

STUDY GUIDE TO ACCOMPANY

Financial Accounting

6th
edition

HOGGETT
EDWARDS
MEDLIN

PREPARED BY ALLAN DUFFUS



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TO THE STUDENT

About the Study Guide

This Study Guide is a self-study aid designed to complement the sixth edition of John Hoggett, Lew Edwards and John Medlin's *Financial Accounting 6e*. For each chapter in the textbook there is a corresponding chapter in the Study Guide. Each chapter in the Study Guide begins with learning objectives and study tips for the chapter. These are followed by a chapter review which takes each of the chapter learning objectives and summarises the significant points. At the end of each chapter is a section designed to test your knowledge of the chapter. Features of the sixth edition are a 'Knowledge checklist' and a crossword designed to consolidate your conceptual understanding of the chapter and your understanding of the terminology introduced in the chapter. Ten true/false statements, ten multiple-choice questions and four demonstration problems are also provided. Solutions to the crossword, and the answers to the true/false statements and the multiple-choice questions are included, as well as suggested solutions to the demonstration problems.

How to use this Study Guide

There are several effective study methods or learning styles. The following suggestions may be useful.

Approach the study of each chapter with a spirit of learning. Some rules and procedures must be memorised. However, rather than try to memorise all definitions, rules or procedures, develop a clear understanding of the main concepts and the logic of the procedures covered.

After you have studied the textbook chapter thoroughly and worked your way through the illustrations, examine the learning objectives again. Ask yourself whether you know and understand them. If there is an objective you do not understand, go back and review related material in the textbook.

Use the 'Knowledge checklist' and the crossword to test how well you understand the concepts and procedures introduced in the chapter. Then complete the 'Test your knowledge' section of the Study Guide. Check your answers and solutions with those provided in the Study Guide only after you have completed the section. If you are still not confident that your answers compare favourably with the solutions provided, refer again to the appropriate material in the textbook and Study Guide.

I wish you every success with your studies.

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Allan J. Duffus, FCPA

CHAPTER

1

Decision making and the role of accounting

TEXT

REFERENCE:

John Hoggett, Lew Edwards & John Medlin,
Financial Accounting, 6th edn, 2006, chapter 1.

OBJECTIVES

When you have studied this chapter, you should be able to:

1. understand the nature of decisions and the decision-making process
2. appreciate the wide range of economic decisions made in the marketplace
3. explain the nature of accounting and its main functions
4. identify the potential users of accounting information
5. use information to make simple economic decisions
6. understand the role of accounting information in the decision-making process
7. understand the differences between accounting for management and accounting for external users
8. understand how the accounting profession is organised in Australia
9. identify the different areas of the economy in which accountants work
10. understand the importance of ethics in business and accounting and how to recognise and handle ethical dilemmas as part of the decision-making process.

STUDY TIPS

1. This is an important chapter because it lays the foundation for all topics that will follow.
2. Make sure that you understand each new term as it is introduced.
3. Pay particular attention to the significance of accounting information for decision-making processes.
4. Identify the types of activities that are carried out by a professional accountant working in Australia.

CHAPTER REVIEW

1. **The nature of decisions and the decision-making process**

Decisions have to be made by all individuals every day. Time and resources are always limited, so decision making arises because of the need to choose between alternatives. Careful consideration must be given to all information available at the time because of the long-term consequences of a decision made now. There are four main steps in the decision-making process:

- (1) Identify each situation in which a decision is needed and determine the goals we wish to achieve.
- (2) Identify the relevant information needed to determine possible available alternatives.
- (3) Having obtained information to help us determine the alternatives available, we need to assess the consequences or outcomes of the alternatives.
- (4) Choose a course of action which we hope will achieve the goals established in step 1.

2. **The wide range of economic decisions made in the marketplace**

Usually, decision making involves the use of limited or scarce economic resources which are traded in the marketplace at a price. However, many factors apart from the monetary impact must be considered, such as personal taste, social factors, environmental factors, religious and/or moral factors, and government policy. Economic decisions usually involve an inward or outward flow of money or monetary equivalents. Economic decisions are made in many different markets, be they retail, wholesale, the stock market, local or international. Hence, if decision makers are to make informed decisions, some knowledge of accounting measurement systems, concepts and standards is desirable.

3. **The nature of accounting and its main functions**

Accounting is a service activity. It uses words and symbols to communicate financial information useful for decision making. The terminology and symbols used have developed from the earliest known accounting records. As a profession, accounting has evolved in response to society's need for economic information to

help people make economic decisions. Accounting is often called the 'language of business'. To be effective, the receiver must understand the message that the sender intends to convey. You must learn the meaning of the words and symbols used by accountants. Many people with little knowledge of accounting must interpret accounting data.

Accounting has been defined as the process of identifying, measuring, recording and communicating economic information to permit informed judgements and economic decisions. The main purpose of accounting is to help people make economic decisions. In our society, resources must be allocated among and within all kinds of entities. Accounting information provides the basis for making decisions about resource allocation. To be useful, data must be identified, measured, recorded, classified, summarised and communicated to potential users. These are the critical elements of accounting.

Accounting information is financial information about economic activities. All economic entities (e.g. businesses, government agencies, families, charitable entities) need such information because it is used for making economic decisions about those entities. An economic event of an entity is referred to as a transaction. Transactions are of two types: external and internal.

Before the effects of transactions can be recorded they must be measurable in terms of a common denomination. Recording provides a history of an entity's economic activities. It maintains files of all identified and measured transactions which have affected the entity. The recorded data must also be classified and summarised to be useful. The economic activities must then be communicated to potential users of the information.

Computers have had a significant impact on the accounting process and hence the recording process is much more efficient and reliable.

4. The potential users of accounting information

The ultimate objective of accounting is to provide information in reports which can be used by **internal** and **external** decision makers. The preparation of this information for users (decision makers) outside the entity is called financial accounting. Such users might be investors or creditors of the entity. The preparation of information for use by decision makers inside the entity to plan and control operations is called management accounting. Inside users means management. Management uses the same financial statements as do outside decision makers, plus internal reports and summaries prepared specifically for it. Accounting reports can be **special-purpose reports** to meet the needs of a specific user group or **general-purpose reports** for the general use of external users.

5. Using information to make simple economic decisions

Economic decisions are made every day. Take the example from the text. A business opportunity is identified which will satisfy the ambitions of the entrepreneur. Some research reveals that there is an opening for such a business. Factors considered in the planning stage are investment needs, financing, estimates of operating costs and how much to charge for services, finally culminating in the decision to proceed with the business.

To summarise, there is the establishment of implicit goals, the collection of information about the proposed business, and consideration of future consequences. As the business proceeds, **accounting information** is needed to monitor how well the business actually performs in comparison with the estimates, how and when to replace assets, and how income tax and goods and services tax (GST) will affect the business.

6. The role of accounting information in the decision-making process

Financial information is needed before any economic decision is made. Financial accounting information focuses on actual events. For the purpose of decision making, the past is used as a guide to future estimates of the consequences of different alternatives. The accountant can help significantly in the areas of budgeting, investigating, interpreting and communicating results for use by both internal and external decision makers.

7. The differences between accounting for management and accounting for external users

Management accounting is that area of accounting concerned with providing financial and other information to all levels of management of an organisation to enable them to carry out their planning, controlling and decision-making responsibilities. Financial accounting is concerned with reporting general-purpose information to users external to an entity in order to help them make sound economic decisions about the entity's performance and financial position. The distinction between management and financial accounting can be identified by reference to (1) the main users of the reports, (2) the types of reports produced, (3) the frequency of reports, (4) the content and format of reports, and (5) external verification.

8. How the accounting profession is organised in Australia

Accountants in Australia are represented by two professional organisations: **CPA Australia** and the **Institute of Chartered Accountants in Australia (ICAA)**. Entry to these two professional bodies requires a number of conditions to be satisfied, including a minimum 3 years appropriate supervised work experience and completion of the CPA or CA Program. Certified practising accountants (CPAs) and chartered accountants (CAs) are required to undertake ongoing professional development activities to maintain their level of membership.

9. The different areas of the economy in which accountants work

Accountants generally work in one of three main areas: public accounting, commerce and industry, or not-for-profit entities, which include government departments at all levels, churches, hospitals, clubs and charities. Public accountants tend to specialise in one of four general services: auditing and assurance, taxation, advisory, and insolvency and administration. Accountants in commerce and industry may be involved in six areas: general accounting, cost accounting, accounting information systems, budgeting, taxation, and internal auditing. Not-for-profit accounting involves many of the problems and decisions

encountered in private industry, but may require a different approach in some respects owing to the absence of a profit motive.

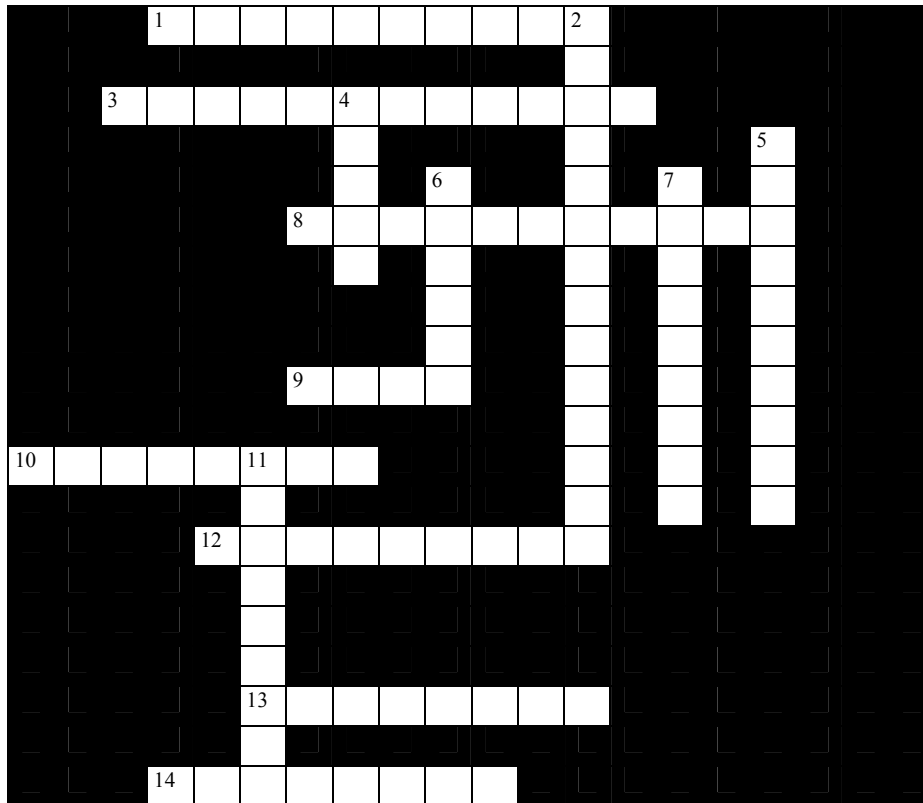
10. The importance of ethics in business and accounting

Most businesses appreciate the importance of ethical behaviour. Regular unethical behaviour by managers, owners, employers and customers must eventually lead to the collapse of the entity. Financial reports and the audit and assurance services functions of accounting represent controlling influences. CPA Australia and the ICAA have issued a joint Code of Professional Conduct (CPC) to provide an authoritative guide to members on acceptable professional behaviour. The rules are mandatory for members, and severe penalties are imposed on members who break the rules.

KNOWLEDGE CHECKLIST

- Can you recall the four steps in the decision-making process?
- Can you name three non-economic factors which must be considered in the decision-making process?
- Do you recall the definition of accounting?
- Can you identify the external users of accounting information?
- Can you identify the internal users of accounting information?
- Do you know how accounting information is used in the decision-making process?
- Can you distinguish between management accounting and financial accounting?
- Do you know how the profession of accounting is organised in Australia?
- Can you name the principal areas in which public accountants and managerial accountants work?
- Are you aware of the importance of ethics in business and accounting, and do you know how they are regulated?

CROSSWORD



ACROSS

1. The process of identifying, measuring, recording and communicating economic information
3. Events that are the economic activities of an entity
8. The winding up of the affairs of a company
9. Accounting that deals with the cost of a product or service
10. A choice made
12. An independent professional review service
13. Traded scarce resources
14. Ongoing investigation of compliance with procedures and polices of an entity:
_____ audit

DOWN

2. Reports designed to meet the information needs of a wide range of users (2 words)
4. An independent examination of the accounts by an accountant
5. A _____ accounting system provides information to internal users
6. A plan for the future operating activities of a business
7. Provides information to external users: _____ accounting
11. Unable to pay debts as they fall due

TEST YOUR KNOWLEDGE

True/False

1. The *first* step taken every time a decision is made is to analyse the consequences of different alternatives. **T. F.**
2. Resources are traded in the marketplace at a price because they are in limited or scarce supply. **T. F.**
3. An internal transaction is an economic event which occurs between one entity and another entity. **T. F.**
4. Public accountants in Australia are found in the public service serving local, state and federal government bodies. **T. F.**
5. Establishing goals, gathering information on alternatives, determining the consequences of alternatives, and choosing a course of action involve estimates of future events. **T. F.**
6. A major focus of accounting information is on actual, historical financial events. Therefore, recording financial transactions of an entity is of no use in establishing future relationships. **T. F.**
7. The area of accounting concerned with providing financial and other information to all levels of management in an organisation is known as financial accounting. **T. F.**
8. Entry to CPA Australia and the Institute of Chartered Accountants in Australia (ICAA) requires holding a degree from an accredited tertiary institution and a minimum of one year's appropriate, supervised work experience. **T. F.**
9. An example of an assurance service in which auditors are becoming involved is electronic commerce. **T. F.**
10. If managers, owners, employees and customers regularly deceived one another, told lies, falsified records and did not conform to rules, the entity must eventually cease to exist. **T. F.**

Multiple choice

For each of the following, select the best answer under normally prevailing circumstances.

1. Which of the following is *not* one of the four main questions to be followed in making a decision?
 - (a) What are we trying to achieve?
 - (b) What information do we need?
 - (c) How long will it take?
 - (d) Which course of action will we choose?

2. Apart from the monetary impact, factors of decision making include:
 - (a) personal taste
 - (b) social factors
 - (c) environmental factors
 - (d) all of the above.

3. The retail market is where:
 - (a) the consumer buys groceries, clothes or home electrical goods
 - (b) retailers buy their supplies for on-selling in their different outlets
 - (c) individuals and business entities buy and sell shares
 - (d) people meet to swap, buy and sell hand-crafted and second-hand goods.

4. If accounting information is to be useful, it must be expressed in terms of:
 - (a) non-monetary units
 - (b) monetary and non-monetary units
 - (c) units of consumer demand
 - (d) a common denominator.

5. An example of an internal transaction is when an entity:
 - (a) purchases merchandise from a supplier
 - (b) borrows money from a bank
 - (c) sells goods to a customer
 - (d) recognises the use over time of machinery and equipment.

6. An example of an external transaction is when an entity:
 - (a) pays an employee his/her fortnightly wages
 - (b) transfers merchandise from the stores department to the sales department
 - (c) recognises the use over time of machinery and equipment
 - (d) uses the maintenance department to service machinery and equipment.

7. Questions raised by external users of accounting information include:
 - (a) Will the entity be able to repay its loans?
 - (b) What is the entity's earning potential?
 - (c) Is the business in a financially sound position?
 - (d) All of the above.

8. For the purpose of decision making:
 - (a) accounting information provides information about future events
 - (b) accounting information provides information about the outcomes of past decisions
 - (c) the future is used as a guide to past estimates
 - (d) the accountant never becomes involved in the budgeting process.

9. The rules of professional conduct set down by the joint Code of Professional Conduct (CPC) are:
 - (a) to be used as a behavioural guide only
 - (b) unenforceable by the professional bodies
 - (c) mandatory for all members
 - (d) the concerns of public practitioners only.
10. The management accountant working in the commercial field will typically be involved in:
 - (a) independent auditing
 - (b) taxation services
 - (c) management advisory services
 - (d) cost accounting.

Demonstration problems

- 1.1 Samantha wishes to purchase her first car. Following the four main steps in making a decision outlined in the chapter, prepare an analysis of each step taken by Samantha.
- 1.2 Develop your own hypothetical business scenario similar to that described for Darren in the text. In doing so, incorporate as much costing, funding and operating estimates as you think appropriate.
- 1.3 In general terms, explain the purpose of accounting.
- 1.4 Provide a list of the main users of accounting information and explain how they use the information in their decision-making processes.

SOLUTIONS

Crossword

Across

1. accounting
3. transactions
8. liquidation
9. cost
10. decision
12. assurance
13. economic
14. internal

Down

2. general purpose
4. audit
5. management
6. budget
7. financial
11. insolvent

True/False

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

Multiple choice

- | | |
|------|-------|
| 1. c | 6. a |
| 2. d | 7. d |
| 3. a | 8. b |
| 4. d | 9. c |
| 5. d | 10. d |

Demonstration problems

- 1.1 No set answer. However, the decision is made to buy a car. Samantha needs to establish her priorities regarding what car will suit her needs in her price range. She may well ask: How much can I afford? Will the price determine whether it is a new or a second-hand car? Do I need to borrow? If yes, from whom do I borrow? Do I want automatic or manual transmission? Is colour a significant factor? What size and/or make of car is acceptable? In deciding on the size or make of car, is fuel consumption a significant factor? If I decide to purchase a second-hand car, how do I find out if a particular car is mechanically sound?
- 1.2 No set answer, but remember the steps outlined in the chapter in the decision-making process.
- 1.3 The purpose of accounting is to provide financial information that is useful in making economic decisions. It is the process of identifying, measuring, recording and communicating economic information to permit informed judgements and decisions by users of the information.
- 1.4 Users of accounting information form two main groups: decision makers who are **internal** to the entity and those who are **external** to the entity.

Internal decision makers are managers at all levels who use financial information for planning and controlling the operations of a business entity. Managers need answers to the following questions: What resources are available? How much debt exists? How profitable are operations? What business should they be in? What are the most efficient processes? What effect might changes in selling prices have? Does the firm have sufficient cash reserves to meet obligations? Should the firm buy or lease resources? Managers need data that will ensure that day-to-day and longer term operations continue successfully.

External users comprise resource providers (creditors and investors), customers, suppliers and regulatory bodies. External users need answers to the following questions: Does the firm have the capacity to meet its monetary obligations when they fall due? What are its earning prospects? How sound is the firm's financial structure? Is continuity of operations and supply assured? Has the firm met its statutory obligations?