Chapter 1
The role of accounting in business

Learning objectives

- Define the main types of accounting
- Describe how decision makers use accounting information
- Describe professional career opportunities in accounting
- Describe how accounting is regulated in Australia
- Explain the role of ethics and sustainability in accounting
- Identify the three main types of business organisations
- Describe the basic accounting principles and their applications in business

Learning objectives

- Recall the accounting equation and its function
- Apply the accounting equation to analyse transactions
- List the different financial statements and demonstrate how they are prepared and used
- Use financial statements to evaluate business performance and make decisions
Defining accounting

Accounting encompasses the information system that
• measures business activity
• processes the data into reports
• communicates the results to decision makers

It is divided into two main types, namely
• financial accounting
• managerial accounting

Decision makers: The users of accounting information

• Individuals
• Businesses
• Investors
• Creditors
• Government regulatory agencies
• Tax authorities
• Non-profit organisations
• Other users, e.g. employees and labour unions

The accounting profession: Career opportunities

• Lucrative career with many opportunities
• Professionally qualified accountants pass the educational and experience requirements of a professional body
• Professional bodies recognised in Australia include
  • Institute of Chartered Accountants in Australia
  • CPA Australia
  • Institute of Public Accountants
  • Chartered Institute of Management Accountants
Accounting regulation

Corporate social responsibility

- Financial reports prepared by accountants play a central part in informing financial decisions.
- The ICAA and CPAA have a joint code of ethics for professional accountants as part of their professional standards.
- It includes the following principles:
  - Integrity
  - Objectivity
  - Professional competence and due care
  - Confidentiality
  - Professional behaviour

Types of business organisations

<table>
<thead>
<tr>
<th>PROPRIETORSHIP</th>
<th>PARTNERSHIP</th>
<th>COMPANY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner(s)</td>
<td>Partners</td>
<td>Shareholders</td>
</tr>
<tr>
<td>- None</td>
<td>- Two or more</td>
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<tr>
<td>Life of organisation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Limited by owner's choice or death</td>
<td>- Limited by partners' choice or death</td>
<td>- Indefinite</td>
</tr>
<tr>
<td>Personal liability of owner(s) for business debts</td>
<td>Personal liability of partners</td>
<td>Shareholders are not personally liable</td>
</tr>
<tr>
<td>- None</td>
<td>- Limited</td>
<td>- None</td>
</tr>
<tr>
<td>Accounting status</td>
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</tr>
<tr>
<td>- Owner is separate from the business</td>
<td>- Partnership is separate from partners</td>
<td>- The company is separate from the shareholders</td>
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</table>
Accounting measurements: Concepts and principles

- The primary objective of external financial reporting is to provide useful information for making investment and lending decisions.
- Useful information must be relevant, valid and reliable.
- Basic measurement concepts and principles include:
  - Entity concept
  - Accounting period concept
  - Cost principle
  - Matching principle
  - Profit recognition principle
  - Conservatism principle
  - Going concern assumption

Accounting measurements: Concepts and principles

- The **entity concept** defines the entity for which accounting data is collected.
- The **accounting period concept** defines the unit of time for which accounting data is collected.
- The **cost principle** states that accounting measures are based upon transaction costs.
- The **matching principle** relates inputs and outputs of goods and services to one another.

Accounting measurements: Concepts and principles

- The **profit recognition principle** states that profit should be recognised when the sales and any other revenues or gains relating to the relevant activity are earned and can be reliably measured.
- The **conservatism principle** constrains management’s natural optimism.
- The **going concern assumption** assumes that the business as a whole will continue operating for the foreseeable future.
The accounting equation

It measures the resources of a business and the claims to those resources

- **Assets** are a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity
- **Liabilities** are debts that are payable to outsiders called creditors
- **Equity** is the residual interest in the assets of the entity after deducting all of its liabilities
- **Income** refers to all increases in equity other than investments by owners
- **Revenue** is that part of income arising from ordinary activities
- **Expenses** decrease equity by using up assets or increasing liabilities in order to deliver goods or services to customers

Accounting for business transactions

- **Accounts** record the impact of events that are considered to affect the value of entities’ assets and liabilities
- **A transaction** is an event that involves at least two parties exchanging resources
- Each transaction affects at least two accounts
- Some transactions affect only one side of the equation; some affect both sides
Accounting for business transactions

Transaction 1: Starting the business
Transaction 2: Purchase of land
Transaction 3: Purchase of office supplies
Transaction 4: Earning of service revenue
Transaction 5: Earning of service revenue on credit
Transaction 6: Payment of expenses
Transaction 7: Payment of account
Transaction 8: Personal transaction
Transaction 9: Collection on account
Transaction 10: Sale of land
Transaction 11: Withdrawal of cash

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<tr>
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<th>Assets</th>
<th></th>
<th>Liabilities</th>
<th></th>
<th>Owners equity</th>
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<tr>
<td></td>
<td>Cash</td>
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<td>Accounts payable</td>
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Preparing the financial statements: The user perspective

A complete set of financial statements comprise

- Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Financial Position
- Statement of Cash Flows

Preparing the financial statements: The user perspective

- The **Statement of Comprehensive Income** presents a summary of an entity’s income and expenses and all changes in equity, other than new owner investments and drawings, for a specific period of time
- The **Statement of Changes in Equity** shows the changes in owners’ equity during a specific time period
- The **Statement of Financial Position** lists all the entity’s assets, liabilities and owners’ equity as at a specific date
- The **Statement of Cash Flows** reports the cash coming in and the amount of cash going out during a period

Preparing the financial statements: The user perspective

Each financial statement should have a heading showing

- the name of the business
- the name of the financial statement
- date or time period covered by the statement
Using financial statements to evaluate business performance and make decisions

Financial statements can be used in several ways, for example

- The **Statement of Comprehensive Income** provides information about profitability for a particular period.
- The **Statement of Changes in Equity** informs users about how much of the earnings were kept and reinvested in the company.
- The **Statement of Financial Position** provides valuable information to financial statement users about the economic resources the company owns (assets) as well as the debts the company owes (liabilities).
- The **Statement of Cash Flows** provides information about three types of business activities.

Summary: Chapter 1

- Accounting is typically divided into financial accounting and managerial accounting.
- Different users review a company’s financial statements for different reasons.
- There are several measurement concepts and principles including the entity concept, accounting period concept, cost principle, matching principle, profit recognition principle, conservatism principle, going concern assumption.
- The accounting equation measures the resources of a business and the claims to those resources.
- Transactions are events involving at least two parties exchanging resources.
- A complete set of financial statements consists of four financial statements.