

CHAPTER 1

Introduction to accounting

TEXT REFERENCE: Birt, J et al., *Accounting: business reporting for decision making*, chapter 1.

REVIEW OF LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- Explain the process of accounting.
- Explain the differences between accounting and bookkeeping.
- Outline the role of accounting in decision making for various users.
- Explain the differences between management accounting and financial accounting.
- Give examples of the limitations of accounting information.
- Outline how corporate collapses and the growth of the multinational have changed the role of accountancy.
- Describe career opportunities for accountants.
- List the two professional associations for accountants.

PREVIEW OF CHAPTER

Accounting today is much more than just bookkeeping, the basic preparation of financial reports, and the traditional work areas of management and financial accounting. Accountants can work in exciting new growth areas such as forensic accounting, environmental accounting and e-commerce. Recent company collapses and advances in information technology have resulted in a new breed of accountant who must possess a variety of skills and knowledge. In the past decade we have also seen enormous changes in information technology, resulting in improved **accounting systems** and the role of the auditor.

LO1 The process of accounting

Accounting can be defined as the process of identifying, measuring and communicating economic information about an entity to a variety of users for decision-making purposes. You must remember that only **business transactions** will be recognised by the accounting system. There is more to accounting than just debits and **credits** or **earnings per share** (EPS) calculations. Accounting has been around for a long time. The ‘Father of Accounting’, and in particular the double-entry system of accounting, is the Italian mathematician Fra Luca Pacioli (1494).

LO2 Differences between accounting and bookkeeping

Bookkeeping is strictly the recording and summarising of financial transactions. Think of bookkeeping as being part of the accounting function.

2 Study Guide to accompany Accounting: business reporting for decision making

Duties of bookkeepers include the following:

- Prepare and send invoices to debtors (perhaps using computer packages such as MYOB).
- Print **financial reports** and debtors listings.
- Check customer credit ratings.
- Receive invoices from suppliers.
- Prepare a list of overdue accounts.
- Calculate and distribute wages and salaries.
- Verify recorded transactions and report inconsistencies to management.

Examples of accountants' duties include the following:

- Update and manage the MYOB system for an entity.
- Supervise activities of the bookkeeper.
- Assist in the preparation of budgets.
- Prepare financial reports.
- Compare budgets with actual performance and produce variance reports.
- Provide assistance to management in setting prices.
- Prepare Business Activity Statements (BASs).
- Liaise with banks to establish funds management arrangements.
- Prepare bank reconciliations.

As you can see, the range and type of tasks are quite different between a bookkeeper and an accountant. However, depending on the size of the entity, sometimes a bookkeeper will perform some of the accounting duties and vice versa.

LO3 The role of accounting in decision making

Accounting information is designed to meet the needs of both internal users and external users of accounting information. **Internal users** are the management of the entity, who require accounting information to assist them in management processes such as:

- budgeting
- setting prices
- forecasting profits
- determining the appropriate sales mix
- assessing the performance of employees
- determining how many overtime hours are required
- determining capacity of plant
- investing the resources of the entity.

External users (i.e. outside users of information who make decisions about the entity) include such parties as:

- employees
- investors
- suppliers
- banks
- consumers
- government agencies (e.g. taxation authorities, ASIC, the ASX)
- lobby groups.

LO4 Management accounting versus financial accounting

Differences between financial and management accounting relate to accounting rules, timeliness, level of detail and users. **Financial accounting** is the preparation and presentation of financial reports (from historical data) for all types of users to make economic decisions regarding the entity. This information is governed by **Generally Accepted Accounting Principles (GAAP)**.

GAAP provide accounting standards for preparing accounting reports and assist in the creation of financial reports such as the **Balance Sheet** and **Income Statement** under an accrual-based accounting system. Financial accounting is also guided by rules set out in:

- **Corporations Law** and
- **Australian Stock Exchange (ASX) Listing Rules.**

Management accounting is a field of accounting that provides economic information for internal users. These reports are bound by no rules and are therefore much less formal and can provide any level of detail.

LO5 Limitations of accounting information

Users of accounting information need to carefully consider a number of limitations of the information provided, especially in the financial reports. These limitations include:

- the time lag in the distribution of the information to the various users (often up to three months between the end of the financial year and the information being published)
- the historical nature of accounting information (financial information is from past data and is therefore often outdated)
- the subjective nature of the financial reports (e.g. choice of depreciation methods for equipment).

There are also some potential costs of providing accounting information to various users. These include information costs (i.e. costs in preparing and disseminating information) and the cost of releasing proprietary information to competitors.

LO6 Changes in the role of accounting

The recent spate of corporate collapses (e.g. Enron, Arthur Andersen and HIH) in the business world has impacted on the role and perception of an accountant. With entities becoming more diversified and multinational, the question of **ethics** (see chapter 3) is taking a more pivotal role. Maintaining ethics in an entity means complying with the rules and policies of the entity, and having an awareness of the different needs of the **stakeholders** in the entity. Similarly, an entity's **corporate governance** structure specifies the distribution of rights and responsibilities among different participants in the entity — such as the board, managers, shareholders and other stakeholders — and spells out the rules and procedures for making decisions on the entity's affairs.

LO7 New opportunities for accountants

The three traditional areas of employment for accountants have been in:

1. public accounting (e.g. providing investment and tax advice to the public)
2. the private sector (e.g. Chief Financial Officer for Coles)
3. the government/not-for-profit sector (e.g. ATO **GST** compliance section).

New opportunities for accountants include positions in:

- forensic accounting (assist in solving such crimes as computer hacking and the theft of large amounts of money through bogus schemes on the Internet)
- e-commerce (e.g. designing web-based payment systems like BPay)
- personal financial planning (e.g. superannuation and share portfolios)
- environmental accounting
- international accounting (taxation, financial derivatives).

LO8 Professional accounting associations in Australia

The two main professional accounting associations in Australia are:

- CPA Australia (CPAA) and
- the Institute of Chartered Accountants in Australia (ICAA).

These two associations provide a range of services for their respective members, such as training, products and services and the right to use the designation (e.g. CPA), and employment opportunities.

CHECKLIST — WHAT YOU SHOULD KNOW FROM CHAPTER 1

- What the accounting process is
- The difference between accounting and bookkeeping
- How accounting assists in decision making by the various users
- The differences between management accounting and financial accounting
- Some of the limitations of accounting information
- How corporate collapses and the growth of multinational entities have changed the role of an accountant
- Some of the new areas that are providing opportunities in accounting
- The two main professional associations for accountants in Australia

KEY TERMS

accounting

accounting system

auditing

Australian Stock Exchange (ASX)

Balance Sheet (statement of financial position)

bookkeeping

business transactions

corporate governance

Corporations Law

credit

earnings per share

ethics

external users

financial accounting

financial reports

generally accepted accounting principles (GAAP)

general purpose financial reports

GST

historical cost

Income Statement (statement of financial performance)

internal users

Listing Rules

management accounting

relevant information

stakeholders

Statement of Cash Flows

MULTIPLE-CHOICE QUESTIONS

1. Accounting can be defined as the process of:
 - (a) identifying economic information
 - (b) measuring economic information
 - (c) communicating economic information
 - (d) all of the above.

2. Improvements to current accounting systems have in the main been due to:
 - (a) companies making bigger profits
 - (b) changes in information technology
 - (c) mandatory reporting of financial reports
 - (d) none of the above.
3. Accountants today work in areas such as:
 - (a) forensic accounting
 - (b) e-commerce
 - (c) environmental accounting
 - (d) all of the above.
4. It is important to remember that in an accounting system we should recognise only:
 - (a) business transactions
 - (b) transactions that affect both the owner and the business
 - (c) revenue and expense items of the entity
 - (d) revenue and expense items for the current period.
5. It is generally recognised that the concept of double-entry accounting commenced:
 - (a) after ASIC called for major reforms in company law
 - (b) in 1494
 - (c) in conjunction with the ASX going public
 - (d) in 1901.
6. The difference between bookkeeping and accounting is that the former:
 - (a) requires subjective figures on 'make/buy' decisions only
 - (b) concentrates only on the revenues, assets and liabilities of a company
 - (c) is left to qualified accountants
 - (d) strictly records and summarises financial transactions.
7. The role of an auditor is to:
 - (a) check the accuracy of financial reports
 - (b) check if the figures in financial reports are correct or not
 - (c) ensure the financial reports are prepared in accordance with policies, laws and regulations
 - (d) both (a) and (c).
8. Accounting information is designed to meet the needs of:
 - (a) internal users
 - (b) external users
 - (c) government agencies only
 - (d) internal and external users.
9. An example of an external user of an entity's accounting reports could be:
 - (a) an employee of the company
 - (b) the entity's financial manager
 - (c) the entity's general manager
 - (d) all of the above.
10. As a general guide for financial reporting, we use the rules and practices of:
 - (a) GAAP
 - (b) ASIC
 - (c) the ASX
 - (d) the ATO.

6 *Study Guide to accompany Accounting: business reporting for decision making*

11. Management accounting generally provides economic information for:
 - (a) managers of competing companies
 - (b) regulatory bodies such as ASIC
 - (c) external users such as investors
 - (d) internal users.
12. The differences between financial and management accounting include:
 - (a) accounting rules and formality
 - (b) timeliness (e.g. of reports)
 - (c) the level of detail disclosed
 - (d) all of the above.
13. Limitations of financial reports include that:
 - (a) we use only objective data in report compilation
 - (b) information in these reports is often outdated
 - (c) only credit transactions are taken into account
 - (d) the cost of financing these reports is usually prohibitive.
14. One of the major costs for every entity in providing accounting information is:
 - (a) the opportunity cost of not providing such information
 - (b) the cost of providing proprietary information to competitors
 - (c) the cost of not having enough accounts receivable during the period
 - (d) not being aware of competitors' cost structures.
15. The corporate governance structure in an entity should specify the:
 - (a) rights and obligations of managers in service industries only
 - (b) links between an entity and the government of the day
 - (c) distribution of rights and responsibilities among all stakeholders
 - (d) winding-up procedures for direct competitors.
16. Maintaining ethics in an entity means complying with and being aware of:
 - (a) the rules of the entity
 - (b) the policies of the entity
 - (c) the different needs of the various stakeholders
 - (d) all of the above.
17. General purpose financial reports are those reports that:
 - (a) are prepared for the general public only
 - (b) are prepared and published under applicable Australian accounting standards
 - (c) are prepared and published before the end of a financial year
 - (d) all of the above.
18. Becoming a CPA entitles you to work in:
 - (a) various areas including public and public-sector accounting
 - (b) private enterprise only
 - (c) public-sector accounting
 - (d) a mentoring program with a private accountant only.
19. To become a CA (Chartered Accountant) you must:
 - (a) complete a Commerce degree from an approved institution
 - (b) complete a university degree and two years of work experience
 - (c) complete an approved university degree and three years of approved work experience
 - (d) become a CPA.

20. EPS as used in financial accounting, stands for:
- earnings per stakeholder
 - earnings per share
 - ethical performance standards
 - ethical performance of stakeholders.

TRUE/FALSE QUESTIONS

- | | | |
|---|----------|----------|
| 1. Accounting can be defined as the process of identifying, measuring and communicating economic information about an entity to a variety of users. | T | F |
| 2. We recognise only business transactions, and not private transactions made by an owner in an accounting system. | T | F |
| 3. A business transaction does not affect the financial position of a business. | T | F |
| 4. The Balance Sheet is used to communicate relevant information. | T | F |
| 5. Bookkeeping is strictly the recording and summarising of financial transactions. | T | F |
| 6. An external auditor may ensure that the books of a company are prepared in accordance with the Corporations Act. | T | F |
| 7. An external user of financial reports could be a supplier. | T | F |
| 8. Financial reports consist only of the entity's Income Statement and Balance Sheet. | T | F |
| 9. Generally Accepted Accounting Principles (GAAP) provide accounting standards for preparing accounting reports. | T | F |
| 10. Management accounting provides economic information for internal users. | T | F |
| 11. Some differences between financial and management accounting include accounting rules and level of detail of reports. | T | F |
| 12. Financial accounting reports often include much subjective information, such as the depreciation method used for equipment. | T | F |

COMPLETE THE FOLLOWING SENTENCES

- Information in financial reports is based on _____ transactions.
- Internal users are the _____ of the entity.
- A _____ would most likely use an entity's financial reports to determine whether or not the entity is eligible for a loan.
- An _____ could use financial reports to investigate his/her job security.
- The Internet has assisted in decreasing the _____ in issuing financial reports to users.
- Non-current assets are shown in the Balance Sheet at _____ cost.
- _____ users are groups outside the entity, who use the information to make decisions about the entity.

8 Study Guide to accompany Accounting: business reporting for decision making

8. The main internal users of financial accounting reports are _____.
9. Competitors could use an entity's _____ information disclosed in reports to strengthen their market position. This is considered a cost to the issuing entity.
10. Among other things, the recent corporate collapses in Australia have raised questions surrounding _____ governance in entities.

CLASSIFICATION

Abbreviation	Stands for
CPA	
ICAA	
ATO	
GPFR	
SPFR	
GAAP	
ASX	
AASB	
IASB	

EXERCISES TO TEST YOUR KNOWLEDGE

1. Many people in today's society think of an accountant as simply a glorified bookkeeper. The roles of bookkeeper and accountant are continually changing. Distinguish between the two positions and, in your answer, explain to a layperson what the process of accounting really is and what the difference is between a financial accountant and a management accountant.
2. A career for today's accountant involves a lot more than the traditional role of overseeing of the bookkeeper, producing debits and credits, preparing financial reports and reporting to the management or finance section of a business. Using your practical experience, knowledge and current accounting material, discuss the various accounting fields where a graduate accountant could expect to find employment and the necessary skills required to be competitive in securing employment. (Hint: go to website <http://www.myfuture.edu.au>.)

3. As a new enrollee in a commerce-based degree, you wish to plan the academic pathway for your degree and the initial period of your professional career. One of your goals is to become a fully qualified accountant. You have a choice of two professional associations — CPA Australia (www.cpaaustralia.com.au) or the Institute of Chartered Accountants in Australia (www.icaa.com.au). Go to the websites of both of these associations and list:
 - (a) the academic prerequisites (including required units of study) for entry into each association
 - (b) what the professional year(s) entail
 - (c) the activities that each body is mainly focused on.

4. Over the next few years we should see an increase in the number of public accountancy practices put up for sale due, in part, to our ‘baby boom’ accountants wishing to retire. The sellers of these practices will wish to obtain a price that is commensurate with the goodwill that they have created over their years in practice. The difficulty for the buyer is to ascertain if the asking price is fair and what guarantee he/she has that the seller’s clients will remain after the sale.

List three or four steps that you, as a potential buyer, could put in place to avoid these difficulties. These will therefore protect your investment and you will pay only a fair and reasonable price for such an accountancy practice.

5. There is an increasing trend and demand for both private- and public-sector organisations to demonstrate transparency and accountability beyond the traditional areas of financial performance. As a result, a new era of ‘triple bottom line’ (TBL) accounting is emerging. This triple bottom line refers to the three elements of social, environmental and financial accountability. From your limited background in accounting, what do you think each of these areas relates to?
 - (a) Social accountability
 - (b) Environmental accountability
 - (c) Financial accountability

6. It has recently been argued that the competitive audit environment has led to a reduction in auditor independence and expertise in skills. We have seen the demise of a number of previously high-profile companies. As a result it is claimed that there has been an increase in ethically undesirable practices.
 - (a) List some of the effects that such bad publicity has on the accounting (in particular auditing) profession as a whole.
 - (b) List three ways in which you think we can maintain the credibility of the accounting profession.

SOLUTIONS

Multiple-choice questions

- | | | | |
|------|-------|-------|-------|
| 1. D | 6. D | 11. D | 16. D |
| 2. B | 7. D | 12. D | 17. B |
| 3. D | 8. D | 13. B | 18. A |
| 4. A | 9. A | 14. B | 19. C |
| 5. B | 10. A | 15. C | 20. B |

True/false questions

- | | | | |
|------|------|------|-------|
| 1. T | 4. T | 7. T | 10. T |
| 2. T | 5. T | 8. F | 11. T |
| 3. F | 6. T | 9. T | 12. T |

Complete the following sentences

1. Information in financial reports is based on **business** transactions.
2. Internal users are the **management** of the entity.
3. A **bank** would most likely use an entity's financial reports to determine whether or not the entity is eligible for a loan.
4. An **employee** could use financial reports to investigate his/her job security.
5. The Internet has assisted in decreasing the **time lag** in issuing financial reports to users.
6. Non-current assets are shown in the Balance Sheet at **historical** cost.
7. **External** users are groups outside the entity, who use the information to make decisions about the entity.
8. The main internal users of financial accounting reports are **management**.
9. Competitors could use an entity's **proprietary** information disclosed in reports to strengthen their market position. This is considered a cost to the issuing entity.
10. Among other things, the recent corporate collapses in Australia have raised questions surrounding **corporate** governance in entities.

Classification

Abbreviation	Stands for
CPA	Certified Practising Accountant
ICAA	Institute of Chartered Accountants in Australia
ATO	Australian Taxation Office
GPFR	General Purpose Financial Reports
SPFR	Special Purpose Financial Reports
GAAP	Generally Accepted Accounting Principles
ASX	Australian Stock Exchange
AASB	Australian Accounting Standards Board
IASB	International Accounting Standards Board

Exercises to test your knowledge

1. The role of a bookkeeper is to:
 - prepare and send invoices to debtors (perhaps using computer packages, e.g. MYOB)
 - print financial reports and debtors listings
 - check customers' credit ratings
 - receive invoices from suppliers
 - prepare a list of overdue accounts
 - calculate and distribute wages and salaries
 - verify recorded transactions and report inconsistencies to management.

Whereas the role of an accountant is to:

- update and manage the MYOB system for an entity
- supervise activities of the bookkeeper
- assist in the preparation of budgets
- prepare financial reports
- compare budgets with actual performance and produce variance reports
- provide assistance to management in setting prices
- prepare Business Activity Statements (BAS)
- liaise with banks to establish funds management arrangements.

Accounting can be defined as the process of identifying, measuring and communicating economic information about an entity to a variety of users for decision-making purposes.

Financial accounting is the preparation and presentation of financial reports for all types of users to make economic decisions regarding the entity. This information is governed by Generally Accepted Accounting Principles (GAAP). GAAP provide accounting standards for preparing accounting reports and assist in the creation of financial reports. Management accounting, on the other hand, is a field of accounting that provides economic information for internal users only — it is bound by no rules, no standards, requires little detail and is much less formal.

2. Accountants today can work in exciting new growth areas such as forensic accounting, budget accounting, cost accounting, environmental accounting, e-commerce and the various agencies within the public sector (e.g. Australian Taxation Office, Auditor-General's department). Recent company collapses and new advances in information technology have resulted in a new breed of accountant who must possess skills and knowledge and show flexibility to complete the varied range of tasks that accountants now perform. Necessary skills for today's accountant include the ability to:
 - develop competence in systems analysis and computer technology
 - develop facilitation skills, such as persuasion and communication skills
 - acquire a broad business knowledge in strategy, operations, human resources, marketing, finance and economics
 - develop analytical skills
 - develop a willingness to embrace change and assume risk
 - complete an internship in business and/or public accounting
 - develop proficiency in accounting and tax issues.

It is also imperative for management accountants, for example, to become knowledgeable about trends affecting business and finance, to be prepared for changing types of tasks performed, and be willing to acquire the necessary knowledge and skills to function as fully fledged business partners.

3. Answers to this web-based activity should revolve around the most recent requirements of the two associations as shown on the individual body's website.

12 *Study Guide to accompany Accounting: business reporting for decision making*

4. Steps to protect your potential investment in an accountancy practice could include:
 - obtaining an independent valuation for the practice
 - drawing up a contract that includes paying by instalments so that if a large part of the client base leaves, you can withhold payments to the seller
 - including in your contract compensation for client poaching after the sale
 - making the transition process gradual so that clients feel comfortable with you, the new owner(s)
 - looking for practices that have previously put in place a three to five year exit plan, so the sale doesn't come as a shock for the existing clients.
5.
 - (a) Social accountability relates to the involvement in shaping local, national and international public policy, equality, treatment of minorities, employee issues and public concern.
 - (b) Environmental accountability refers to the impacts made through processes, products or services, for example, effects on air, water, land, natural resources, flora, fauna and human health as a result of a particular process.
 - (c) Financial accountability includes financial performance activities that relate to shaping the demand for products and services, employee compensation, community contributions and local procurement policies.
6.
 - (a) The effects that bad publicity has had on the accounting profession, auditing in particular, include loss of confidence by the general public, a certain demise in the perception of ethical standards, accounting entities underpricing one another to obtain business, the demise of some of the bigger accounting entities (we used to have the big eight accounting icons, now we have the big four) to name a few.
 - (b) Three ways in which we can maintain the credibility of the accounting profession include:
 - an extensive education program for accounting students
 - ensuring auditing standards are standardised, regularly updated and communicated to all interested parties
 - regularly updating auditors' skills, competence levels and/or qualifications to help maintain public confidence.