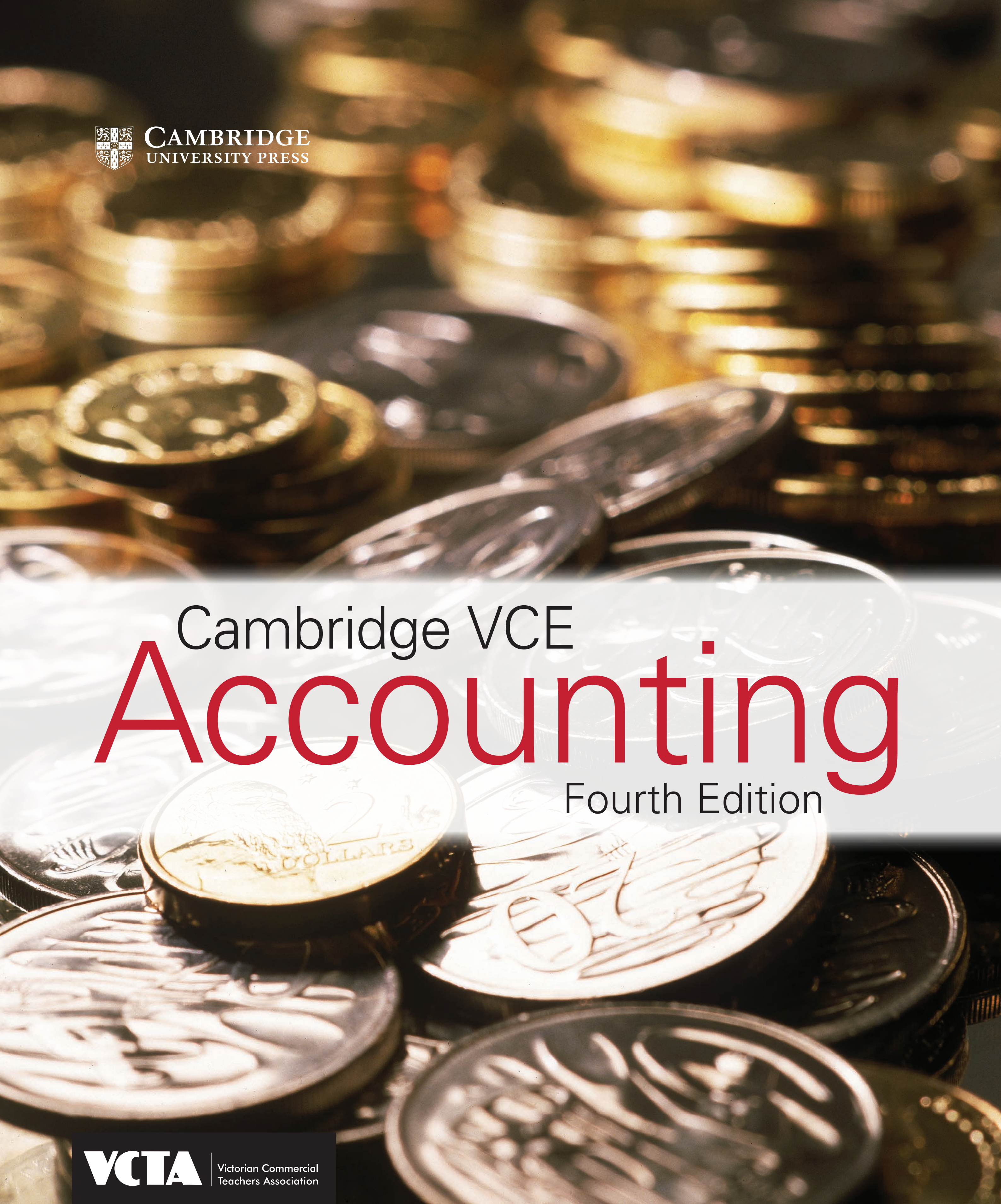

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Anthony Simmons
Richard Hardy

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Author acknowledgements

Although we have been working on these editions of our textbooks for a year or two, we've been developing our understanding – of both Accounting as well as students and how they learn – for the best part of 50 years between us. And in that time we have had the guidance and support of a whole host of people who, together, have helped these books come into being.

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Finally, thank you for choosing this resource. We hope it helps you to understand Accounting as a discipline, and that as a result of using it you are able to think a little bit more like an Accountant, so that your decisions are just a little more informed, and help you in making your own sound financial decisions.

Anthony and Richard

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Foreword

Cambridge Accounting for Units 3 and 4 Fourth Edition, written for the current study design by Anthony Simmons and Richard Hardy, represents an excellent reflection and interpretation of the course. Each chapter follows and collates all the relevant key knowledge into one comprehensive chapter allowing students to gain a complete and in-depth understanding of the relationships between the various key knowledge points.

Examples and scenarios provided in each chapter enable students and teachers to be guided as to the process and provide detailed explanations of the whys with links to accounting assumptions, qualitative characteristics and the ever-important new concept of ethical considerations in decision-making.

Above all else, the main features of the original text remain. The layout with margin definitions, study tips and review questions throughout each chapter guide students in their learning and alert them to key information.

I am pleased to be able to recommend this as an excellent resource for VCE accounting teachers and their students.

Vicki Baron
2018

Features of this resource

Chapter openers: Each chapter opens with a summary of what is to come (*Where are we headed?*) as well as a list of Key terms for you to familiarise yourself with.

Glossary terms and definitions: All of the glossary terms in each chapter are defined for you in the margin and in the glossary at the end of the book. The glossary is also marked with page references for ease of use.

Use of colour: Colour has been used to make it easy for you to follow particular transactions through the Accounting process. You can simply track what impact a transaction had in the journals, the ledger and in various reports.

Review questions: Review questions are placed at the end of each section within each chapter, giving you the opportunity to review and reinforce your understanding as you work through the book.

Study tips: Study tips are included in the page margin to draw attention to particular issues, provide a technique for understanding or remembering an element of the course content.

Ethical considerations: Ethical considerations are highlighted in the page margin to draw attention to this particular element of the course.

End of chapter sections: At the end of each chapter, you will find a chapter summary (*Where have we been?*) and exam-style Exercises, each of which is linked with an icon to the corresponding Workbook pro-forma.

Downloadable Exercise pro-formas: In the Interactive Textbook you will find downloadable versions of all Review questions, as well as Exercise pro-formas in both Excel and Word formats.

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Financial Accounting for a trading business

Unit 3

In Unit 3 of the VCE Accounting course, we will cover the following chapters:

Chapter 1	**The role of Accounting**	2
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Chapter 1

The role of Accounting

Where are we headed?

After completing this chapter, you should be able to:

- **explain** the purpose of Accounting
- **explain** the importance of non-financial information
- **explain** how ethical considerations affect business decision-making
- **identify** the users of Accounting information and the financial information they may require
- **distinguish** between financial data and financial information
- **identify** and **explain** the stages in the Accounting process
- **define** and **apply** the Accounting assumptions and Qualitative characteristics
- **explain** the relationships between the Accounting assumptions and Qualitative characteristics
- **identify** and **define** the Elements of financial statements.

Key terms

After completing this chapter, you should be familiar with the following terms:

- purpose of Accounting
- Accounting
- non-financial information
- ethical considerations
- financial data
- financial information
- transaction
- Accounting process
  – source documents
  – recording
  – reporting
  – advice
- Accounting Standard
- Conceptual Framework
- Accounting assumptions
  – Accounting entity
  – Going concern
  – Period
  – Accrual basis
- Qualitative characteristics
  – Relevance
  – Faithful representation
  – Verifiability
  – Comparability
  – Timeliness
  – Understandability
- materiality
- Elements of financial statements
  – assets
  – liabilities
  – owner's equity
  – revenue
  – expense.

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1.1 The purpose of Accounting

Decisions, decisions, decisions – we make them every day. From deciding what to wear in the morning to choosing what we will eat for dinner, decision-making is part of our lives as people, citizens and consumers. The bases on which we make those decisions vary as much as the decisions themselves, as we use logic, preference, instinct, emotion and even a 'toss of a coin' to make up our minds and decide what we should do.

When we reflect on the best decisions we have made, we may find that sometimes we have been very successful 'going with our gut' or 'following our heart'. But when we think about *financial* decisions, it is usually the case that our best decisions are made when we have good data and information, analyse carefully, weigh our options logically, and then pick the one that is most likely to succeed.

In financial decisions, we need a way – a 'system' – to generate and analyse information so that we may make sound decisions. This is the **purpose of Accounting**: to provide financial information and advice to assist decision-making.

With this purpose in mind, **Accounting** can be described by the processes it uses to generate and communicate financial information. That is, Accounting involves:

- collecting and recording financial data
- reporting, analysing and interpreting financial information
- advising users about possible courses of action to assist decision-making.

> Accounting is best described as a *process* – a 'way of doing things' – that is designed to generate financial information to support decision-making.

purpose of Accounting
to provide financial information and advice to assist decision-making

Accounting
the process of collecting and recording financial data; reporting, analysing and interpreting financial information; and advising users about possible courses of action to assist decision-making

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At its core, Accounting is about decision-making. Just as history exists as a way of understanding the present by making sense of the past, Accounting exists as a way of improving decision-making by making sense of financial information. Accounting cannot guarantee that decision makers will make the *right* decisions, but through the provision of information and advice it should at least help them to make *more informed* decisions, increasing the chances of better decisions being made.

Accounting for small business

Accounting is used by individuals, businesses (large and small), not-for-profit organisations and governments, and in all cases serves the purpose of generating and communicating financial information and advice so that better decisions can be made. In this course, we will focus on how Accounting supports decision-making for small businesses, defined (for the purpose of this course) as sole traders, where there is one owner of the business, who is also its manager.

Study tip

There are other ways to define 'small business', but this course concentrates on sole traders only.

Many owner/operators begin in business precisely because they have expertise related to the product they are selling and the market in which it is being sold. Indeed, it is this expertise that helps them to make decisions about selecting product lines, setting prices and approving advertising campaigns.

However, small business owners also need detailed information about a range of other financial issues that may affect their chances of business success, including:

- keeping financial records
- preparing financial reports
- determining the firm's tax obligations
- managing cash and ensuring the business can meet its short-term debts
- assessing the firm's ability to earn profit and continue operating into the future.

Accounting plays a critical role in providing important financial information on issues like these so that the owner can make informed decisions about how to respond.

Financial information

The quality of the information generated by an Accounting system will have a direct effect on the quality of the decisions that are made: good financial information will improve the chances of good decisions being made.

For this reason, the Accounting profession (in conjunction with governments and professional bodies) has developed a framework for how Accounting information should be generated and reported, which includes:

- a number of assumptions that underpin the preparation of financial reports (see Section 1.4)
- the Qualitative characteristics of the information in the reports (see Section 1.5)
- the definitions of the Elements of the reports themselves (see Section 1.6).

Study tip

Much of this text is concerned with applying these theoretical components, and each is explained in detail in this chapter and throughout the text as it arises.

Each feature of the Accounting system is designed to both reflect and support this framework for how financial information should be generated and presented.

Other considerations

However, the ability to make good decisions rests not only on the financial information generated by an Accounting system: decision makers must also take into account any available non-financial information, and think about the social and environmental consequences – the ethical considerations – of a decision.

Non-financial information

Most information used in Accounting is financial in nature. Important information like sales revenue, monthly wages, cash in the bank and even Net Profit are all measured in dollars and cents (or another currency) and reported in the financial statements. This

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information is critical to decision-making, but even the best financial information cannot provide a complete picture.

Non-financial information is a very broad term that includes any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation. It could include business-specific information like the number of website hits in the last month, the number of customer complaints about a particular product, or the average length of employment for staff; to more general information like a council decision to change parking conditions at a shopping centre, a looming legal case about the safety of particular products, changes to workplace laws or even the weather reports that might affect sales of ice-creams at a beach café!

non-financial information any information that cannot be found in the financial statements, and is not expressed in dollars and cents, or reliant on dollars and cents for its calculation

Taken together with the financial information, this non-financial information helps to present a more complete and accurate picture of the firm's circumstances, allowing the owner to make more informed and thus more effective decisions.

Ethical considerations

Ethical considerations

Even with complete information, decisions themselves need to be made within an ethical context, as they can have real and lasting effects on people and the environments in which they live. Deciding to change wages and conditions can affect not just the profit of the business concerned, but also the livelihood of its employees and, in a small town, the viability of the entire community. Obtaining materials from a renewable source might mean marginally higher short-term costs, but might provide long-term sustainability of the resource itself.

Examples like these illustrate that financial decisions usually have non-financial consequences. For this reason, Accounting is increasingly concerned not just with the financial parameters of decision-making, but also with its ethical ramifications. These **ethical considerations** include the social and environmental consequences of a decision: the effects on people, communities and society, and the local and wider environment.

ethical considerations the social and environmental consequences of a financial decision

Users of Accounting information need to think about how a decision will affect not only the financial side of the business, but also the people and community with whom it is connected, and its local and global environment. After all, the long-term success of a business is inextricably linked to the health of the society and environment in which it operates.

Study tip

There is no set list of 'ethical considerations' in this course, but examples will be presented as issues arise.

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Considering all these factors – financial information, non-financial information and ethical considerations – Accounting should be seen as both a *technical* and a *social* practice:

- *technical* in that it applies specific, *technical knowledge* and *processes* to generate, communicate and analyse financial information
- *social* in that it involves understanding, liaising with and advising *people* who are not only responsible for decision-making, but also affected by the decisions that are made.

Review questions 1.1

1 **Explain** the purpose of Accounting.
2 **Define** 'Accounting'.
3 **List** five financial issues about which small business owners would need detailed information.
4 **Define** the term 'non-financial information'. **Identify** two examples of non-financial information and **explain** how each might affect business decision-making.
5 **Explain** why non-financial information is important for decision-making.

Ethical considerations

6 **Define** the term 'ethical considerations' as it relates to business decision-making.
7 **Explain** the importance of ethical considerations in business decision-making.

1.2 Users of financial information

This course concentrates specifically on Accounting for sole traders; that is, trading businesses that are owned by only one person, who is usually responsible for running the firm. For this reason, we will concentrate on the information that the *owner* will want to see.

However, it is important to note that a number of different parties may be interested in the firm's financial information. Including the owner, these parties are known as the 'users' of the Accounting information, and may include:

- *Accounts Receivable (debtors) and other customers*, who may wish to know about the firm's continuing ability to provide them with goods
- *Accounts Payable (creditors) and other suppliers*, who may wish to know about the firm's ability to repay what it owes them
- *banks and other financial institutions*, who will want to know about the firm's current levels of debt before providing it with any additional finance
- *employees*, who may wish to know about the firm's long-term viability – and their long-term employment prospects – or its ability to afford improvements in wages and conditions
- *prospective owners*, who may wish to know about the firm's financial structure and earnings performance
- *the Australian Tax Office (ATO)*, which will require financial information for taxation purposes.

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Considering the variety of users of financial information, and the different information each may require, what information should the Accounting system provide? This seemingly broad question has a surprisingly straight-forward answer: the Accounting system should provide whatever information the user decides is necessary. This means that it is the *user* – not the accountant or the Accounting system – who decides what is necessary.

Financial data versus financial information

Given that Accounting is concerned with providing information, it is worth noting the difference between financial *data* and financial *information.* **Financial data** refers to the raw facts and figures on which financial information will be based. For most businesses, this data is contained in their receipts, cheque butts, invoices and other business documents. For instance, a file full of business documents may provide the details (data) relating to the firm's activities over the last week or month.

In their original form these documents would be of limited use as the data has not been processed in any way. Only when this information is sorted, classified and summarised into a more useable and understandable form does it become **financial information** that can be used as the basis for business decisions. This sorting, classifying and summarising is performed by the Accounting system.

financial data
the raw facts and figures upon which financial information is based

financial information
financial data that has been sorted, classified and summarised into a more useable and understandable form

Review questions 1.2

1 **List** six likely users of financial information.
2 **Explain** why banks and other financial institutions will be interested in the financial information of a small business.
3 **Explain** the difference between 'financial data' and 'financial information'.

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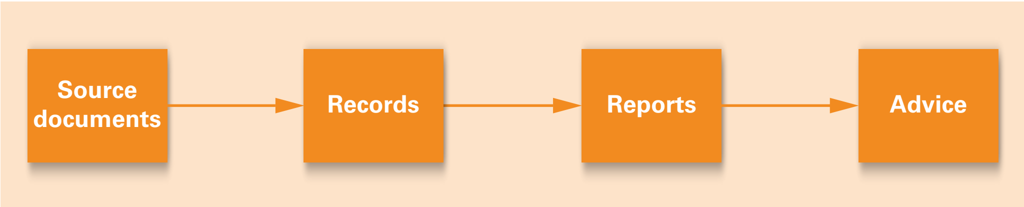
1.3 The Accounting process

Accounting process
the process used to generate financial information from financial data leading to the provision of advice to assist decision-making

Earlier, Accounting was described as 'a process' – a way of doing things – to aid decision-making. This process involves financial data first being collected; then processed into a useable form; and then communicated so that the business owner has meaningful information on which to base a decision. The accountant should then provide some guidance as to appropriate courses of action. These four 'phases' or 'stages' are the basis of what is known as the **Accounting process.**

Figure 1.1 The Accounting process



Stage 1: source documents

transaction
an exchange of goods or services with another party

source documents
documents that provide both the evidence that a transaction has occurred and the details of the transaction itself

This is sometimes known as the 'input stage', with the source documents providing the data on which the Accounting information is based.

The most basic unit of business activity is a **transaction** (an exchange of goods or services with another party), and each transaction must be verified or 'proven' by a source document. **Source documents** are therefore the documents (paper or electronic) that provide both the evidence that a transaction has occurred and the details of the transaction itself.

Common source documents include:

- *receipts (including EFTPOS) and Bank Statements*, which provide evidence of cash received by the business
- *cheque butts, EFTPOS receipts (issued by the seller) and bank statements*, which provide evidence of cash paid by the business
- *invoices*, which provide evidence of credit sales and purchases
- *memos*, which provide evidence of transactions within the firm itself.

These source documents are covered in more detail in Chapter 4.

A business will enter into many transactions every day, and every one of these transactions must be detailed on a source document, with the documents collected, sorted and stored. As far as the Accounting process is concerned, if it isn't written down, it didn't happen.

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Stage 2: recording

Once the source documents have been collected, the data each contains must be written down or noted in a more useable form, or 'recorded'. **Recording** thus involves sorting, classifying and summarising the data contained in the source documents so that it is more useable. This is sometimes known as the 'processing' stage, where data becomes information.

recording
sorting, classifying and summarising the data contained in the source documents so that it is more useable

Common Accounting records include:

- *journals*, which record daily transactions
- *ledgers*, which record the effect of transactions on each of the items in the firm's Accounting reports
- *inventory cards*, which record all the movements of inventory (stock) in and out of the business.

These Accounting records, and how they are used, will be discussed in detail throughout this text.

Stage 3: reporting

The 'output' stage of the Accounting process involves taking the information generated by the Accounting records (in Stage 2) and reporting that financial information to the owner of the business in an understandable form. **Reporting** thus involves the preparation of financial statements that communicate financial information to the owner, so that advice can be provided and decisions can be made.

reporting
the preparation of financial statements that communicate financial information to the owner

There are three general-purpose reports that all businesses should prepare:

- *Cash Flow Statement*, which reports on the firm's cash inflows and outflows, and the change in its cash balance over a period
- *Income Statement*, which reports on the firm's revenues, expenses and profit from its trading activities over a period
- *Balance Sheet*, which reports on the firm's assets and liabilities at a particular point in time.

This text explores each of these reports developmentally, beginning with simple versions and adding layers of complexity as the Accounting system becomes more sophisticated.

Stage 4: advice

Armed with the information presented in the reports, the owner should be in a better position to make informed decisions and take action. However, the best course of action is sometimes unclear. Therefore, the accountant should be able to offer **advice** by presenting owners with a range of options, an assessment of those options, and some suggestions about an appropriate response. The advice should also consider any available non-financial information, and take into account any relevant ethical considerations.

advice
the provision to the owners of a range of options appropriate to their aims/objectives, together with recommendations as to the suitability of those aims/objectives

Ethical considerations

Essentially, the Accounting process involves collecting data from source documents; sorting it, classifying it and writing it down; communicating the financial information to the owner; and providing advice about that information to support decision-making. It is the provision of advice that is the accountant's key function, as it is this advice that assists the owner in decision-making, but the advice itself rests on the information generated by the first three stages of the Accounting process.

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