail than management accounting.
- B** Management accounting is subject to the same standards as financial accounting.
- C** The financial accountant can plan their annual two-week vacation more reliably than the management accountant.
- D** Financial accounting is forward-looking.
- E** None of the above.

Concept check 7



Which of the following is false?

- A** Management accounting provides more scope for creativity than financial accounting.
- B** There are more rules to follow in financial accounting than in management accounting.
- C** Management accounting reports tend to provide a wider range of information than that provided by financial accounting.
- D** All of the above are false.
- E** None of the above are false.

WHAT IS THE FINANCIAL OBJECTIVE OF A BUSINESS?

A business is normally created to enhance the wealth of its owners. Throughout this book we shall assume that this is its main objective. This may come as a surprise, as there are other objectives that a business may pursue that are related to the needs of others associated with the business. For example, a business may seek to provide good working conditions for its employees, or it may seek to conserve the environment for the local community. While a business may pursue these objectives, it is normally set up with a view to increasing the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

Within a market economy there are strong competitive forces at work that ensure that failure to enhance owners' wealth will not be tolerated for long. Competition for the funds provided by the owners and competition for managers' jobs will normally mean that the owners' interests will prevail. If the managers do not provide the expected increase in ownership wealth, the owners have the power to replace the existing management team with a new team that is more responsive to owners' needs. Does this mean that the needs of other groups associated with the business (employees, customers, suppliers, the community and so on) are not really important? The answer to this question is certainly no, if the business wishes to survive and prosper over the longer term.

Satisfying the needs of other groups is usually consistent with increasing the wealth of the owners over the longer term. A business with disaffected customers, for example, may find that they turn to another supplier, resulting in a loss of shareholder wealth. A dissatisfied workforce may result in low productivity, strikes and so forth, which will in turn have an adverse effect on owners' wealth. Similarly, a business that upsets the local community by unacceptable behaviour, such as polluting the environment or ignoring human rights issues, may attract bad publicity, resulting in a loss of customers and heavy fines.

While the idea of an objective of wealth enhancement is still reasonable, there is now considerably more awareness of the damage that can be done to individuals, to the environment and to society at large, by unconstrained wealth maximisation. Real World 1.1, written when the global financial crisis was in the forefront of most people's minds, provides clear recognition of the potential problems that can arise.

LO4

Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship

We should be clear that generating wealth for the owners is not the same as seeking to maximise the current year's profit. Wealth creation is concerned with the longer term. It relates not only to this year's profit but to that of future years as well. In the short term, corners can be cut and risks taken that improve current profit at the expense of future profit.

REAL WORLD 1.1

Short-term gains, long-term problems

For many years, under the guise of defending capitalism, we have been allowing ourselves to degrade it. We have been poisoning the well from which we have drawn wealth. We have misunderstood the importance of values to capitalism. We have surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made.

Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them was not their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was thirty years ago. Public anger at the crisis will make visible what was previously hidden. Take the building up of huge portfolios of loans to poor people on US trailer parks. These loans were authorised without proper scrutiny of the circumstances of the borrowers. Somebody else then deemed them fit to be securitised and so on through credit default swaps and the rest without anyone seeing the transaction in terms of its ultimate human origin.

Each of the decision makers thought it okay to act like the thoughtless footwear buyer of the 1970s. The price was attractive. There was money to make on the deal. Was it responsible? Irrelevant. It was legal, and others were making money that way. And the consequences for the banking system if everybody did it? Not our problem.

The consumer has had a profound shock. Surely we could have expected the clever and wise people who invested our money to be better at risk management than they have shown themselves to be in the present crisis? How could they have been so gullible in not challenging the bankers whose lending proved so flaky? How could they have believed that the levels of bonuses that were, at least in part, coming out of their savings could have been justified in 'incentivising' a better performance? How could they have believed that a 'better' performance would be one that is achieved for one bank without regard to its effect on the whole banking

system? Where was the stewardship from those exercising investment on their behalf?

The answer has been that very few of them do exercise that stewardship. Most have stood back and said it doesn't really pay them to do so. The failure of stewardship comes from the same mindset that created the irresponsible lending in the first place. We are back to the mindset that has allowed us to poison the well: never mind the health of the system as a whole, I'm making money out of it at the moment. Responsibility means awareness for the system consequences of our actions. It is not a luxury. It is the cornerstone of prudence.

Source: Extract from M. Goyder, 'How we've poisoned the well of wealth', Financial Times, 15 February 2009. © The Financial Times Limited 2009. All Rights Reserved. FT and 'Financial Times' are trademarks of the Financial Times.

Class discussion points

- 1 Try to explain the thinking behind the type of decision made by footwear companies 30 years ago, in terms of sourcing shoes from poorer countries.
- 2 Why do you think that Nike found it necessary to transform its business model?
- 3 Explain the reference to US trailer camps and the idea of the sub-prime crisis.
- 4 How do you feel about the idea—'it was legal and others were making money this way'?
- 5 How might we best move away from this attitude—and what should our approach be?
- 6 Estimating profit as it relates to a particular business is manageable. But measurement of social and environmental issues is more difficult. How might you approach this issue?
- 7 What do you understand by stewardship? Does the traditional approach to stewardship accounting accord with your view? Identify reasons why the main financial reports prepared for external use are still largely financially oriented?
- 8 Assume that you are a member of a superannuation fund. Which investment choices did you/will you make? Did you consider anything green, or ethically based, or did you simply go for growth? Why did you make the choice that you did?

Stakeholder theory

Stakeholder theory was introduced in the section on users of accounting information, but the theory now goes way beyond what users might need from accounting. Freeman has been developing his theory for the last 30 years. A sense of his current thinking is summarised in Real World 1.2.

REAL WORLD 1.2

Stakeholder theory—current thinking

As we saw earlier, Freeman argued strongly that managerial self-interest and shareholder profits, which he described as ‘the old story’, were not the driving force of business. He felt that people were interested in, and motivated by, far more than profit, and that all of their interests needed to be given appropriate recognition. Of course, profits were part of the story, but profits were seen as the outcome rather than the aim.

So, what makes a successful business? Obvious elements include good products or services, a good and committed workforce, reliable suppliers who provide goods and services at the right quality, and a good relationship with the community at large.

Freeman now talks about working to ‘harmonise’ the various stakeholders’ interests. There will of course be some conflict between some stakeholders, but such conflict should be seen as an opportunity to value-create.

Value is perceived by Freeman as much broader than simply financial value. He believes ‘we create value when we do things that people find valuable’.

The traditional approach is reasonably easily associated with measurement. Most businesses know how to measure customer satisfaction and whether they are creating value for their customers. Other areas, such as value for employees and the community, are less commonly addressed—and these need to be worked on.

Source: Eva Tsahuridu & David Walker, ‘R. Edward Freeman—The Stakeholder Revolutionary’, InTheBlack, 1 April 2015. It is recommended that you read the entire article.

Class discussion points

- 1 What value do you think a company creates for its employees?
- 2 What might be the components of value for employees in general? And at an individual level?
- 3 How might they be measured?
- 4 How might the social or environmental impact be identified and measured?
- 5 What kind of information might you collect if you thought that you needed to figure out how to create value, not just for investors, but for customers, suppliers, employees and communities?
- 6 Do you think, from your own experience, that the ideas of stakeholder theory, as compared with the traditional search for profit, are gaining ground, and if so in which areas and ways?
- 7 In recent years the banks have been the subject of much criticism. How might a bank balance the conflicting needs of shareholders, customers (both borrowers and depositors) and government?

Clearly stakeholder theory has had considerable influence over time, but whether accounting is doing enough in this area remains debatable. What is not in doubt is that social and environmental accounting has become much more important in assessing performance. Freeman believes that the way in which these have been ‘bolted on’ to the old business model of financial accounting suggests that there is a long way to go. We shall see in Chapter 9 just how many improvements have been made in reporting on social and environmental aspects and impacts, now more commonly called sustainability reporting or integrated reporting. There also remains scope for considerably more work to be carried out to deal with some of the issues implicit in Freeman’s theory. Just how easy it will be to find appropriate ways of dealing with the issues he raises remains to be seen.

return

The gain that results from a particular event or occurrence.

risk

The likelihood that what is projected to occur will not actually occur.

Balancing risk and return

In considering wealth enhancement as our primary goal, we also need to recognise the need to balance the required **return** with the **risk** level associated with the business.

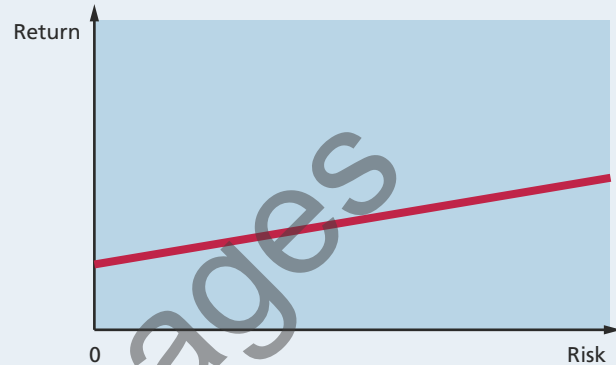
All decision-making involves the future. Business decision-making is no exception. The only thing certain about the future, however, is that we cannot be sure what will happen. Things may not turn out as planned, and this risk should be carefully considered when making financial decisions.

As in other aspects of life, risk and return tend to be related. Evidence shows that returns relate to risk in something like the way shown in Figure 1.4.

FIGURE 1.4

Relationship between risk and return

Even at zero risk, a certain level of return will be required. This will increase as the level of risk increases.



ACTIVITY 1.4

Look at Figure 1.4 and state, in broad terms, where an investment in:

- (a) a government savings account, and
- (b) a lottery ticket

should be placed on the risk–return line.

This relationship between risk and return has important implications for setting financial objectives for a business. The owners will require a minimum return to induce them to invest at all, but will require an additional return to compensate for taking risks; the higher the risk, the higher the required return. Managers must be aware of this and must strike the appropriate balance between risk and return when setting objectives and pursuing particular courses of action.

The turmoil in the banking sector as a result of the global financial crisis has shown that the right balance is not always struck. Some banks took excessive risks in pursuit of higher returns and, as a consequence, incurred massive losses. There is little doubt that the risk appetite of the banks has changed dramatically over the past few years, and with good reason. Whether this change in appetite is permanent remains to be seen.

Concept check 8



A corporate mission statement would usually include an objective relating to:

- A** Provision of good working conditions for employees
- B** Conservation of the environment
- C** Earning of profits in the short term
- D** Enhancement of the wealth of its owners
- E** The need to be an industry leader.

Concept check 9



Which of the following statements is false?

- A** The expected level of return increases as the level of risk increases.
- B** The GFC is a good example of the consequences of appropriate risk behaviour.
- C** Life without risk is death.
- D** Managers and organisations must strike a balance between risk and return.
- E** None of the above. All are true.

L05

Provide an overview of the main financial reports prepared by a business

THE MAIN FINANCIAL REPORTS—AN OVERVIEW

Financial accounting

Financial accounting grew from the old idea of stewardship accounting where stewards (managers/representatives) gave an accounting of how they had fulfilled their responsibilities. When you remember that this was happening throughout the Industrial Revolution, you should realise that these statements were all about wealth. There was little concern about staff (workers), social issues or the environment. Human rights was not a term even thought about, other than as it related to the bosses! Times have changed, as we shall see as we progress through the book. However, the need for basic financial statements remains. A very simple illustration is given next. You will find that the rules and regulations surrounding these statements have become more rigorous as time has passed and business has become more complicated.

The main financial statements are designed to provide a picture of the overall financial position and performance of the business. To do this, the accounting system normally produces three main financial reports on a recurring basis. These financial statements are concerned with answering the following questions:

- What cash movements (i.e. cash in and cash out) took place over a particular period?
- How much did wealth increase over a particular period as a result of operating and other activities? In other words, how much profit did the business generate from its overall activities?
- What is the financial position of the business at the end of a particular period?

These questions are all addressed by the three main financial reports listed below:

- 1 the **statement of cash flows** for the period
- 2 the **statement of financial performance** for the period, commonly known as the **income statement**. It is often also referred to as the **profit and loss statement**, especially when used internally in a business. For limited companies, the annual published statement is now called a **statement of comprehensive income**, and formats and requirements will be dealt with in Chapters 3 and 7.
- 3 the **statement of financial position** as at the end of the period, commonly known as the **balance sheet**.

In due course we will also introduce a fourth statement, the **statement of changes in equity**, but this statement is really only important for limited companies and we will leave discussion until the appropriate later chapter. Basically, **equity** is the term used to indicate the share of the business which represents the owners' interests.

Taken together, the three main statements provide an overall picture of the financial health of the business. Perhaps the best way to introduce the financial reports is to look at an example of a very simple business. From this we shall be able to see what sort of useful information each of the statements can provide.

We can see from the financial reports in Example 1.1 that each provides part of the picture of the financial performance and position of the business. We begin by showing the cash movements.

statement of cash flows

The statement that shows the sources and uses of cash for a period.

statement of financial performance/income statement/profit and loss statement

The statement which measures and reports how much wealth (profit) has been generated in a period.

statement of comprehensive income

A statement that presents all items of income and expense recognised in a period, either in a single statement of comprehensive income or in two statements, the first being a statement displaying components of profit and loss (normal income statement), and a second which begins with profit or loss and displays components of other comprehensive income. From January 2018 the two-statement approach will need to be modified to a two-section approach, with the income statement preceding the other comprehensive income section.

statement of financial position

A statement that shows the assets of a business and the claim on those assets at a point in time.

balance sheet

A statement that shows the assets of a business and the claims on the business. Assets must always equal claims. Claims will relate to external liabilities and owner's claims (known as equity).

statement of changes in equity

The statement that shows all changes in the owners' interest in the net assets of the business as a result of transactions and events during a period. This includes total comprehensive income for the period, including profit or loss, and transactions with owners in their capacity as owners, showing contributions by and distributions to owners.

equity

The share of the business which represents the owners' interests.

Cash is vital for any business to function effectively: to meet obligations, to acquire other resources (such as stock/inventory), to satisfy operating expenses and to meet ownership distributions. Cash has been described as the 'life blood' of a business, and movements in cash are usually given close scrutiny by users of financial statements.

EXAMPLE**1.1**

Paul was unemployed and unable to find a job. He decided to embark on a business venture to meet his living expenses. Christmas was approaching, so he decided to buy gift-wrapping from a local supplier and sell it on the corner of his local main street. He felt that the price of wrapping paper in the shops was excessive and that this would give him a useful business opportunity.

He began the venture with \$600 in cash. On the first day of trading he purchased wrapping paper for \$600. This is called stock (of goods) or inventory. Later in the day he sold three-quarters of his inventory for \$660 cash.

What cash movements took place in the first day of trading?

On the first day of trading a statement of cash flows, showing the cash movements for the day, can be prepared as follows:

| | \$ |
|--|-------|
| Statement of cash flows for day 1 | |
| Opening balance (cash introduced) | 600 |
| Sale of wrapping paper | 660 |
| | 1260 |
| Purchase of wrapping paper | (600) |
| Closing balance | 660 |

How much did wealth increase as a result of operations in the first day of trading? In other words, how much profit was generated by the business?

A statement of financial performance (income statement) can be prepared to show the increase in wealth (profit) generated on the first day. The wealth generated will represent the difference between the sales made and the cost of the goods (i.e. wrapping paper) sold.

| | \$ |
|--|-------|
| Statement of financial performance (income statement) for day 1 | |
| Sales | 660 |
| Cost of goods sold ($\frac{3}{4}$ of \$600) | (450) |
| Profit | 210 |

Note that only the cost of the wrapping paper sold is matched against the sales to find the profit, not the whole cost of wrapping paper acquired. Any unsold wrapping paper (known as inventory or stock) will be charged against future sales.

What is the financial position at the end of the first day?

To establish this we can draw up a statement of financial position listing the resources held at the end of the day.

| | \$ |
|--|-----|
| Statement of financial position (balance sheet) at the end of day 1 | |
| Cash (closing balance) | 660 |
| Inventory (stock of goods for resale: $\frac{1}{4}$ of \$600) | 150 |
| Total assets held | 810 |
| = Paul's wealth in the business (equity) | 810 |

Note that the profit has led to an increase in wealth (\$210). In this particular business, all of the business wealth is the entitlement of Paul, so Paul's equity can be seen to be \$810. As we shall see in the next chapter, the situation in which there are no other claims on the business wealth is unusual. The situation in practice is rather more involved than that found in this simple example.

It is clear that reporting cash movements alone would not be enough to portray the financial health of the business. The changes in cash over time do not fully reveal the profit generated. The

statement of financial performance provides an insight into this aspect of performance. For day 1, for example, we saw that the cash balance increased by \$60 but the profit generated, as shown in the statement of financial performance, was \$210. The increase in wealth (\$210) was represented by \$60 cash and \$150 in the form of stock (inventory).

To determine the total wealth of the business, a statement of financial position is drawn up at the end of the day. Cash is only one form in which wealth can be held. In the case of this business, wealth is also held in the form of inventory (stock of goods for resale). Drawing up the statement of financial position involves listing both forms of wealth held. In the case of a large business, there may be many other forms of holding wealth, such as land and buildings, equipment and motor vehicles.

Let us now continue with our example.

On the second day of trading, Paul purchased more wrapping paper for \$300 cash. He managed to sell all the new wrapping paper and half of the earlier stock for a total of \$540.

The statement of cash flows on day 2 is as follows:

| \$ | |
|---|-------|
| Statement of cash flows for day 2 | |
| Opening balance (i.e. closing balance from day 1) | 660 |
| Sale of wrapping paper | 540 |
| | 1200 |
| Purchase of wrapping paper | (300) |
| Closing balance | 900 |

The statement of financial performance for day 2 is:

| \$ | |
|---|-------|
| Statement of financial performance for day 2 | |
| Sales | 540 |
| Cost of goods sold (\$300 + ½ of \$150) | (375) |
| Profit | 165 |

The statement of financial position (balance sheet) at the end of day 2 is:

| \$ | |
|--|-----|
| Statement of financial position (balance sheet) at the end of day 2 | |
| Cash | 900 |
| Inventory (stock of goods for resale: ½ of \$150) | 75 |
| Total assets | 975 |
| = Paul's wealth in the business (equity) | 975 |

We can see that the total business wealth increased to \$975 by the end of day 2. This represents an increase of \$165 (i.e. \$975 – \$810) over the previous day. Note that this is the amount of profit made during day 2 as shown on the statement of financial performance.



continued

ACTIVITY 1.5

On the third day of his business venture, Paul purchased more stock for \$600 cash. However, it was raining hard for much of the day and sales were slow. After Paul had sold half of his total stock for \$390, he decided to stop trading until the following day. Have a go at drawing up the three financial reports for day 3 of Paul's business venture.

The solution to Activity 1.5 shows that the total business wealth increased by \$52.50 (i.e. the amount of the day's profit) even though the cash balance declined. This is due to the fact that the business is holding more of its wealth in the form of inventory rather than cash, compared with at the end of day 2.

Note that the statement of financial performance and the statement of cash flows are both concerned with measuring flows (of wealth and cash, respectively) over time. The period of time

may be one day, one month, one year, etc. The statement of financial position (balance sheet), however, is concerned with the financial position (or wealth) at a particular moment in time (the end of one day, one week, etc). Figure 1.5 illustrates this point. The statement of financial performance, statement of cash flows and statement of financial position, when taken together, are often referred to as the ‘final accounts’ of the business.

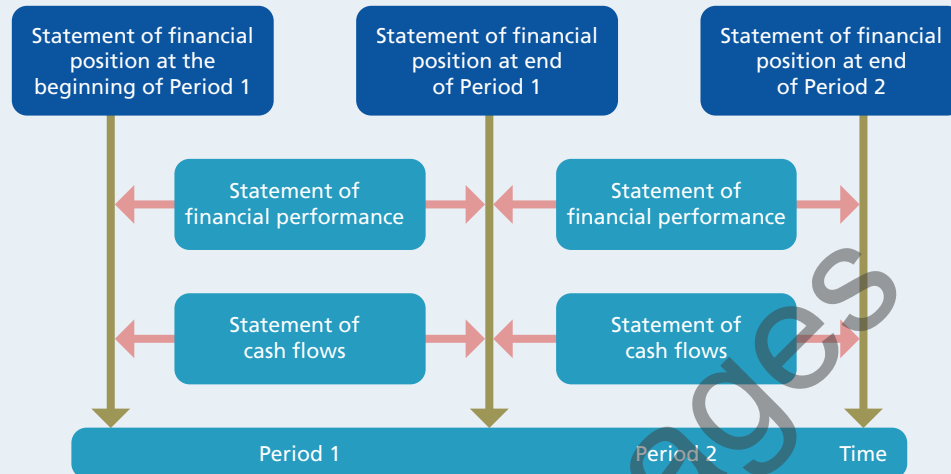


FIGURE 1.5

The relationship between the statement of financial position, the statement of financial performance and the statement of cash flows

The figure shows how the statement of financial performance and statement of cash flows are concerned with measuring flows of wealth over time. The statement of financial position, however, is concerned with measuring the stock of wealth at a particular moment in time.

For external users of the accounts, these reports are normally backward-looking and are based on records of past events and transactions. This can be useful as feedback on past performance and for identifying trends and clues to future performance. However, the reports can also be prepared using projected data in order to help assess likely future profits, cash flows, etc. The financial reports are normally prepared on a projected basis for internal decision-making purposes only. Managers are usually reluctant to publish these projected figures for external users.

Nevertheless, as external users have to make decisions about the future, projected financial reports prepared by managers are likely to be useful for this purpose. Managers are, after all, in a good position to assess future performance, and so their assessments are likely to provide valuable information. In certain circumstances, such as raising fresh capital or resisting a hostile takeover bid, managers are prepared to depart from normal practice and issue projected figures to external users. Where publication does occur, some independent verification of the assumptions underlying the forecasts is often provided by a firm of accountants to lend credibility to the figures produced.

Management accounting

By now it should be clear that management accounting uses financial information (and increasingly non-financial information) in a variety of different ways, with the general aim of achieving good decisions. The main areas of use include: prediction of future financial performance as part of long-term planning; budgeting as a means of both planning and control; cost control and savings; pricing; and project appraisal.

Concept check 10



The statement of financial performance is also known as:

- A** Statement of financial position
- B** The income statement
- C** The profit and loss statement
- D** The balance sheet
- E** Statement of comprehensive income.

Concept check 11



Which statement shows all changes in the owners' interest in the business?

- A** The statement of changes in equity
- B** The balance sheet
- C** The statement of financial performance
- D** The statement of comprehensive income
- E** The statement of cash flows.

Concept check 12



Which financial statements are videos rather than snapshots?

- A** Income statement and balance sheet
- B** Statement of cash flows and statement of financial position
- C** Balance sheet and statement of cash flows
- D** Statement of financial performance and statement of cash flows
- E** None of the above.

SELF-ASSESSMENT QUESTION 1.1

While on holiday on the Gold Coast, Helen had her credit cards and purse stolen from a beach where she was swimming. She was left with only \$120, which she had left in her hotel room. There were three days of her holiday remaining. She was determined to continue her holiday and so decided to make some money in order to be able to complete her holiday. She decided to sell orange juice to holiday-makers on the local beach. On day 1 she purchased 80 cartons of orange juice at \$1.50 each for cash, and sold 70 of these for \$2.40 each. On the following day she purchased 60 cartons for cash and sold 65 at \$2.40 each. On the third and final day she purchased another 60 cartons for cash. However, it rained and, as a result, business was poor. She managed to sell 20 at \$2.40 each, but was forced to sell the rest of her stock at \$1.20 each.

Prepare a statement of financial performance (income statement) and a statement of cash flows for each day's trading, and a statement of financial position at the end of each day's trading.

L06

Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context

sole proprietorship

An individual in business on his or her own account.

BUSINESS AND ACCOUNTING

So far in this chapter we have talked in general terms about the kind of accounting information that might be used by various user groups. In practice, however, the forms of business ownership and the differing types of business activities engaged in will influence these needs. In the next section we will consider some of these factors.

What kinds of business ownership exist?

The particular form of business ownership has important implications for accounting purposes, and so it is useful to be clear about the main forms of ownership that can arise. There are basically three arrangements:

- sole proprietorship (also known as sole trader)
- partnership, and
- limited company.

We shall now consider the first two in reasonable detail, and limited companies in outline. Chapters 6 and 7 will provide more detail for limited companies.

Sole proprietorship

Sole proprietorship (also known as sole trader), as the name suggests, is where an individual is the sole owner (known as the proprietor) of a business. This type of business is often quite small in terms of total income or profits, or number of employees. However, the number of businesses that operate as sole proprietors is very large, far greater than the number of businesses that operate as companies. Examples of sole proprietor businesses can be found in most sectors, but the service sector predominates. Hence, services such as electrical repairs, plumbing, picture framing, photography, driving instruction, retail shops and hotels have a large proportion of sole proprietor businesses.

A sole proprietor business is easy to set up, with no formal procedures being required. Operations can generally commence immediately (unless special permission is required because of the nature of the trade or service, such as running licensed premises). The owner has considerable discretion as to how the business is to be conducted, and is able to restructure or dissolve the business whenever it suits.

A sole proprietorship has no separate legal identity. From a legal perspective there is no distinction between the owner (Bill Bloggs) and the business (Bill's Diner). However, from an accounting perspective we distinguish clearly between the owner (Bill Bloggs) and the business (Bill's Diner). The accounting entity (Bill's Diner) will recognise transactions between the owner (Bill Bloggs) and the business. These transactions concern capital (funds) contributed to the business by the owner, profit earned by the business and not distributed to the owner, and distributions to the owner. Distributions to the owner, which are often labelled 'drawings', may be any of the following:

- cash taken out of the business on a regular (weekly) or irregular basis
- other assets taken out of the business for personal consumption or use (e.g. merchandise or equipment)
- personal accounts paid by the business (e.g. insurance, rent, electricity)
- personal benefits derived from business assets (e.g. accommodation, use of motor vehicle).

Another consequence of the fact that the law does not recognise the sole proprietor business as being separate from the owner is that the business will cease on the death of the owner.

A sole proprietor has unlimited liability, and no distinction is made between the proprietor's personal wealth and that of the business if there are business debts to be paid.

The important characteristics of the sole proprietorship entity structure from the perspective of both the owner and other people or other entities dealing with this business are summarised in Table 1.1.

TABLE 1.1 CHARACTERISTICS OF A SOLE PROPRIETORSHIP

No separate legal entity. While the business is a separate accounting (recording/reporting) entity, it is not a separate legal entity. It cannot enter into contractual arrangements (borrow, lend, purchase, sell, sue or be sued) in its own right; rather, the legal owner must negotiate such contracts.

Limited life. The sole proprietorship structure has a limited life. The life of the business is restricted to the period in which the owner continues in that position. This does not mean that the activity of the business necessarily stops when the owner dies, retires or leaves the business, but that sole proprietorship business ceases and possibly another commences (e.g. new owner, new name).

Unlimited liability. The owner of a sole proprietorship has unlimited liability with respect to the activities of the business. That is, he or she is fully responsible for the obligations and debts of the business.

Minimum reporting regulations. Regulations for financial recording and reporting are minimal compared with those for other entity structures. However, the introduction of the Goods and Services Tax (GST) has increased the requirement for regular detailed reports.

Limited access to funds. Access to funds is potentially limited. With a sole proprietorship, the ownership funding is restricted to the personal resources of a single owner. Additionally, certain forms of borrowing are not available to sole proprietors that may be available to companies, and lenders may be more reluctant to provide credit or funds to sole proprietorships.

The costs to establish a sole proprietorship structure are normally much lower than for other entity structures. By costs we are referring to those involved in setting up the business entity, not the costs to make the business operational (e.g. the necessary resources, property, plant, equipment, inventories, staff and other expenditure).

A sole proprietor will usually need some indication of the financial performance and position of the business, and certainly will need to provide the taxation authorities with accounting information sufficient to satisfy their needs. However, there is no legal requirement to produce accounting information relating to the business for other user groups, though some may have the power (e.g. a lending bank) to demand accounting information about the business. All of this means that the range and quality of the accounting information required by a sole proprietor is likely to vary quite a bit. It is reasonable to assume that a report explaining the calculation of income for use by the Australian Taxation Office would be a minimum. Of course, many sole proprietors will require much more than this minimum and will look for as much accounting information as is considered useful.

Having highlighted some key features of the sole proprietorship entity structure, we can determine its advantages and disadvantages. The advantages include:

- they are simple and inexpensive to establish and operate
- there is minimal financial reporting regulation
- ownership and management are normally combined
- the financial rewards flow directly to the owner
- timely decision-making is possible.

Potential disadvantages of the sole proprietorship structure when compared to other structures include:

- the liability of the owner is unlimited, and personal assets may have to be used to satisfy business debts
- access to ownership funds is restricted to the personal resources of the proprietor
- experience and knowledge is limited to the extent that the sole owner is frequently the sole manager
- access to non-ownership funding (suppliers of goods and services on credit, external loans) is often limited.

partnership

The relationship that exists between two or more persons carrying on a business with a view to profit.

Partnership

The **partnership** structure represents the relationship that two or more individuals share with the aim of generating a financial profit. Partnerships are usually quite small in size (although some, such as partnerships of accountants and solicitors, can be large). Partnerships are also easy to set up. They may be established by a formal partnership agreement or an informal arrangement between the parties, or agreement may be simply inferred by the actions of two or more individuals. The partners can agree whatever arrangements suit them concerning the financial and management aspects of the business. Similarly, the partnership can be restructured or dissolved by agreement between the partners.

The partnership represents a separate accounting entity distinct from the owners (partners). However, as with the sole proprietorship, there is no separate *legal* entity. From the viewpoint of the law there are just the individual owners. Contracts with third parties must be entered into in the name of individual partners. The partners of a business usually have unlimited liability.

The main characteristics of a partnership are shown in Table 1.2.

TABLE 1.2 CHARACTERISTICS OF A PARTNERSHIP

No separate legal entity. While the partnership is a separate accounting entity, there is no legal distinction between the business and the partners. As with a sole proprietorship, it is the partners, not the partnership, who enter into all contractual arrangements (e.g. borrow, lend, buy, sell, employ, dismiss, sue, be sued).

Limited life. The partnership has a limited life, as each time there is a change in ownership (partners leave, new partners are introduced), the current partnership concludes and a new partnership commences.

Unlimited liability. The liability of partners jointly and separately is unlimited with respect to the debts of the business. This means that each partner's personal assets can be called upon to satisfy the claims of business creditors, well beyond the amount of the individual partner's share of the business.

Mutual agency. Each partner is responsible for the business actions of all other partners as if they had taken the action themselves.

Co-ownership of assets. The partnership assets are owned by the partners in aggregate rather than individually.

Co-ownership of profits. The partnership profits belong to the partners equally or in otherwise agreed proportions.

Limited membership. There are certain restrictions on how many partners can belong to a partnership entity structure. While this is normally limited to 20, there are some exceptions in certain professions (e.g. accounting practices). Given the expanded number of owners, the access to ownership funds is normally much greater than for a sole proprietorship.

Increased regulation. Most states have Partnership Acts which provide direction for the activities of partnerships and the rights and responsibilities of partners.

It is worth noting that, because of the fact that a partnership is not a separate legal entity, the partnership will pay no tax. The partnership profit or loss will be distributed to each partner, who will then include it in his or her tax return (just like a sole trader).

The potential advantages of partnerships might include the following:

- there would normally be greater access to capital since there are two or more owners
- the partners normally bring different skills to the partnership (professional, administrative, technical)
- greater management flexibility is gained by having more than one owner
- taxation advantages often arise when the partnership income can be spread among the partners; this applies particularly to 'husband and wife' activities.

When considering the potential disadvantages of partnerships, it is important to identify the entity structure with which the partnership is being compared. In comparison with a sole proprietorship, the disadvantages could include:

- a higher level of regulation
- giving up profit share to other owners (co-ownership)
- giving up individual asset ownership (co-ownership)
- reduced decision-making authority (shared management)
- mutual agency imposes extra responsibility for the business actions of other partners.

In comparing a partnership with a limited company, the disadvantages could include:

- a limited life may affect long-term planning
- unlimited liability creates greater risk for ownership investment
- absence of a specialist management team
- mutual agency imposes extra responsibility for the business actions of the partners
- access to both ownership funds and debt funds is limited.

While not legally necessary, it is sensible for partners to have a formal and detailed partnership agreement in order to avoid the problems that invariably arise over the operation of the partnership and the relations between partners. When problems between partners cannot be resolved without recourse to the law, the requirements of the relevant Partnership Act will apply.

On the distribution of partnership profit, most Partnership Acts indicate the following:

- partners are not entitled to a ‘salary or wage equivalent’ related to their input (physical or mental) into the business operations
- partners are not entitled to an ‘interest equivalent’ on the capital contributions they make to the business
- the profit or loss is to be divided equally among the partners.

However, these rules apply only in the absence of an agreement. Partners can (and should) agree to share profits in any way they choose, including payment of interest on capital and the equivalent of a wage to partners.

With regard to the accounting requirements of a partnership, the only major difference between this and a sole proprietorship is that there is more than one owner. This means that the income figure will need to be divided between the partners, as will the calculation of owners’ wealth (equity). Typically, the partnership maintains individual records of each partner’s transactions with the partnership, as follows:

- resource contributions (capital)
- resource withdrawals (drawings)
- share of undistributed profits (either current or retained earnings—earnings made in earlier periods but not withdrawn by the owners).

Limited company

Limited companies are businesses which are owned by multiple investors, each of which owns a share of the company. Hence the owners of a limited company are often known as ‘shareholders’. Limited companies can range in size from quite small to very large. The number of individuals who invest in the company and become part-owners (known as ‘subscribing capital’) may be unlimited, which provides the opportunity to create a very large-scale business, although many are quite small. The liability of owners, however, is limited (hence ‘limited’ company), which means that those individuals subscribing capital to the company are liable only for debts incurred by the company up to the amount that they have agreed to invest. This cap on the liability of the owners is designed to limit risk and to produce greater confidence to invest. Without such limits on owner liability, it is difficult to see how a modern capitalist economy could operate. In many cases, the owners of a limited company are not involved in the day-to-day running of the business and will, therefore, invest in a business only if there is a clear limit set on the level of investment risk.

limited company

An artificial legal entity which has an identity separate from that of those who own and manage it.

limited liability

The situation in which an investor in a business (a limited company) has his or her liability limited to a maximum specified amount; namely the maximum that he or she has agreed to subscribe to the business.

Australian Securities and Investments Commission (ASIC)

The government body responsible for regulating companies, company borrowings, and investment advisers and dealers.

audit

A process in which a range of activities are checked to ensure that the activities have been completed in accordance with a set of rules or guidelines.

board of directors

The team of people chosen by the shareholders to manage a company on their behalf.

The benefit of **limited liability**, however, imposes certain obligations on such companies. To start up a limited company an application must be made to the **Australian Securities and Investments Commission (ASIC)** for registration of the company, and every person who agrees to be a shareholder, director or company secretary must register. The company will be allocated an Australian Company Number, which acts as an identifier. The company must also register for an ABN, a number which assists in transactions relating to various aspects of taxation. The Corporations Act, which covers most companies, provides a framework for company procedures and the way in which companies conduct their affairs, including the accounting and reporting requirements. Part of this regulatory framework requires annual financial reports to be made available to owners and lenders, and usually an annual general meeting of the owners has to be held to approve the reports. In addition, a copy of the annual financial reports must be lodged with the ASIC for public inspection. In this way, the financial affairs of a limited company enter the public domain. With the exception of small proprietary companies, there is also a requirement for the annual financial reports to be subject to an **audit**. This involves an independent firm of accountants examining the annual reports and underlying records to see whether the reports provide a true and fair view of the financial health of the company, and whether they comply with the relevant accounting rules established by law and by accounting rule-makers. Limited companies are considered in more detail in Chapters 6 and 7. All of the large household-name Australian businesses (BHP Billiton, Woolworths, Telstra, IAG and so on) are limited companies.

This book concentrates on the accounting aspects of limited liability companies, because this type of business is by far the most important in economic terms. However, there are a number of complications associated with limited companies that do not exist with sole proprietorships or partnerships. Some of these relate to the structure of limited companies, and some relate to the increased regulation associated with companies. The next two chapters will introduce you to the basic accounting concepts and financial statements with reference to sole proprietorships and partnerships, together with some very simple company structures. Once we have dealt with the basic accounting principles, which are the same for all three types of business, we can then go on in later chapters to see how they are applied in more detail to limited companies. It must be emphasised that there are no differences in principle in the way these three forms of business keep their day-to-day accounting records. However, in preparing their periodic financial statements, there are certain differences that need to be considered. These differences are not ones of principle, however, but of detail.

Nearly all businesses that involve more than a few owners and/or employees are set up as limited companies. Finance will come from the owners (shareholders) in the form of a cash investment in the company or by leaving in the business profits to which they are entitled. Finance can also come from lenders who earn interest on the amount lent to the business, or from suppliers who provide goods on credit. Credit means that goods and services are provided with a payment date agreed for some time in the future (typically one to three months).

In larger limited companies, the owners (shareholders) tend not to be involved in the daily running of the business. They appoint a **board of directors** to manage the business on their behalf. The board is charged with three major tasks:

- 1 setting the overall direction and strategy for the business
- 2 monitoring and controlling the activities of the business, and
- 3 communicating with shareholders and others connected with the business.

Each board has a chairman, elected by the directors, who is responsible for running the board in an efficient manner. In addition, each board has a chief executive officer (CEO) (sometimes referred to as the 'managing director') who is responsible for running the business on a day-to-day basis. Occasionally, the roles of chairman and CEO are combined, although it is usually considered to be a good idea to separate them in order to prevent a single individual having excessive power.

The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager typically being given responsibility for a particular part of the business's operations. Just how a particular business organises its operations is up to the board. Possibilities include:

- the splitting up into separate departments, often on functional lines (e.g. production, finishing, distribution, marketing, personnel and finance)
- running the business on geographical lines, or
- any number of combinations of these and others.

The implications of complicated organisations of this type are considerable for both the user and the accountant. There is a need to consider just how best to provide relevant information to help in the management process, and management accounting reports need to be appropriately detailed. In the area of financial accounting we need to consider how to best provide general-purpose accounting information that is relevant to assessing the performance of the business.

How are businesses managed?

Strategic management is essentially a process of identifying, choosing and implementing activities that will enhance the long-term performance of an organisation. It aims to provide an organisation with a clear sense of purpose and direction. It should link the internal resources of the business to the external environment of competitors, suppliers, customers and so on. This will usually involve capitalising on existing strengths and limiting exposure to weaknesses. It will also typically involve careful examination of the opportunities available to the business and any threats to the business.

It is vitally important that businesses plan their future. Whatever a business is trying to achieve, it is unlikely to be successful unless its managers are clear what the plans are. Planning is vital for businesses of all sizes, but where a business involves more than one manager it is vital also that all their actions coordinate. For example, it is crucial to a manufacturing business that production levels and sales levels are related to one another. It is not feasible for sales and production to go their own separate ways. There must be plans to ensure that production and sales levels match each other. This is not to say that plans, once made, cannot be revised. Unexpected changes in the market or unforeseen production problems may well demand revision of all plans likely to be affected by these new circumstances.

Closely linked to planning is decision-making. Planning involves making decisions about the best course of action.

strategic management

An approach which seeks to provide a business with a clear sense of purpose and to ensure that appropriate action occurs to achieve that purpose.

Steps in the planning process

Planning is usually broken down into three stages:

- 1 **Setting the objectives or mission of the business.** This is what the particular business is basically trying to achieve. The objectives are likely to reflect the attitudes of owners (shareholders) and managers. They tend to be framed in broad, generalised non-numerical terms. Once the objectives have been established, they are likely to remain in force for the long term—for example, 10 years. For most private-sector organisations, wealth generation is likely to be the main financial/economic objective. However, businesses typically have objectives other than the financial ones—for example, being environmentally friendly or providing employment for the family. In practice, therefore, any decision is likely to be the result of a compromise between more than one objective.
- 2 **Setting long-term plans.** These are plans setting out how the business will aim to achieve its objectives over a period of, say, five years. They are likely to deal with such matters as:
 - type of products or services to be offered by the business
 - amounts and sources of finance required by the business
 - capital investments (e.g. in new plant and machinery) required
 - sources of raw materials
 - labour requirements.

In the case of each of these, the pursuit of the established objectives of the business over the planning horizon (perhaps five years) will lay the foundation for the plans. Long-term plans tend to be stated in financial terms.

budget

A financial plan for the short term, typically one year.

3 Setting detailed short-term plans or budgets. Budgets are financial plans for the short term, typically one year. Their role is to convert the long-term plans into actionable blueprints for the immediate future. Budgets usually define precise targets in areas such as:

- cash receipts and payments
- sales, broken down into amounts and prices for each of the products or services provided by the business
- detailed inventory (i.e. stock of goods held for sale) requirements
- detailed labour requirements
- specific production requirements.

It must be emphasised that planning (and decision-making) is not the role of accountants; it is the role of managers. However, much of the planning will be expressed in financial terms, and most of the data for decision-making are of an accounting nature. Therefore, accountants, because of their background knowledge, expertise and skills, together with their understanding of the accounting system, are very well placed to give technical advice and assistance to managers in this context. It is the managers of the various departments of the business who must actually do the planning, however. Only in respect of the accounting department, of which the most senior accountant will be the manager, should an accountant be taking decisions and making plans.

ACTIVITY 1.6

The approach described above suggests that decision-makers will examine all of the various courses of action available and then systematically rank them in order of preference.

Do you think this is what decision-makers really do? Is this how you approach decisions—for example, choosing a career?

Control

However well planned the activities of the business may be, they will come to nothing unless steps are taken to try to put them into practice. The process of making planned events actually occur is known as control. **Control** can be defined as compelling events to conform to the plan. This definition of control is valid in any context. For example, when we talk about controlling a car, we mean making the car do what we intend it to do. Our plan may be made only split seconds before we act on it, but, if the car is under control, it is doing what the driver intended.

In a business context, accounting is very useful in the control process. This is because it is possible to state both plans and actual outcomes in the same accounting terms, thus making comparison between actual and planned outcomes relatively easy. Where actual outcomes are at variance with detailed plans (which are called ‘budgets’), this should be highlighted in the accounting information. Managers can then take steps to get the business back on track towards the achievement of the plans (budgets). Figure 1.6 shows the decision-making, planning and control process in diagrammatic form.

The accountant must be aware of the fact that people can process only so much information. Too much information can be as bad as too little information, as it can overload and confuse people. This, in turn, can lead to poor evaluations and poor decisions. The information provided to managers must be restricted to what is relevant to the particular decision and to what can be absorbed. In practice, this may mean that information is produced in summarised form and that only a restricted range of options will be considered.

Not-for-profit organisations

Although the focus of this book is accounting as it relates to private-sector businesses, there are many **not-for-profit organisations** that do not exist mainly for the pursuit of profit. Examples include:

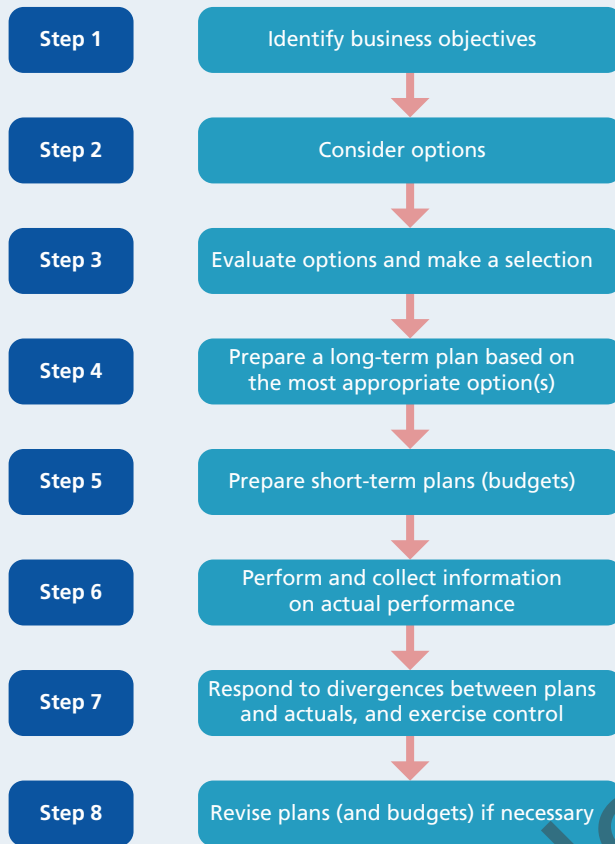
- charities
- clubs and associations
- universities

control

To compel events to conform to the plan.

not-for-profit organisation

An organisation whose main aim is not to make a profit, but to achieve some other clear goal, usually of a social nature.

**FIGURE 1.6****The planning and control process**

The figure shows the key steps in the planning and control process as described in this chapter.

- local government authorities
- national government departments and associated agencies
- churches, and
- trade unions.

Such organisations also need to produce accounting information for decision-making purposes. Various user groups need accounting information about these types of organisations to help them to make decisions. These groups are often the same as, or similar to, those identified for private-sector businesses. They may have a stake in the future viability of the organisation, and may use accounting information to check that the wealth of the organisation is being properly controlled and used in a way that is consistent with its objectives.

Concept check 13



You've decided to follow Bill Gates and dump university to go into business. You will probably set up your business initially as a:

- A** Limited company
- B** Partnership
- C** Non-profit organisation (NPO)
- D** Sole trader
- E** Any of the above.

Concept check 14



Advantages of a sole proprietorship include:

- A** Separate legal entity
- B** Minimum reporting requirements
- C** Unlimited liability
- D** Limited life
- E** Limited access to funds.

Concept check 15



Disadvantages of a partnership include:

- A** Not a separate legal entity
- B** Increased regulation (Partnership Acts)
- C** Unlimited liability
- D** Have to share profits with partners
- E** All of the above.

THE CHANGING FACE OF BUSINESS AND ACCOUNTING

Over the past 40 years, the environment within which businesses operate has become increasingly turbulent and competitive. Various reasons have been identified to explain these changes, including:

- increasingly sophisticated and demanding customers
- the development of a global economy where national frontiers are less important
- rapid changes in technology
- the deregulation of domestic markets (e.g. electricity, water and gas)
- increasing pressure from owners (shareholders) for competitive economic returns
- the increasing volatility of financial markets, and
- substantially increased awareness of the need to recognise the implications of the actions of business on the environment and society at large.

This new, more complex environment has brought new challenges for managers and other users of accounting information. Their needs have changed, and both financial accounting and management accounting have had to respond. To meet the changing needs of users there has been a radical review of the kind of information to be reported.

The internationalisation of businesses has created a need for accounting rules to have an international reach. It can no longer be assumed that users of accounting information relating to a particular business are based in the country in which the business has its base, or are familiar with the accounting rules of that country. Thus, there has been increasing harmonisation of accounting rules across national frontiers. A more detailed review of these developments is included in Chapter 7.

The changing business environment has also given added impetus to the search for a clear framework and principles upon which to base financial accounting reports. Various attempts have been made to clarify their purpose and to provide a more solid foundation for the development of accounting rules. The frameworks and principles that have been developed try to address fundamental questions such as:

- Who are the users of financial accounting information?
- What kind of financial accounting reports should be prepared and what should they contain?
- How should items such as profit be presented and assets valued?

L07

Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting, including current thinking on ethics in business

As a result of criticisms that the financial reports of some businesses are not clear enough to users, accounting rule-makers have tried to improve reporting rules to ensure that the accounting policies of businesses are more comparable and more transparent, and that they portray economic reality more faithfully.

The importance of this work has been reinforced by a number of scandals over the past couple of decades, typically relating to the financial reports prepared for general-purpose external users. These scandals have become front-page news in Australia, and a major talking point among those connected with the world of business. Unfortunately, all this attention has been for all the wrong reasons. We have seen that investors rely on financial reports to help keep an eye on their investments and on the managers. However, these scandals clearly indicate that cases have arisen where managers have been providing misleading information to their investors.

Two of the most notorious cases have been those of Enron, a Texas-based energy-trading business accused of making complicated financial arrangements to obscure losses and to inflate profits, and HIH Insurance Group, where mismanagement and an inadequate response to emerging pressures in international insurance markets led to Australia's greatest corporate collapse, with losses of up to \$5.3 billion. In the wake of these scandals, there was much closer scrutiny of businesses' financial reports by investment analysts and investors. This has led to further businesses, in Australia and worldwide, being accused of using dubious accounting practices to bolster profits.

Various reasons have been put forward to explain this spate of scandals. Some may have been caused by the pressures on managers to meet investors' unrealistic expectations of continually rising profits; others by the greed of unscrupulous executives whose pay is linked to financial performance. However, they may all reflect a particular economic environment.

The Australian legal system has made it plain that it deplores the actions of unscrupulous executives. In 2005, Ray Williams and Rodney Adler, former chiefs of HIH, were sentenced to four and a half years in prison for their part in the fraud.

ACTIVITY 1.7

Can you identify a significant Australian corporate crash in the past decade that has also brought into question accounting, financial reporting and auditing practices?

Whatever the causes, the result of these accounting scandals has been to undermine the credibility of financial statements and to introduce much stricter regulations concerning the quality of financial information. More recently, the global financial crisis has further highlighted, among many other things, inadequacies and inconsistencies in financial reporting regulations and reporting practices. Real World 1.3 reinforces the need for the application of consistent, high-quality international financial reporting standards.

REAL WORLD 1.3

Crisis a wake-up call for change

The global financial crisis was a 'wake-up call' for the need to have a common global standard, chairman and chief executive of the Australian Accounting Standards Board says. Kevin Stevenson said the GFC allowed standard setting to come to life. Global standards were initially issued in the 70s, beginning with the Board of the International Accounting Standards Committee, which paved the way to the current International Accounting Standards Board. That led to the International Financial Reporting Standards, which Australia moved to adopt in 2005. Head of reporting for the Institute of Chartered Accountants, Kerry Hicks, said Australian standards

have been applied to both listed and unlisted companies – any which claim they produce general purpose financial reports.

Source: Tim Mendham, 'Crisis a wake-up call for change', Australian Financial Review, 21 April 2010.

Class discussion points

- 1 Did the GFC actually wake people up or have we forgotten the lessons?
- 2 To what extent do you think global accounting standards help when something like the GFC occurs?

Parallel to this work are major efforts to improve corporate governance.

Increasingly, concern with the environment—particularly via climate change—has led to considerably more focus being directed to environmental and social factors, typically wrapped up together under a generic heading of ‘sustainability reporting’. Many companies, especially the larger ones, now use sustainability as a core part of their business’s approach and associated planning. More recently, the idea of integrated accounting, which is all about value creation, has been developed. These topics will be considered in more detail in Chapter 9.

Management accounting has also changed by becoming more outward-looking and more customer-focused. In the past, information provided to managers was largely restricted to that collected within the business. However, the attitude and behaviour of customers and rival businesses have now become the object of much information gathering. Increasingly, successful businesses are those that are able to secure and maintain competitive advantage over their rivals. In addition, information about the costs and profits of rival businesses, which can be used as ‘benchmarks’ by which to gauge competitiveness, is gathered and reported.

To compete successfully, businesses must also find ways of managing costs. The cost base of modern businesses is under continual review, and this in turn has led to the development of more sophisticated methods of measuring and controlling costs.

Ethics and ethical behaviour in business

It is now clearly recognised that in free societies businesses need to be good corporate citizens. Also, the idea discussed in an earlier section, that businesses need to harmonise stakeholders’ interests, implies that there is a need for **ethics** and ethical behaviour.

As we have already seen, the last couple of decades have witnessed a number of scandals in which behaviour has been identified as both illegal and unethical. The regulatory framework has been tightened as a result, as have the codes of ethics of various professional organisations. By way of illustration, the International Federation of Accountants (IFAC), an independent worldwide organisation with a stated purpose ‘to develop and enhance a coordinated worldwide accountancy profession with harmonised standards’, has developed a code of ethics for accountants in each country to use as the basis for founding their own codes of ethics. The major Australian accounting bodies have developed a ‘Code of Ethics for Professional Accountants’ based on the IFAC code. Members are expected to comply with both the words and spirit of the code. There is an overarching responsibility to act in the public interest—satisfying the needs of a particular client is not enough. A number of fundamental principles guide the code; these cover integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Through these principles, the code emphasises professional judgement and awareness of potential threats to compliance. (For more detail on the code, see CPA Australia, ‘An overview of APES 110—Code of Ethics for Professional Accountants’.)

A considerable amount of work on ethics has been done over the years. For example, the Institute for Global Ethics (www.globalethics.org), a non-profit organisation, uses the same kind of values-driven ethos implicit in Freeman’s work on stakeholder theory. Rewards identified include: increased shareholder confidence; enhanced productivity; attraction and retention of a quality workforce; protection of customer trust; improved efficiency; and expansion of compliance efforts (i.e. ensuring rules and regulations are followed). Guiding principles include: honesty and truthfulness in all dealings; responsibility and accountability in every transaction; fairness and equity in each relationship; respect and mindfulness of the dignity of every individual; and compassion and caring in each situation. The Institute’s research suggests that these principles transcend national and cultural borders, economic stratification, language, gender and religion.

These principles are also important in developing a set of corporate ethical values, or ideology (the way in which a corporation actually does business). This set of values is not necessarily the same as business ethics. **Business ethics** has been defined as ‘The study of proper business policies and practices regarding potentially controversial issues, such as corporate governance, insider trading, bribery, discrimination, corporate social responsibility and fiduciary responsibilities. Business ethics are often guided by law, while other times provide a basic framework that businesses may choose to follow in order to gain public acceptance’ (www.investopedia.com/terms/b/business-ethics.asp).

ethics

A code of behaviour considered correct, especially that of a particular group, organisation or individual.

business ethics

The study of proper business policies and practices regarding potentially controversial issues, such as corporate governance, insider trading, bribery, discrimination, corporate social responsibility and fiduciary responsibilities. Business ethics are often guided by law, while other times provide a basic framework that businesses may choose to follow in order to gain public acceptance.

Conversion of this definition to what actually happens on the ground can still vary tremendously. There is undoubtedly a real concern about behaviour being ethically sound, and the general public is increasingly critical of failures in this arena. Examples of clear failures can be seen in Real World 1.4.

REAL WORLD 1.4

Ethical failures

Volkswagen's emission-cheating scandal beggars belief. Volkswagen admitted to cheating on emissions tests for nearly half a million diesel-powered cars sold since 2008. Volkswagen says that as many as 11 million vehicles worldwide use what authorities call defeat devices, or software that can make cars appear cleaner than they are during regulatory tests and disable emissions controls during normal driving. Volkswagen apologised and asked for patience, while setting aside US\$7.3 billion to cover fallout from the scandal.

Since that time the US Justice Department has sued Volkswagen in an action that could cost Volkswagen US\$18 billion. The final direct cost in the US was around \$15 billion, plus a further US\$4.7 billion. VW subsequently made clear that it had no intention of offering equal compensation to Europeans who had bought tainted diesel vehicles. This claim was based on differing emissions standards.

VW reported a 20% slump in pre-tax profits in the first three months of 2016.

Sources: Mike Spector, 'Volkswagen facing barrage of litigation', *The Australian*, 30 September 2015.

Arona Viswanatha & Mike Spector, 'VW faces \$25bn payout in US emissions lawsuit', *The Australian*, 6 January 2016.

William Boston, 'VW rejects cash offer for owners in Europe', *The Australian*, 5 July 2016.

Kate Palmer, 'VW profit sharply lower as effects of emissions-rigging scandal continues', *The Daily Telegraph* (UK), 1 June 2016.

Several Ponzi schemes have been identified recently. In India, Pearls Agrotech Corporation was found to have raised money from investors who thought they were buying valuable plots of land, which the company promised to develop and sell on, ostensibly generating lucrative returns. Investors were often assigned vaguely defined plots in regions far from where they lived, leaving them unable to check out realities on the ground.

Sources: Amy Kazmin, 'Indian real estate group fined \$1.1bn for preying on investors', *Financial Times*, 23 September 2013.

Madhura Karnik & Manu Balachandran, 'Yet another massive Ponzi scheme goes pop in India', *Quartz India*, 12 January 2016.

In China, authorities accused an online financing platform of deceiving mostly small investors out of more than 50 billion yuan. Ezubo and its parent, Yucheng International Holdings Group, were charged with illegally soliciting funds from the public, and fraud. The companies had allegedly lured investors with promises of high-interest payouts from leasing projects. It was also alleged that 95% of the projects were false.

Source: Chuin-Wei Yap, 'Ezubo a \$10bn "Ponzi scheme", says Beijing', *The Australian*, 3 February 2016.

In 2015 'a joint investigation by Four Corners and Fairfax found systematic underpayment of wages and the doctoring of payroll records' in 7-Eleven, Australia's biggest convenience store chain (Ferguson & Danckert). Workers, many of whom were international students on particular visas with restrictions, were found to be intimidated and exploited. International students are only allowed to work 20 hours a week. Many workers told the ABC that they were forced to work 40 hours a week while being paid for only 20 hours ... Many others did not receive penalty rates and were threatened with losing their visas if they complained (Branley) While blame was laid at the door of individual franchisees, there remained considerable criticism of the head office, including claims of payroll non-compliance. Issues were seen as systemic, i.e. company-wide. A subsequent Senate committee heard that franchisees were 'still taking 7-Eleven workers to ATMs to withdraw and pay back wages, and some have resorted to violence and intimidation to deter underpayment claims ... On average workers were underpaid \$23,000 each' (Karp).

Sources: Adele Ferguson & Sarah Danckert, 'How 7-Eleven is ripping off its workers', *Sydney Morning Herald*, www.smh.com.au/interactiv/2015/7-eleven-revealed/-Revealed.

Alison Branley, '7-Eleven staff work twice as long at half pay rate, investigation reveals', *ABC News*, 29 August 2015, www.abc.net.au/news/2015-08-29/7-eleven-half-pay-scam-exposed/6734174.

Paul Karp, '7-Eleven workers beaten and forced to pay back wages, Senate enquiry told', *The Guardian*, 5 February 2016, www.theguardian.com/australia-news.2016/feb/05/7-eleven-workers-beaten-and-forced-to-pay-back-wages-senate-inquiry-hears.

Class discussion points

- 1 In the light of the examples included in Real World 1.4, do you believe that ethics in today's business world are improving?
- 2 The guiding principles of the Institute of Global Ethics, namely honesty, responsibility, fairness, respect and compassion, are laudable. How easy do you think it will be to operationalise them?
- 3 Summarise your views on either the Volkswagen or 7-Eleven failings identified in Real World 1.4.
- 4 A whistle-blower raised questions in relation to the 7-Eleven saga as to whether the practice identified above

was a fundamental part of the way in which the business was run, and whether the business could succeed without doing things this way. What do you think?

- 5 Do you purchase any goods that might be categorised as Fairtrade? Why/why not? To what extent might your decision be influenced by your own particular circumstances.
- 6 What do you consider are ethical considerations that might occur with data mining and privacy?
- 7 'When we talk about an ethical culture, we are discussing a set of basic assumptions that is being lived out. We can

talk all we want about those values we want to embody, but without examining the basic assumptions beneath them, we won't understand how radical a shift we are proposing in the world we inhabit' (Institute for Global Ethics, 'The foundation of an ethical culture', p. 1). Comment on this statement. Is this shift feasible, or do we need to rely on regulation?

- 8 Identify and discuss any recent cases where you think behaviour has been unethical.

Real World 1.4 provides some extreme illustrations, but there are many other examples of breakdowns or failures that range from minor moral misjudgements through sloppiness in the way business is transacted and general sharp practice, to plain fraud. Also, thinking back to the section on stakeholder theory, Freeman's 'new story' clearly has not reached parts of the business community (and possibly the entire community). Do we accept that this is reality, or try to do something more positive?

In fact, the impact of ethical considerations is now well recognised. There have been substantial improvements in corporate governance—the system by which corporations are directed and controlled—and compliance and other regulatory requirements are more rigorous. Many superannuation funds now have investment categories with names such as 'ethically based investments', which enable investors to choose investments with a sound ethical (or green) underpinning. Consumers seem to be increasingly turning to businesses or industries which engage in ethical trading, such as Fairtrade coffee.

In the course of this text we shall see that accountants play a very important role in compliance and certain ethical issues. Increasingly, as community expectations change, so will compliance needs. The increased emphasis in recent years on sustainability has led to substantially expanded reports, which are discussed in Chapter 9. The ideas of Freeman regarding stakeholder theory's 'new story' are likely to lead to a range of new measurement systems over the next few decades.

Eva Tsahuridu, in a regular piece on ethics in *InTheBlack* ('How do you stop bad apples?', May 2015) asked how we might move from a compliance-based approach to one which focuses on shared values and benefit creation. The article suggests that we need to develop a positive ethical organisation, in which doing the right thing is the normal thing to do. Such an organisation will require attention to:

- leadership that is visibly ethical, with explicit commitment to ethics
- culture and informal systems that include values, role models, language, norms, symbols and heroes
- formal systems that include codes of conduct, policies and rules, structure, performance management and reward systems, and decision-making processes.

There is considerable overlap between the ideas covered in the section on stakeholder theory and this one on ethics. The use of the term 'values driven' is increasingly common. Accounting has led the field in terms of measurement, and remains the principal discipline for measurement. However, many of the ideas raised in this chapter are difficult to measure, so considerable work still needs to be done.

Concept check 16



Which of the following factors have contributed to the changing business and reporting environment we live in?

- A** Advances in technology
- B** Deregulation of utility providers (e.g. electricity, water)
- C** Breakdown of political barriers
- D** None of the above
- E** The first three.

Concept check 17



Which of the following is NOT a response of the accounting profession to the changing environment being faced by today's businesses?

- A** Accounting standards that meet the unique needs of a particular country
- B** Increased clarity of financial reports
- C** Harmonisation of accounting rules across countries and continents
- D** Greater transparency in financial reporting
- E** Greater comparability in financial reporting.

HOW USEFUL IS ACCOUNTING INFORMATION?

No-one would seriously claim that accounting information fully meets all of the needs of each of the various user groups. Accounting is still a developing subject, and we still have much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained in accounting reports should help users make decisions relating to the business. The information should reduce uncertainty about the financial position and performance of the business. It should help to answer questions concerning the availability of funds to pay owners a return, to repay loans, to reward employees and so on.

While we cannot be sure just how useful accounting information actually is to users, there is little doubt that accounting is *perceived* as being useful. Several studies have attempted to rank the importance of accounting information in relation to other sources of information. Generally, these studies have found that accounting information is ranked more highly than other sources of information. The impact on share prices of accounting information is one area where some clear evidence can be seen to support these views. Real World 1.5 provides examples of the impact on share prices of announcements regarding current or anticipated profits.

LO8

Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting

REAL WORLD 1.5

Impact of financial results on share price

CBA reported a better than expected profit amounting to \$4.8 billion. It held the dividend steady. At this time the investor market was best described as 'rattled'. The overall stock market was close to being in 'bear' territory, having lost around 20% over the last six months. Shares rose by 1.8%, a remarkably good performance under the circumstances.

Source: Michael Bennet, 'CBA posts \$5bn profit but dividend frozen', *The Australian*, 11 February 2016.

The Reject Shop smashed profit forecasts by reporting half-yearly profit of \$18.3 million on a 5.6% lift in sales to \$424.7 million. This represented a 43% increase in profit. Its share price increased by 26%.

Source: Eli Greenblat, 'Super profit for Reject Shop', *The Australian*, 18 February 2016.

BlueScope issued an upgrade of its December half-year profit guidance, from \$180 million to \$230 million, for underlying earnings before interest and tax. Substantial cost savings were the main cause. The share price went up by 14%.

Source: Barry FitzGerald, 'BlueScope on a roll with shock profit upgrade', *The Weekend Australian*, 13–14 February 2016.

AGL flagged a fall in profits of \$100 million after being caught short of lower priced gas. AGL share price went lower by 6%, but recovered to only 2% lower after it became clear that it still expected to deliver higher earnings for 2017.

Source: Barry Fitzgerald, 'AGL flags \$100m fall in gas profit', *The Australian*, 8 July 2016.

Class discussion points

- 1 What do you understand by 'bear' territory? While accounting information is clearly important in determining share value, what do you think might be its relative importance compared with the level of investor confidence at a more national or global level?
- 2 How might The Reject Shop have achieved a 43% increase in profit with a 5.6% lift in sales?
- 3 Discuss how shares might be valued and which accounting information might be included in the valuation process. In discussing this, you might like to factor in to your thinking the BlueScope and AGL examples in Real World 1.5.

Typically, there is no close substitute for the information provided by the financial statements. Thus, if users cannot glean the required information from the financial statements, it is often unavailable to them. Other sources of information concerning the financial health of a business are normally much less useful.

ACTIVITY 1.8

What other sources of information might, say, an investment analyst use in an attempt to gain an impression of the financial position and performance of a business? What kind of information might be gleaned from these sources?

Why do I need to know anything about accounting and finance?

At some stage of your study you have probably asked yourself: ‘Why do I need to study accounting? I am not even sure that I want to become an accountant!’ Well, from the explanation of what accounting is about, which has broadly been the subject of this chapter, it should be clear that the accounting function within a business is a central part of its management information system. On the basis of information provided by the system, managers make decisions concerning the allocation of resources. As we have seen, these decisions may concern whether to:

- continue with or expand certain business operations
- invest in particular projects, or
- sell particular products.

Such decisions can have a profound effect on all of those connected with the business. It is important, therefore, that *all* of those who intend to work in a business should have a fairly clear idea of certain important aspects of accounting and finance. These aspects include:

- how financial reports should be read and interpreted
- how financial plans are made
- how investment decisions are made, and
- how businesses are financed.

Many, perhaps most, students have a career goal of being a manager within a business—perhaps a personnel manager, a production manager, a marketing manager or an IT manager. If you are one of these students, an understanding of accounting and finance is very important. When you become a manager, even a junior one, it is almost certain that you will have to use financial reports to help you to carry out your role. It is equally certain that it is largely on the basis of financial information and reports that your performance as a manager will be judged.

As part of your management role, it is likely that you will be expected to help in forward planning for the business. This will often involve the preparation of projected financial statements and the setting of financial targets. If you do not understand what the financial statements really mean and the extent to which the financial information is reliable, you will find yourself at a distinct disadvantage to others who know their way around the system. Along with other managers, you will also be expected to help decide how the limited resources available to the business should be allocated between competing options. This will require an ability to evaluate the costs and benefits of the different options available. Once again, an understanding of accounting and finance is important to carrying out this management task.

This is not to say that you cannot be an effective and successful personnel, production, marketing or IT manager unless you are also a qualified accountant. It does mean, however, that you need to become a bit ‘streetwise’ in accounting and finance if you are to succeed. This book should give you that street wisdom.

If you intend to become an accountant, the question is not as relevant. However, it is worth noting that many accountants eventually move out of accounting per se and into general management, so for those who finish up on this track, the same arguments as above are relevant. For those who intend having a career in accounting, this book should provide you with a sound foundation for your future role and in business generally.

Concept check 18



Which of the following statements is true?

- A** Well-prepared financial statements will meet all of the needs of most but not all user groups.
- B** Accounting information is useful only to those trained in accounting.
- C** The ability to understand financial statements is important and even critical for many non-accounting managers in business.
- D** All of the above.
- E** None of the above.

Concept check 19



Financial statements and accounting information can provide information to aid which of the following decisions?

- A** Whether or not to buy shares in a company
- B** Whether or not to provide credit to a business
- C** Whether to invest in a particular project
- D** Whether to buy products or services from a company
- E** All of the above.

THE ALTC'S ACADEMIC STANDARDS FOR ACCOUNTING

The Australian Learning and Teaching Council (ALTC) developed a Learning and Teaching Academic Standards Statement for Accounting in 2010.

This statement relates to accounting at a program level, rather than at an individual course (subject) level.

The main standards statement includes the following points:

- Accounting is concerned with the provision, analysis and communication of information to a broad range of internal and external stakeholders for a variety of resource allocation and compliance purposes.
- Accounting can be applied at different levels, including individuals, private, public and not-for-profit organisations, markets, society and the environment.
- Accounting is not conducted in isolation, but is informed by various perspectives, including social, ethical, economic, regulatory and global.
- The body of accounting knowledge is informed by relevant research, scholarship and professional practice, and application.
- Topics included in the body of accounting knowledge include financial accounting, management accounting, and a selection of auditing and assurance, finance, economics, quantitative methods, information systems, commercial law, corporation law and taxation law.
- Many accounting degree programs prepare accounting graduates to work effectively as accounting professionals. This includes being able to manage and interact with various accounting and business contexts, think reflectively and conceptually about financial and other information, work collaboratively with accountants and other users to make informed judgements, and justify such advice to others.

L09

Identify the learning outcomes associated with the Australian Learning and Teaching Council's Academic Standards Statement for Accounting: namely judgement; knowledge; application skills; communication and teamwork; and self-management; and examine how these compare with characteristics of successful business people

The statement includes a range of **threshold learning outcomes** that are expected of new graduates embarking on a career in accounting. These are:

Judgement—reflecting an ability to solve accounting problems in relatively straightforward contexts, using social, ethical, regulatory and global perspectives

Knowledge—an ability to integrate theoretical and technical accounting knowledge

Application skills—critically apply theoretical and technical accounting knowledge and skills to solve accounting problems

Communication and teamwork—justify and communicate accounting advice and ideas in a straightforward collaborative context involving both accountants and non-accountants

Self-management—reflect on performance feedback to identify and action learning opportunities and self-improvement.

The standards can be seen in operation at various levels in this book.

The threshold learning objectives, or rather the ideas that underpin them, namely knowledge, application skills, judgement, communication and teamwork, and self-management, provide a framework for thinking about how programs and, to a lesser extent, courses need to be developed and taught.

At an introductory level, much of what is included in this book is **knowledge-based**. We have tried to ensure that all the knowledge that might reasonably be required by a first level course has been included. Hence, it includes sections on financial accounting (both reports used and analysis), management accounting and aspects of finance, together with an introduction to governance, sustainability reporting (and its various components) and strategic management.

Knowledge requires appropriate **application** if maximum benefit is to be obtained. Throughout the book knowledge is applied through examples, activities, and further exercises and cases. The applications are usually problem-based.

Given the introductory nature of the book, the emphasis is inevitably on the first two elements, knowledge and application. However, as the book develops, there are examples and cases which build on the analysis and foster sound **judgement**. The inclusion of current *Real World* examples should enable students to reflect on how what is actually happening coincides (or not) with what is being taught. The *Accounting and You* features should also reinforce the ability of the student to apply knowledge and to reflect on its use.

The areas of **teamwork and communication** are dealt with through the *Class Discussion Points* following the *Accounting and You* sections and the *Real World* examples, and the end-of-chapter discussion questions, application exercises and case studies. However, it must be recognised that a subject like accounting requires development of good individual skills, which of necessity means that specific time for development of teamwork is restricted, other than in the areas mentioned above. With regard to communication, students have to be able to consider how best to communicate accounting information and analyses to users of the information.

The approach to this book, which is based on an open learning approach, should facilitate **self-management**. This approach uses a series of in-chapter activities, self-assessment questions, discussion questions, application exercises and case studies. Answers are provided to the activities and self-assessment questions. *MyAccountingLab*, which is designed as a virtual tutor, enables you to test your knowledge with sample tests, facilitates the development of an individually tailored study plan and enables you to target those areas where you need to develop further understanding.

The standards are written from the perspective of the accounting profession. They apply to the entire field. However, many accounting issues and problems also apply to users of accounting, as the main problems are fairly generic. Ultimately, users of accounting information need to have a reasonably thorough understanding of accounting. The threshold learning objectives for the subject of Accounting will probably eventually have a great deal in common with those devised for Business students.

Characteristics of successful business people

It would not be appropriate in a book of this type to spend a lot of time discussing characteristics of successful business people, but it is interesting to consider how the learning outcomes described above might relate to these characteristics. Are these characteristics consistent with the learning outcomes?

A supplement entitled ‘Psychology of success’, sponsored by NAB, appeared in *The Australian* on 9 October 2015. This supplement included a range of articles relating to a number of very successful, quite young entrepreneurs. The content of these is broadly summarised in Table 1.3.

TABLE 1.3 CHARACTERISTICS OF SUCCESSFUL BUSINESS PEOPLE

- Being able to break down challenges into bite-sized chunks, and resisting looking too far into the future
- Being able to keep one’s nerve and avoid a crisis of confidence
- Having self-belief and being able to spot it in others
- Being able to crash through your comfort zones
- Avoiding the temptation to believe that the problem is external. What sets apart those who are able to conquer challenges to self-belief is a willingness to face up to fear and the possibility of failure
- Being comfortable with feeling uncomfortable, and understanding that emotional fortitude is something that develops
- Recognising that the early days of any business are going to be something of a roller-coaster ride
- Not comparing yourself with others
- Recognising that persistence, determination and a never-say-die attitude are vital, but not the only ingredients for business success
- Having a need for self-awareness and balance
- Avoiding the pitfall that people with a lot of drive and determination can get caught up in the business and become obsessive
- Recognising, though, that obsession creates a source of energy, and when focused and aligned with persistence, can be a mechanism for success
- Never taking rejection or negative feedback personally, but deal with the rejections
- Recognising that a defensive reaction to criticism and negative feedback can be disastrous. There is a need to view negative feedback as a gift
- Recognising your own strengths and weaknesses. It is rare that one person is great at running every part of a business. Recognise your own unique talents and find people who excel where you don’t
- Recognising the need for sheer determination, hard work and a burning desire to succeed

Source: Based on ‘Psychology of success’, *The Australian*, 9 October 2015.

What can we learn from this? Probably the most important thing is that these ideas relate to the personality of the entrepreneur. But how do they relate to the study of accounting?

ACTIVITY 1.9

You are required to:

- (a) discuss the kind of skill set required for a successful career in business in the future
- (b) identify just how accounting can link with these characteristics.

SUMMARY

In this chapter we have achieved the following objectives in the way shown.

| OBJECTIVE | METHOD ACHIEVED | | | | | | | | | | | | | | | | | | | | | |
|---|--|--|----------------------|-----------------------|---------------|-------------------|-------------------|-----------------|--------------|-------------|--------------|-----------------------------|------------------------|--------------------|-------------------|-------------------|--------------|--------------------|-------------------|----------------------|------------------------------------|--|
| <p><i>LO1: Explain the nature and role of accounting</i></p> | <ul style="list-style-type: none"> • Distinguished two distinct roles—a stewardship role and a decision-usefulness role • Identified the role as the provision of economic information to assist in decision-making • Explained accounting as a service function with particular emphasis on quantitative characteristics • Explained accounting as an information system concerned with the collection, analysis and communication of economic information | | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO2: List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information</i></p> | <ul style="list-style-type: none"> • Identified the following groups: <ul style="list-style-type: none"> • owners • managers • lenders • suppliers • investment analysts • customers • competitors • employees and their representatives • government • community representatives • Discussed uses made of accounting through an activity • Introduced stakeholder theory | | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO3: Compare and contrast financial and management accounting</i></p> | <p>Identified differences as follows:</p> <table border="1" data-bbox="579 1052 1395 1308"> <thead> <tr> <th data-bbox="579 1052 806 1308"></th> <th data-bbox="806 1052 1091 1308">Financial accounting</th> <th data-bbox="1091 1052 1395 1308">Management accounting</th> </tr> </thead> <tbody> <tr> <td data-bbox="579 1094 806 1121">Report nature</td> <td data-bbox="806 1094 1091 1121">• General purpose</td> <td data-bbox="1091 1094 1395 1121">• Special purpose</td> </tr> <tr> <td data-bbox="579 1121 806 1148">Level of detail</td> <td data-bbox="806 1121 1091 1148">• Aggregated</td> <td data-bbox="1091 1121 1395 1148">• Dissected</td> </tr> <tr> <td data-bbox="579 1148 806 1176">Restrictions</td> <td data-bbox="806 1148 1091 1176">• Standardised or regulated</td> <td data-bbox="1091 1148 1395 1176">• Minimum restrictions</td> </tr> <tr> <td data-bbox="579 1176 806 1203">Reporting interval</td> <td data-bbox="806 1176 1091 1203">• Less frequently</td> <td data-bbox="1091 1176 1395 1203">• More frequently</td> </tr> <tr> <td data-bbox="579 1203 806 1230">Time horizon</td> <td data-bbox="806 1203 1091 1230">• Backward-looking</td> <td data-bbox="1091 1203 1395 1230">• Forward-looking</td> </tr> <tr> <td data-bbox="579 1230 806 1268">Range of information</td> <td data-bbox="806 1230 1091 1268">• Primarily monetary and objective</td> <td data-bbox="1091 1230 1395 1268">• Often non-monetary with less objective constraints</td> </tr> </tbody> </table> | | Financial accounting | Management accounting | Report nature | • General purpose | • Special purpose | Level of detail | • Aggregated | • Dissected | Restrictions | • Standardised or regulated | • Minimum restrictions | Reporting interval | • Less frequently | • More frequently | Time horizon | • Backward-looking | • Forward-looking | Range of information | • Primarily monetary and objective | • Often non-monetary with less objective constraints |
| | Financial accounting | Management accounting | | | | | | | | | | | | | | | | | | | | |
| Report nature | • General purpose | • Special purpose | | | | | | | | | | | | | | | | | | | | |
| Level of detail | • Aggregated | • Dissected | | | | | | | | | | | | | | | | | | | | |
| Restrictions | • Standardised or regulated | • Minimum restrictions | | | | | | | | | | | | | | | | | | | | |
| Reporting interval | • Less frequently | • More frequently | | | | | | | | | | | | | | | | | | | | |
| Time horizon | • Backward-looking | • Forward-looking | | | | | | | | | | | | | | | | | | | | |
| Range of information | • Primarily monetary and objective | • Often non-monetary with less objective constraints | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO4: Identify the main purpose of a business, and explain the traditional risk–return relationship</i></p> | <ul style="list-style-type: none"> • Identified wealth enhancement as the main objective of a business • Discussed a range of other secondary objectives that may influence the way in which a business is run • Explained the need to retain a balance between risk and return | | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO5: Provide an overview of the main financial reports prepared by a business</i></p> | <ul style="list-style-type: none"> • Illustrated the need for and development of the statement of cash flows, the statement of financial position and the statement of financial performance (profit and loss account) • Identified the typical management accounting reports prepared | | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO6: Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context</i></p> | <ul style="list-style-type: none"> • Identified and outlined the main kinds of business ownership <ul style="list-style-type: none"> • sole proprietorship • partnership • limited company • Outlined the ways in which a business is typically managed • Identified ways in which accounting is likely to be used • Identified a range of not-for-profit organisations, and explained that their information needs are similar to those of for-profit organisations | | | | | | | | | | | | | | | | | | | | | |
| <p><i>LO7: Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting, including current thinking on ethics in business</i></p> | <ul style="list-style-type: none"> • Identified the ways in which business has become increasingly complex and turbulent • Explained how internationalisation of business has led to harmonisation of accounting rules • Identified areas of concern and current activity in accounting, as a result of the greater complexity • Outlined the importance of ethics in business | | | | | | | | | | | | | | | | | | | | | |

| | |
|--|--|
| <p><i>L08: Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting</i></p> | <ul style="list-style-type: none"> Explained that accounting is central to all businesses, and that a basic knowledge is essential if you are to fulfil a managerial role in a business |
| <p><i>L09: Identify the learning outcomes associated with the Australian Learning and Teaching Council's Academic Standards Statement for Accounting: namely judgement; knowledge; application skills; communication and teamwork; and self-management; and examine how these compare with characteristics of successful business people</i></p> | <ul style="list-style-type: none"> Identified and discussed the ALTC Academic Standards and threshold learning outcomes for Accounting Introduced some perceived characteristics of successful business people Discussed through an activity whether these are consistent with each other |

REFERENCE

CPA Australia, 'An overview of APES 110: Code of Ethics for Professional Accountants' April 2014, www.cpaaustralia.com.au/professional-resources/ethics/apes/overview.

DISCUSSION QUESTIONS

EASY

- 1.1 **L01** What is the purpose of producing accounting information?
- 1.2 **L06** Why is it important to have a partnership agreement specifying the arrangement for allocating (dividing) profits between the partners?
- 1.3 **L03** What type of accounting information is produced more frequently? Why?
- 1.4 **L04** List three reasons for starting a business. Explain which reason is most important and why.
- 1.5 **L05** Identify the similarities and differences between the three major external financial reports (statement of financial position, statement of financial performance, statement of cash flows).
- 1.6 **L06** Distinguish between 'accounting entities' and 'legal entities' as business structures.
- 1.7 **L07** As business changes, accounting must change. Do you agree?
- 1.8 **L08** 'Understandability' is identified in the text as a key characteristic of accounting information. By whom should the financial reports be readily understood?
- 1.9 **L03/4/6** Distinguish between 'planning' and 'control'.
- 1.10 **L03/4/6** Within a business, how can accounting facilitate control?
- 1.11 **L03/4/6** How are annual budgets linked to the long-term plans of an organisation?

INTERMEDIATE

- 1.12 **L01** 'Relevance' and 'reliability' represent two key qualitative characteristics of accounting information. What do these two terms mean in an accounting context? Are they in conflict?
- 1.13 **L02** As an owner of a small business, what are three key financial attributes of the business you would wish to assess when you review financial reports?
- 1.14 **L03** Reconcile financial accounting with management accounting. Your textbook clearly distinguishes between them. What are the similarities?

- 1.15 L04** What is meant by the 'risk–return' relationship? Provide a non-accounting example of the trade-off between risk and return.
- 1.16 L06** Describe two advantages for each type of business organisation.
- 1.17 L07** In relation to recent corporate crashes, what have been the main lessons in relation to the accounting process (recording and reporting procedures)?
- 1.18 L08** Which economic principle should determine which accounting information should be produced? Should economics be the only issue here? (Consider who the users of accounting information are.)
- 1.19 L05/6** Accounting is said to perform a 'decision-usefulness role' as well as an 'accountability (stewardship) role'. Distinguish between these two roles and provide an example of each.
- 1.20 L06** Control in accounting is linked to timely comparison between actual and budget figures. What are the implications of this relationship for:
- the budgeting process, and
 - the financial reporting process?

CHALLENGING

- 1.21 L01** Financial accounting statements tend to reflect past events. In view of this, how can they help a user make a decision when decisions, by their very nature, can only be made about future actions?
- 1.22 L02/6** However a business is organised, it must meet the needs or demands of various stakeholders.
- What are the different types of business structure?
 - What is meant by the term 'stakeholder'?
 - Who are the stakeholders for each type of business?
 - What are their needs or demands, and why should they be met?
 - Will stakeholder demands affect the choice of business structure?
- 1.23 L03** You have just graduated from university with an accounting degree and are about to start job-hunting. You want to have a job that will allow you to use your creative streak. Discuss how creativity will enhance or inhibit your performance as a financial accountant, and as a management accountant.
- 1.24 L04** The global financial crisis showed us that risk is bad. Do you agree?
- 1.25 L05** 'The statement of financial performance reflects the financial performance for the period and explains the changes in the statement of financial position.' Do you agree or disagree with this statement? Why?
- 1.26 L07** It has been suggested that the global financial crisis might have been avoided if we had used cash-based accounting. Discuss.
- 1.27 L08** Which financial information would be useful if you were running the sales department of a large business? Can you think of any non-financial information that you might want to have?
- 1.28 L07** Access the overview of APES 110 on the internet. How important, in your opinion, is acceptance of the overarching responsibility by professional accountants to act in the public interest? Discuss the fundamental principles of the code. Discuss what you think would be an appropriate course of action if you felt that compliance with the fundamental principles was threatened?
- 1.29 L01–8** Accounting is normally defined in terms of 'recording, classifying, summarising and communicating economic information about a reporting entity'. Explain and provide an example of the following key terms used in this definition:
- classifying
 - summarising
 - communicating
 - economic information.
- 1.30 L09** How important do you think communication and teamwork is in business?
- 1.31 L09** Self-management is one of the key threshold learning outcomes expected of new graduates embarking on a career in accounting. This is almost certainly expected of any business graduate as well. What do you understand by this term and how might you ensure that you achieve this outcome.

CHAPTER 1 CASE STUDY

Below is an article which illustrates the importance of collecting and using good financial numbers. Read the article and answer the questions that follow.

If you have the numbers, use them

A reluctance to do the necessary financial analysis leaves many businesses flying blind.

There is a great challenge facing business owners today—whatever they're selling can usually be found cheaper online. That's the rule for the internet age. And while you offer something of value, your prospective customers may be willing to pay shipping and handling if they can shave 20–30% off the asking price. Just ask Harvey Norman, Dick Smith or Borders.

Business models are hard to change—and the tendency is to cut prices and costs to cope with this new rule. And that raises another challenge. How do you take such action and avoid going under? This is a real problem when many business owners don't truly know how their operation is travelling day-to-day.

US author Michael Gerber, of *The E-Myth* fame, talks about 'entrepreneurial seizure', in which a business owner falls victim to the 'most disastrous assumption anyone can make' about going into business, an assumption made by all people who have some skills and who go into business for themselves. That 'fatal assumption' (Gerber's words) is that 'if you understand the technical work of a business, you understand a business that does that technical work. And the reason it's fatal is that it just isn't true.'

In fact, it's the root of most small business failures. Most people aren't highly literate in financial management. Do you know the difference between cash and profit? Or direct and fixed costs? Or how to manage your accountant? Surprisingly, many business owners say no to these questions. But without financial management, they're driving without a dashboard.

Wayne Burgan, founder and chief executive of Cashflow-manager.com.au believes that in today's competitive climate many small and medium-sized businesses fail to scrutinise their financial statements and reports. 'They get the statements from their accountant and focus only on what they need to pay the tax office,' he says. 'Few do any financial analysis. Most don't particularly like or understand financial management. They leave it to others.' Burgan, a Certified Practising Accountant and a 20-year veteran of helping business owners become better financial managers, says that getting SMBs to do any real financial analysis, such as

a debtor analysis, cashflow forecast or accounts receivable, is crucial.

Setting prices in a competitive framework requires analysis. Matching competitors' prices may be necessary, but discounting can be dangerous to an SMB's financial health. 'Some business owners discount without fully appreciating the effect on profits,' Burgan says. 'For the average business a 10 per cent discount would need something like a 30 per cent increase in volume to maintain profit levels.'

Pricing is very much a strategic financial issue. Exactly how much profit you want to make, and by when, should show up in your overall strategic objectives. The message is to start looking at the numbers. If you have a system that can produce timely and accurate financial statements, use them. The key reports are the balance sheet, which delivers a picture of how well your investment in the business is performing; income statements, which tell you the cost of doing business; gross margin and profits; and cashflow statements, which forecast cash-crunch times.

Financial management is about looking at the history of actual sales, so you can accurately estimate output and assess the differing sales of products and services. It's about determining how much profit you'll make by selling X product at Y dollars.

Discounting may be one way to meet the competition, but if you can't increase volumes, you might consider trimming some fat, either in fixed costs, inventory or less profitable lines. 'With financial analysis you may find that some products or services are costing more to provide than you can ever recoup,' Burgan says.

Business owners will want to run different scenarios to determine the outcome of various price points for a product or service. Not everyone will opt for a discounting solution. When a customer feels that the value they're receiving is worth more than the money they are exchanging for it, there's no real competition.

'You should be able to find a price that will work for both you and your customers. You need timely information and a system to produce reports. Today, business needs to invoice quickly and have an efficient collection method. You need to follow up.'

Source: Morris Kaplan, *The Deal*—The Australian Business Magazine, vol. 5, no. 1, February 2012, p. 32. News Corp.

QUESTIONS

- 1 What is the main issue in running a business in the internet age?
- 2 What is likely to be the impact on profits of a business cutting prices to meet the competition?
- 3 Explain what is meant by 'the most disastrous assumption anyone can make'.
- 4 Casual observation suggests that the life span of many cafes or similar businesses is very short. Yet many are run by very good cooks and make good coffee. Suggest why this phenomenon might occur.
- 5 Do you know the difference between profit and cash? Explain.
- 6 Why might you choose to use an accountant to maintain a sound system of financial reporting if you were to run a small business?
- 7 What kind of financial information might be useful to you in running a small business?
- 8 Explain what you understand by a debtors or accounts receivable analysis.
- 9 What kind of information would you need before you set a price for a product that you wish to sell?
- 10 Why does the article suggest that discounting can be dangerous to an SMB's health?
- 11 Assume that you plan to sell a product for \$10 that costs you \$6. At that price you expect to be able to sell 1,000 units. You are being pressured to discount the price by 10%. How many units will you need to be able to sell to obtain the same amount of profit (ignoring other costs)?
- 12 What is the main message of the article?
- 13 Which ways were identified for 'trimming the fat'?
- 14 What do you think might be meant by the term 'scenario analysis'?

Concept check answers

| | | | | | | | |
|-----|---|-----|---------------------------------------|------|--------------------|------|---|
| CC1 | A | CC6 | Possibly C though more likely to be E | CC10 | B but also C and E | CC15 | E |
| CC2 | C | CC7 | E | CC11 | A | CC16 | E |
| CC3 | D | CC8 | D | CC12 | D | CC17 | A |
| CC4 | D | CC9 | B | CC13 | D | CC18 | C |
| CC5 | A | | | CC14 | B | CC19 | E |

SOLUTIONS TO ACTIVITIES**ACTIVITY 1.1**

It would be very useful if accounting reports could be understood by everyone. This, however, is unrealistic, as complex financial events and transactions cannot normally be expressed in simple terms. It is probably best that we regard accounting reports in the same way that we regard a report written in a foreign language. To understand either of these, we need to have had some preparation. When producing accounting reports, it is normally assumed that the user not only has a reasonable knowledge of business and accounting, but is also prepared to invest some time in studying the reports.

ACTIVITY 1.2

Your answer may be along the following lines:

| User group | Decision |
|-------------|---|
| Customers | Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet their needs, particularly in respect of any insurance claims made. |
| Competitors | How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This might involve competitors using PI's performance in |

various aspects as a 'benchmark' when evaluating their own performance. They might also try to assess PI's financial strength and identify significant changes that may signal PI's future actions (e.g. raising funds as a prelude to market expansion).

| | |
|---------------------|--|
| Employees | Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions. |
| Government | Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions, an assessment of PI's profits, sales revenues and financial strength would be made. |
| Community | Whether to allow PI to expand its premises and/or whether to provide economic support for the business. PI's ability to continue to provide employment for the community, the extent to which it is likely to use community resources, and its likely willingness to help fund environmental improvements are likely to be considered when arriving at such decisions. |
| Investment analysts | Whether to advise clients to invest in PI. This would involve an assessment of the likely risks and future returns associated with PI. |
| Suppliers | Whether to continue to supply PI and, if so, whether to supply on credit. This would involve an assessment of PI's ability to pay for any goods and services supplied. |
| Lenders | Whether to lend money to PI and/or whether to require repayment of any existing loans. PI's ability to pay the interest and to repay the principal sum would be important factors in such decisions. |
| Managers | Whether the performance of the business needs to be improved. Performance to date would be compared with earlier plans or some other 'benchmark' to decide whether action needs to be taken. Managers may also wish to decide whether there should be a change in PI's future direction. This would involve looking at PI's ability to perform and at the opportunities available to it. |
| Owners | Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on rewarding senior managers. The financial performance of the business would normally be considered when making such a decision. |

Although this answer covers many of the key points, you may have identified other decisions and/or other factors to be taken into account by each group.

ACTIVITY 1.3

We thought of two points:

- Managers will, at times, be interested in receiving an historical overview of business operations of the sort provided to other users.
- Other users would be interested in receiving information relating to the future, such as the planned level of profits, and non-financial information, such as the state of the sales order book and the extent of product innovations.

ACTIVITY 1.4

A government savings account is normally a very safe investment. Even if a government is in financial difficulties, it can always print more money to repay investors. Returns from this form of investment, however, are normally very low. Investing in a lottery ticket runs a very high risk of losing the whole amount invested. This is because the probability of winning is normally very low. However, a winning ticket can produce enormous returns.

Thus, the government savings account should be placed towards the far left of the risk–return line and the lottery ticket towards the far right.

ACTIVITY 1.5

| Statement of cash flows for day 3 | \$ |
|-----------------------------------|-------------------|
| Opening balance (from day 2) | 900 |
| Sale of wrapping paper | <u>390</u> |
| | 1290 |
| Purchase of wrapping paper | <u>600</u> |
| Closing balance | <u><u>690</u></u> |

| Statement of financial performance for day 3 | | \$ |
|--|--|----------------|
| Sales | | 390.00 |
| Cost of goods sold (½ of \$(600 + 75)) | | <u>337.50</u> |
| Profit | | <u>52.50</u> |
| Statement of financial position at the end of day 3 | | \$ |
| Cash | | 690.00 |
| Inventory (½ of \$(600 + 75)) | | <u>337.50</u> |
| Total assets | | <u>1027.50</u> |
| = Paul's wealth in the business—equity | | <u>1027.50</u> |

ACTIVITY 1.6

In practice, decision-makers may not be as rational and capable as implied in the planning process. Individuals may find it difficult to handle large amounts of information about a wide range of options. As a result, they may restrict their range of options or discard some information to avoid becoming overloaded. They may also adopt rather simple approaches to evaluating such a mass of information. For example, they might ignore any information that does not fit well with the decision-makers' desired outcome.

ACTIVITY 1.7

There have been a number of corporate crashes, by far the most significant being HIH Insurance. Others that have had wide press coverage include OneTel, ABC Learning Centres, Allco, Timbercorp and Great Southern Plantations. Recently we have had Dick Smith.

ACTIVITY 1.8

Other sources of information available include:

- meetings with managers of the business
- public announcements made by the business
- newspaper and magazine articles
- websites, including the website of the business
- radio and TV reports
- information-gathering agencies (e.g. agencies that assess businesses' creditworthiness or credit ratings)
- industry reports, and
- economy-wide reports.

These sources can provide information on various aspects of the business, such as new products or services being offered, management changes, new contracts offered or awarded, the competitive environment within which the business operates, the impact of new technology, changes in legislation, changes in interest rates and future levels of inflation. However, the various sources of information identified are not really substitutes for accounting reports. Rather, they are best used in conjunction with the reports in order to obtain a clearer picture of the financial health of a business.

ACTIVITY 1.9

(a) The characteristics appear to include:

- ability to be analytical
- confidence
- self-belief
- determination
- emotional fortitude
- hard work
- taking responsibility/avoiding blaming others
- independence
- balanced/not obsessive
- self-awareness
- ability to take criticism
- ability to be a member of a team.

- (b)
- Judgement implies self-awareness, balance and an ability to analyse.
 - Communication and teamwork implies an ability to take responsibility and not blame others, to be able to take criticism and to be an effective member of a team.
 - Self-management implies self-awareness, independence, self-belief and confidence.
 - Application skills imply hard work and determination.

There appears to be a high degree of consistency between the characteristics and the outcomes. The characteristics identified, however, don't all necessarily work together. A passion for hard work can sometimes result in obsession, or a feeling that others are not pulling their weight. Teamwork, to be effective, requires everyone to be working together. This can be very difficult to achieve. Dealing with criticism can be difficult, even if well intentioned. Emotional fortitude can usually last for only so long.

Overall, both the characteristics and the learning outcomes have a high degree of consistency, but vigilance and care is always necessary.

Sample pages