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Financial Accounting 7e



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Financial Accounting



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John Wiley & Sons Australia, Ltd

Seventh edition published 2009 by
John Wiley & Sons Australia, Ltd
42 McDougall Street, Milton Qld 4064

First edition published 1987
Second edition published 1990
Revised and updated second edition published 1992
Third edition published 1996
Fourth edition published 2000
Fifth edition published 2003
Sixth edition published 2006

Typeset in 10/12pt Times LT Roman

Australian edition © John Wiley & Sons Australia, Ltd
1987, 1990, 1992, 1996, 2000, 2003, 2006, 2009

Authorised adaptation of the original edition of *Principles of Accounting*, published by John Wiley & Sons, Inc., New York, United States of America. © 1983 in the United States of America by John Wiley & Sons, Inc. All rights reserved.

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National Library of Australia
Cataloguing-in-Publication data

Title:	Financial accounting / John Hoggett... [et al.]
Edition:	7th ed.
ISBN:	978-0-470-81678-3 (pbk.)
Notes:	Includes index.
Subjects:	Accounting. Accounting—Australia.
Other Authors/ Contributors:	Hoggett, J.R. (John Robert), 1948—.
Dewey Number:	657.0994

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Edited by Janette Whelan

Typeset in India by Aptara

Printed in Thailand supervised by
Kyodo Printing Co (S'pore) Pte Ltd

10 9 8 7 6 5 4 3 2 1

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John Hoggett, BCom (Hons), BTh, MFM (Qld), AAUQ, FCPA, has taught accounting at several different universities in both Western Australia and Queensland during his 35+ years as an academic. He has taught introductory accounting, corporate accounting and accounting theory to undergraduate and postgraduate students, written books and monographs for a variety of organisations including CPA Australia and the Group of 100, and has been involved in secondary accounting education for several years with the Curriculum Council of Western Australia.

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Lew Edwards is Emeritus Professor of the School of Accountancy, Queensland University of Technology (where he was Head of the School for 18 years). For over 25 years Lew taught financial and managerial accounting to undergraduate and postgraduate students. He is both a chartered accountant and a CPA, and served for many years on education and technical standards committees (both state and national) of the professional accounting bodies. He has also served as a consultant to accounting firms, industry and government at both national and international levels. Lew has also published (as author and co-author) a wide range of both manual and computerised accounting practice sets.

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John Medlin, BEc (Adelaide), MEc (UNE), CA, is a senior lecturer in the School of Commerce at the University of South Australia. John began his career with Ernst & Whinney (now Ernst & Young) in the early 1980s. After some years practical experience, John moved to accounting education in which he has lectured in both financial and management accounting, accounting theory, economics and business finance. Since 1998, John has coordinated a general first-year accounting subject with an annual enrolment of over 1500 students, 80% of whom are non-accounting majors. He has been recognised with teaching awards from the University of South Australia. His research interest is in the area of accounting education in which he is currently undertaking his PhD.

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Matthew Tilling, BCom (Flinders), is a senior lecturer in financial accounting in the Murdoch Business School at Murdoch University, Western Australia. He has taught accounting to both undergraduates and postgraduates over a decade of university teaching, with a primary focus on issues affecting large corporations. He has also been involved with syllabus and exam design for high school accounting in Western Australia. Matthew has published articles on accounting education and social and environmental accounting in a range of international journals. He is in the final stages of a PhD examining occupational health and safety disclosures made by Australian corporations in their annual reports.

Preface

Our main purpose in writing this book is to provide a comprehensive but introductory description of the purpose, practice and process behind contemporary international financial accounting in an Australian context. With the increased emphasis on the globalisation of business, the material is very suitable for the study of introductory accounting in a broad international context.

The book is designed for tertiary students interested in an accounting career and for others wanting a general understanding of the use of accounting information, especially in the business sector. This seventh edition also considers more fully the need for accounting information by students undertaking business studies in areas other than accounting. The book caters for a two-semester course in financial accounting at an undergraduate level, but it can also be used in courses at a postgraduate level for those who wish to obtain a general understanding of the role of financial accounting information systems in the business and not-for-profit sectors.

The seventh edition builds on the strengths of previous editions with a strong focus on the decision-making role of accounting as well as on a student's acquisition of generic skills such as interpersonal communication, analysis and problem solving, critical thinking, use of the Internet, and an appreciation of ethical issues. However, the authors also believe that competency in the technical skills of accounting should not be overlooked, and the book therefore continues to provide discussion of technical matters at an introductory level. It is our belief that a person equipped with knowledge of technical material in accounting possesses a powerful tool for making economic decisions and for analysing and solving business problems. These technical skills are used in the book to explain the accounting concepts that form the basis of the practice of financial accounting. The use of the technical skills in teaching financial accounting concepts gives students a practical framework on which to build their understanding.

Significant changes from the previous edition

The most significant changes in the seventh edition result from Australia's continued adoption of international accounting standards and financial reporting standards issued by the International Accounting Standards Board (IASB). The Australian Accounting Standards Board (AASB) initially adopted IASB standards on 1 January 2005, and has continued to add to and amend these standards as new ones are issued by the IASB. The AASB also modifies the standards so that they apply to both the not-for-profit sector and the business sector. Newly adopted financial reporting standards since 2005, particularly in the area of presentation of financial statements, have caused major rewrites and changes in the financial reporting sections of the seventh edition. Where appropriate, the book refers to both the IASB and AASB accounting standards to encourage thinking at a global level in the field of accounting.

Significant amendments have been made in the seventh edition to the material relating to the basic objectives of financial reporting, the qualitative characteristics of financial information and definitions of the elements of financial reports. These amendments are a result of the IASB and its American counterpart, the Financial Accounting Standards Board, jointly deliberating on the content of the conceptual framework in order to ensure that the IASB's *Framework for the Preparation and Presentation of Financial Statements* reflects the contemporary thinking of accounting regulators globally. These proposed amendments to the framework will eventually be adopted in Australia.

The book is organised in five parts as follows, with emphasis on decision making in a business enterprise before consideration of external reporting issues.

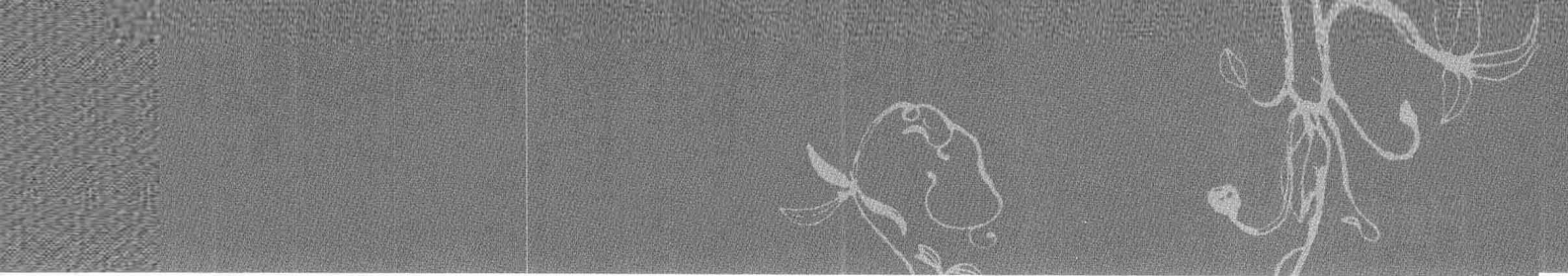
Part 1: Accounting for decision making (chapters 1–2)

Part 2: Accounting systems and processes (chapters 3–7)

Part 3: Equity in business (chapters 8–9)

Part 4: Accounting regulation of assets and liabilities (chapters 10–16)

Part 5: External reporting and performance evaluation (chapters 17–19).



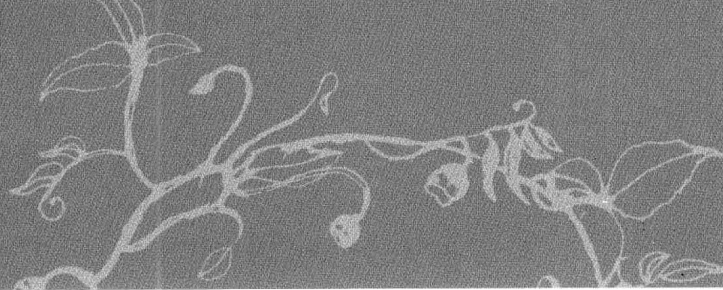
Based on feedback from users of the previous editions of this book, there remains in the seventh edition a strong focus on:

- service organisations operating in the business and not-for-profit sectors
- the use of accounting information by non-accountants, both in the text examples and in end-of-chapter activities
- the impact of the goods and services tax (GST) on business records in a number of exercises and problems
- the effect of accounting information on decisions made in business (segments in each chapter provide links to business activities, and each chapter contains a scene setter)
- the effect on accounting systems of improvements in information technology
- the impact of developments in the regulation of accounting standards at national and international levels.

We have continued to improve the readability of the book without compromising the integrity of its theoretical and practical content, and have continued the policy of including detailed learning objectives.

The major features of this seventh edition include the following:

- Material has been extensively rewritten in relation to the new regulatory arrangements for the development of accounting standards globally, and in the Australian context.
- The text takes into account the impact of the newly adopted IASB standards in Australia, dealing with (a) the presentation of financial statements, especially in relation to the statement of comprehensive income, statement of changes in equity, and statement of financial position, and (b) the statement of cash flows as a result of acceptance of the direct approach of reporting cash flows from operating activities in Australia.
- The text discusses new thinking on the conceptual framework's (a) objectives of general-purpose financial reporting, (b) qualitative characteristics of financial information, (c) the reporting entity concept, (d) the definitions of elements, and (e) recognition criteria.
- Terminology has been updated to reflect the continued adoption of international accounting standards — e.g. the 'statement of comprehensive income' will gradually replace the 'income statement' in external financial reports, the 'balance sheet' should be called the 'statement of financial position' in external financial reports, and the 'cash flow statement' is now the 'statement of cash flows'. Furthermore, the contents of the 'statement of changes in equity' have changed as a result of the issue of recent accounting standards on presentation of financial statements.
- The emphasis on service organisations in the earlier parts of the book is retained, and many new exercises and problems have been added to the book with a greater focus on such organisations. Icons next to exercises and problems indicate whether the question deals with a service, a retail or a manufacturing organisation.
- Many chapters provide a discussion of the impact of the GST on business, especially on small business. However, instructors can ignore the effects of the GST if they wish to pay attention to the other accounting issues in each chapter. An introductory coverage of the GST is provided as an appendix to chapter 3. Many exercises and problems permit lecturers to select where GST is included and where it is excluded. Those questions that incorporate GST throughout are marked with a GST icon.
- Material on basic accounting systems and computerised systems has been updated and rewritten to help students use computer packages such as the latest versions of MYOB and QuickBooks.
- The text continues to develop web-based activities for students in many chapters, in order to indicate the importance of the Internet as an information tool for accounting practitioners, and a 'Using the web' case is included in some chapters.



- ‘Scene setters’ at the beginning of each chapter help students understand the relevance of the accounting material in that chapter to the issues faced by accountants in practice.
- ‘Link to business’ features in each chapter show the relevance of accounting to the practical world of business.
- A list of key terms with page numbers is provided at the end of each chapter, with full definitions of these terms (and their page numbers) listed in a key terms list at the back of the book.
- The number of discussion questions, exercises and problems in many chapters has been increased to 15, and approximately half of the questions are new.
- Problems are graded using a star system, where one star indicates an ‘easy’ problem and three stars indicate a ‘challenging’ problem.
- In the end-of-chapter case material, several decision cases, critical thinking cases, communication/group activities and ethical issues are either new or updated. Web-based activities are included in several chapters. In addition, the financial reporting case is based on the latest David Jones Limited annual report, which is available on its website, www.davidjones.com.au. An updated solution to this case will be available in lecturer resources on the John Wiley website after the latest financial report is released. The case will be based on the latest adopted accounting standards.

Supplementary materials

Financial Accounting 7th edition is supported by an extensive teaching and learning resources supplementary package.

For the lecturer

The following supplementary materials are available:

- A solutions manual contains worked solutions to all end-of-chapter discussion questions, exercises, problems, case studies and activities. The solutions manual has been thoroughly checked for accuracy and correctness.
- PowerPoint Presentation, prepared by Anne Abraham (University of Wollongong), is an extensive teaching resource containing over 1000 slides. The presentation contains summaries of key information presented in the chapter, animations and video interviews.
- Computerised Test Bank, prepared by Barbara Burns, contains over 2000 multiple-choice and true/false questions. Compatible with Respondus, the test bank is a fast and convenient resource for designing, preparing and delivering examinations.
- Blackboard course management system is course-ready containing all teaching resources, student activities and media enhancements.
- Wiley Web Questions (WWQ), prepared by Barbara Burns, are online self-testing questions that are ideal for student self-paced learning. There are over 1500 true/false and multiple-choice questions (with solutions linked to the chapter), which students will find useful. These questions are accessible in both Blackboard and WileyPlus.
- CD Art File contains all figures and tables from the text in a format that allows easy integration into the lecturer’s own resources.
- ClickON is a classroom response system and is available on request. Please contact your John Wiley & Sons sales consultant.
- WileyPlus is an online suite of teaching and learning resources that includes a powerful automated homework system. WileyPlus enables lecturers to prepare, assign and grade assignment questions easily and quickly.





For the student

The following resources are available:

- Study Guide, prepared by Nila Latimer (Macquarie University), contains additional chapter summaries and activity-based learning resources designed to reinforce students' understanding of accounting principles and processes.
- Wiley Web Questions (WWQ) are online self-testing questions that are ideal for self-paced assessment and will help students pass examinations. All questions have solutions and are linked to the chapter.
- WileyPlus contains assignment questions for all chapters that will develop students' knowledge of accounting and confidence in completing a range of practice problems and exercises. Students receive instant feedback and context-sensitive assistance (including links to the relevant section of the online text) and are able to track their progress throughout the course.
- TakeNote is a PowerPoint presentation conveniently presented as a handout for note-taking during lectures.

Acknowledgements

We wish to express our appreciation of the following people and organisations who have contributed in some way to the development of the seventh edition of this book and to the refinement of our ideas. Particular appreciation is again extended to our very patient wives and to our families for their continued understanding, assistance with finding material for cases, business links and profiles, and with proofreading, and for their tolerance of husbands and fathers who are buried in their studies for long hours at evenings and weekends.

Special appreciation is also extended to those who have contributed to the text as independent reviewers and preparers of the extensive teaching and learning resources associated with the textbook. We appreciate the contributions of Anne Abraham (University of Wollongong), Barbara Burns, and Nila Latimer (Macquarie University), and Brian Perrin (Curtin University) for providing new content on computer accounting systems in chapter 7.

Finally, we wish to thank the editor, Jan Whelan, for her continued efforts and support, and all of the Wiley staff who have contributed to this book's production. Of course, any errors or omissions are the sole responsibilities of the authors. Feedback from lecturers and students who use the text has been helpful in the past and will always be welcomed and appreciated.

John Hoggett, Lew Edwards, John Medlin and Matthew Tilling

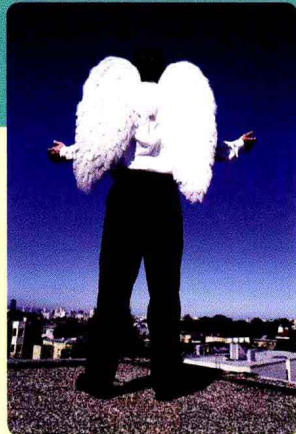
June 2008

How to use this book

Financial Accounting 7th edition has been designed with you — the student — in mind. The inclusion of new learning features and a four-colour design is our attempt to provide you with a book that both communicates the subject matter and facilitates learning. We have tried to accomplish these goals through the following elements.

Chapter
2

Financial statements for decision making



Concepts for review

Before studying this chapter, you should understand as follows, if necessary, revise:

- the steps used in the decision-making process (p. 5)
- the nature of economic decisions (p. 5)
- the nature of accounting and the users of accounting information (pp. 7–10)
- the use of information in economic decisions (pp. 10–12)
- the role of accounting information in the decision-making process (p. 12)
- the differences and similarities between management accounting and financial accounting (pp. 13–14)
- the areas of business in which accountants are employed (pp. 14–17)

Types of business entities 32
Management functions 33
Basic financial statements 34
Assumptions made and characteristics of information 41
The effects of transactions on the accounting equation and financial statements 45

Key terms 50
Discussion questions 50
Exercises 51
Problems 56
Decision case 63
Critical thinking case 64
Communication/group activity 65
Ethical issues 65
Financial reporting case 66

Learning objectives

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

- 1 identify the common types of business entities (pp. 32–3)
- 2 understand and identify the functions carried out by managers (pp. 33–4)
- 3 identify the basic financial statements used in business to report to users for decision-making purposes (pp. 34–41)
- 4 explain the main assumptions made and the characteristics of information to be used in the preparation of financial statements (pp. 41–5)
- 5 analyse the effects of business transactions on the accounting equation and on financial statements (pp. 45–9)

In good company

Companies are finding that doing good pays dividends in the long run.

When Nobel Prize-winning economist Milton Friedman famously argued that the business of business is business, little did he know that 30 years later, corporations would be counting the number of trees they'd planted in the community as well as their profits.

Then again, Friedman's business era is long gone. It's no longer enough for a company to make a profit, obey the law and keep shareholders happy. They must now consider the non-financial aspects of their business as they navigate a complex and changing set of economic, social and environmental challenges. They must work to earn public respect at a time when corporate reputations are increasingly fragile and have a clear impact on a company's valuation. They must strive to find new ways to motivate employees who want more than just financial rewards. All this, while also defending corporate social responsibility (CSR) as more than window dressing for capitalism. It's one thing to publish glossy corporate citizenship reports and quite another to embrace genuine social opportunities that promote both stakeholder and shareholder return.

According to Wayne Burns, director of the Australian Centre for Corporate Public Affairs (ACCPA), it pays to be good. 'Embracing social opportunities gives companies a licence to operate,' he says. 'It's building a corporate infrastructure that will last. It's a no-brainer good business policy.'

David Mol, government and public affairs manager for Hewlett-Packard South Pacific, agrees. 'When you look at the expectations that customers have, if we meet those expectations, if they see us as socially responsible and engage in issues which have a higher relevance in the community in which we live, they're going to be more inclined to support us, to buy our products, to reference HP as doing the right thing, and recommending the brand as a result. It's a very clear dynamic that's synergistic and it does translate into good business.'

Mol is on to something. Reputation is one of the most important measures of corporate success. According to the Harris-Fombrun Reputation Quotient, the value of a reputation can be as much as 40 per cent of a company's overall market value. It influences what we buy, and the appeal of a company to potential employees, investors and analysts.

Globally, HP donated approximately \$61.6 million in cash and equipment last year, representing approximately 1.5 per cent of its pre-tax profits. Aside from traditional philanthropic donations, HP also works with charities and non-government organisations, such as the Starlight Children's Foundation, to strengthen its link between philanthropic investments and long-term business objectives.

Source: Excerpts from Susan Muldowney, 'In good company', *InTheBlack*, December 2005, pp. 29–34.

The **concepts for review** identify what you should have learnt before studying the current chapter.

The double-page **chapter opener** displays, at a glance, a 'scene setter' presenting issues and topics relevant to the chapter, concepts for review and expected learning outcomes, providing you with a clear outline for each chapter.

A **scene setter** is presented in each chapter and highlights current accounting and business issues.

Expenses

Expenses are decreases in equity. They are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. Expenses are measured by the amount of assets used up or the amount of liabilities incurred. They may arise through immediate cash payments, as for current wages and salaries, or through promises to pay cash in the future for services received, such as advertising. In some cases, cash may be paid out before the expense is incurred, such as payment for next month's or next year's rent. These prepayments represent assets until they are used. In figure 2.4, the total of all expenses incurred during 2010 by Don's Auto Repairs was \$348 150. Subtracting these expenses from income produces a profit of \$94 350. It is important to understand that the profit represents an increase in equity. Because income results in an increase in equity and expenses result in a decrease in equity, the difference between the two — profit — must represent a net increase in equity. Similarly, a loss represents a decrease in equity.

The statement of changes in equity

The statement of changes in equity (figure 2.5) serves as a connecting link between the balance sheet and the income statement, and explains the changes that took place in equity during the period. For example, assuming that Don's capital balance on 1 July 2009 was \$237 330 and that he withdrew \$45 000 from the business for personal use during 2010 (referred to as drawings), the statement of changes in equity for 2010 would be as shown in figure 2.5.

DON'S AUTO REPAIRS Statement of Changes in Equity for the year ended 30 June 2010	
Don Brady, Capital — 1 July 2009	\$237 330
Add: Profit for the year	94 350
	331 680
Less: Drawings	45 000
Don Brady, Capital — 30 June 2010	\$286 680

Figure 2.5 Statement of changes in equity

The three statements illustrated above — balance sheet, income statement and statement of changes in equity — are related to one another. The balance sheet at the end of one period is the balance sheet at the beginning of the next period. The balance sheets at the beginning and end of a period are linked by the income statement and the statement of changes in equity as shown in figure 2.6 (p. 40).

The statement of cash flows

Another important financial statement prepared by entities is a statement of cash flows. An entity's income statement does not report on the cash flows of the entity, but on its revenues and expenses (chapter 4 discusses this further). Income and expenses as defined above do not necessarily represent cash flows. Consequently, a statement of cash flows is prepared to show the cash flows in and out of the entity. It is particularly useful in helping users to assess the sources and uses of an entity's cash, and the likely ability of the entity to remain solvent and able to pay its debts, so that the users can make informed decisions. The statement reports the entity's performance in generating cash flows from operating activities, investing and financing activities as shown in figure 2.7 for Don's Auto Repairs, assuming that the business began its operations on 1 July 2009 when the owner, Don Brady, invested \$237 330 in the business.

By comparing the entity's statement of cash flows with its income statement, we can see that the reported profits are represented by cash inflows from operating activities. We

Financial statements

Figure 2.6 Financial statements relationship

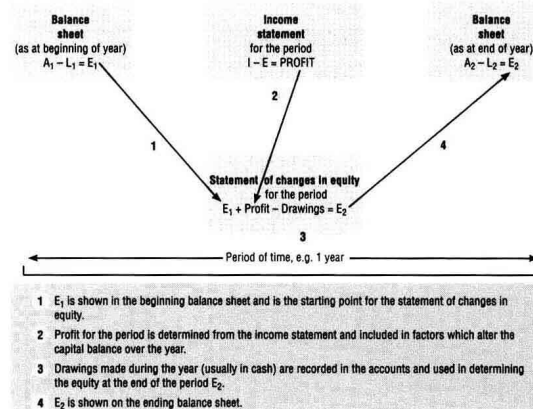


Figure 2.7 Statement of cash flows

DON'S AUTO REPAIRS Statement of Cash Flows for the year ended 30 June 2010	
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	\$424 710
Cash paid to suppliers and employees	(342 000)
Net cash from operating activities	\$ 82 710
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of land and buildings	(315 000)
Purchase of repair equipment	(110 700)
Net cash used in investing activities	(425 700)
CASH FLOWS FROM FINANCING ACTIVITIES	
Amount borrowed under mortgage	201 000
Investment by owner	237 330
Drawings by owner	(45 000)
Net cash used in financing activities	393 330
Net increase (decrease) in cash held	50 340
Cash at beginning of year	
Cash at end of year	\$ 50 340

Financial statements, accounting flow charts and other diagrams have been redesigned to enhance your understanding of the key accounting processes.

'Link to business' highlights topical and contemporary accounting issues to apply the concepts presented in the chapter. This feature appears in each chapter.

The **key terms** list the important terms presented in the chapter. Refer to the **end-of-book key terms** for definitions of these terms.

Exercises provide a range of activities that will develop skills and confidence in accounting. Icons clearly identify whether the exercises relate to manufacturing, retail or service business entities.

LINK TO BUSINESS

Towards the globalisation of accounting

Whether people agree or disagree with the effects of globalisation, one thing that most can agree on is that it has transformed our world. The accounting profession, like many others, has not been immune from these effects. Combined with the developments in information technology and regulatory changes introduced by governments, this trilogy has led to a metamorphosis of accounting principles and practices. The ongoing challenge for our profession is to continually respond as the needs of the markets we work in transform.

The environment and platform for financial reporting is becoming universal, to the advantage of companies, accountants, investors and governments. The great news for accountants is the many opportunities that have emerged as a result of these changes. Qualified accountants who have a sound knowledge of accounting from a global context are wanted for their services across the world by businesses expanding in emerging markets.

Source: Excerpts from Mark Coughlin, 'Towards the globalisation of accounting', *In The Black*, May 2005, p. 9.



The effects of transactions on the accounting equation and financial statements

The basic accounting model or accounting equation was expressed earlier as:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The sum of the assets of an entity is always equal to the total sources from which those assets came — liabilities plus equity. Transactions result in changes in assets, liabilities and equity. Even though the elements of the accounting equation change as a result of transactions, the basic equality of the accounting equation remains unchanged, which is illustrated using some transactions undertaken by the business of Darren's Lawn and Gardening Services, introduced in chapter 1.

Note that the impact of GST is not discussed in this example in order to focus on the basic accounting principles involved in recording the transactions for Darren's business. GST is introduced in chapter 3.

Transaction 1 Assume that Darren Jones decided to set up a business called Darren's Lawn and Gardening Services on 2 January 2010 by taking \$35 000 from his personal savings account and depositing it in a business bank account he opened in the business name. This investment by Darren represents the first transaction (1) of Darren's Lawn and Gardening Services. After this initial investment, the new business has one asset (cash at bank), no liabilities and Darren's equity. Thus, the accounting equation for Darren's Lawn and Gardening Services is as shown below.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Learning objective 5

Effects of business transactions on the accounting equation and financial statements

KEY TERMS

Accounting entity assumption, p. 41	Effectiveness, p. 33	Materiality, p. 44
Accounting equation, p. 36	Efficiency, p. 33	Net assets, p. 36
Accounts payable, p. 37	Equity, p. 37	Operating activities, p. 35
Accounts receivable, p. 38	Expenses, p. 39	Operating statement, p. 38
Accrual basis, p. 42	Faithful representation, p. 43	Organisation, p. 33
Assets, p. 36	Financial position, p. 35	Partnership, p. 32
Balance sheet (statement of financial position), p. 35	Financing activities, p. 35	Performance, p. 34
Company (or corporation), p. 32	Going concern assumption, p. 42	Period assumption, p. 42
Comparability, p. 43	Income, p. 38	Profit, p. 39
Consistency, p. 44	Income statement, p. 38	Profit and loss statement, p. 38
Creditors, p. 37	Investing activities, p. 35	Relevance, p. 42
Debtors, p. 38	Liabilities, p. 37	Reliability, p. 43
Double-entry accounting, p. 48	Limited liability, p. 32	Shareholders, p. 32
Drawings, p. 39	Loss, p. 39	Single proprietorship (sole trader), p. 32
Economic substance, p. 43	Management by exception, p. 34	Statement of cash flows, p. 39
	Management functions, p. 33	Understandability, p. 44

DISCUSSION QUESTIONS

1. Explain the basic differences between a sole trader (or single proprietorship), a partnership and a company. What factors need to be considered in selecting an appropriate structure for Darren's lawn-mowing business?
2. 'Good planning is useless without good control.' Discuss.
3. Discuss the meaning of 'performance' both for business entities and for not-for-profit entities. Is performance able to be expressed totally in financial terms?
4. The coach of the local football team was trying to motivate the team before a big match. He said: 'Our team is like any organisation. We must have goals, we must practise the usual management functions, and we must make use of all relevant information.' Do you agree with the coach? Explain your position.
5. Define the terms *assets*, *liabilities* and *equity*. Are these terms related in any way? If so, how?
6. Why is it that, in an entity's financial statements, assets leased by an entity are sometimes shown on that entity's balance sheet even though those assets are not legally owned?
7. A local restaurant is noted for its fine food, as evidenced by the large number of customers. A customer was heard to remark that the secret of the restaurant's success was its fine chef. Would you regard the chef as an asset of the business? If so, would you include the chef on the balance sheet of the business and at what value?
8. The local parkland is owned and maintained by the local government council. Is the parkland an asset of the council and should it be included on its balance sheet?
9. Moonshine Enterprises hired an accountant at the rate of \$1000 per week. The person is to commence duty on 1 February. On 1 February, does the business have a liability in respect of the accountant's salary? Explain.
10. Discuss the significance of the following assumptions in the preparation of an entity's financial statements:
 - (a) entity assumption
 - (b) accrual basis assumption
 - (c) going concern assumption
 - (d) period assumption.

11. What is meant by the terms *relevance* and *reliability/faithful representation* in the context of information to be included in financial statements?
12. Distinguish between the concepts of consistency and comparability. Should the same accounting method always be applied consistently in financial statements?
13. When considering the characteristic of understandability in the preparation of financial statements, does this mean that financial statements should be simple to understand? Discuss.
14. What is meant by the requirement that information to be included in financial statements should be 'material'?
15. Explain the concept of 'double entry' in the preparation of financial statements.

EXERCISES

Note: The impact of GST is ignored in all exercises and problems in this chapter for reasons of simplicity.

Exercise 2.1 PREPARING A BALANCE SHEET

Financial items for Rob Mundt's Marketing Services on 31 May 2010 are presented below in alphabetical order.

Accounts payable	\$ 32 000	Land	\$140 000
Accounts receivable	36 000	Mortgage payable	380 000
Building	600 000	Office equipment	120 000
Cash at bank	33 000	Office supplies	18 000

Required

- A. Use these items to prepare a balance sheet similar to the one in figure 2.2. (Note that a major item is missing in the list.)
- B. Recast the statement to present it in narrative form as in figure 2.3.

Exercise 2.2 INCOME STATEMENT AND ANALYSIS

During the year ended 30 June 2010, Johnson Services, a provider of temporary secretary personnel, had collected receipts from clients for a total value of \$450 000. Wages of \$336 000 had been paid to the temporary workers, rental of office space and electricity costs were \$18 000 and \$5700 respectively for the year, and salary paid to Johnson's personal assistant was \$46 000.

Required

- A. Prepare an income statement for the year for Johnson Services.
- B. Who made more out of the personnel business — Johnson or her personal assistant? What action might Johnson take to increase the profitability of the business in the year ended 30 June 2011?

Exercise 2.3 ANALYSIS OF EQUITY

Sarah Hodge is a self-employed piano teacher operating her business from home. She keeps her accounting records for business activities completely separate from her records for personal activities. At 30 June 2009, Sarah had business assets and liabilities worth \$37 500 and \$21 000 respectively. At 30 June 2010, Sarah had business assets and liabilities worth \$39 000 and \$18 000 respectively.

Required

- A. If Sarah did not contribute to or withdraw from the business during the year 2009–10, what was the profit/loss for the year?
- B. If Sarah had withdrawn \$12 000 during the year, calculate the profit/loss for the year.
- C. If Sarah had contributed \$15 000 and withdrawn \$8000, prepare a statement of changes in equity for the year ended 30 June 2010.

Discussion questions test your understanding of the concepts in the chapter.

Required

By analysing the changes in equity each year, calculate the profit (loss) made by the business for each year ending 30 June, assuming the following events also occurred:

1. On 1 January 2010, Richard withdrew \$40 000 in cash from the business for personal use.
2. On 28 August 2010, Richard invested additional cash of \$70 000 into the business.
3. On 31 July 2011, Richard invested additional cash of \$50 000 into the business.
4. On 28 January 2012, Richard withdrew \$30 000 in cash for personal use.

PROBLEMS

- Basic
- • Moderate
- • • Challenging

Problem 2.1 PREPARING FINANCIAL STATEMENTS •

Financial data for Safety Hire as of 30 June 2009 are:

Accounts receivable	\$ 63 000	Wages expense	\$ 75 000
Equipment hire income	170 000	Advertising expense	30 000
Accounts payable	40 000	Land	75 000
Carrie Wills, Capital	?	Hire equipment	180 000
Cash at bank	45 000	Loan payable	50 000
Mortgage payable	130 000	Electricity expense	18 000
Building	85 000	Telephone expense	7 500

Required

Prepare an income statement for the month of June and a balance sheet in account format for Safety Hire as at 30 June 2009.

Problem 2.2 PREPARING FINANCIAL STATEMENTS •

Asset, liability, equity, income and expense amounts for Naoko's Interior Decorating at 30 June 2010 are presented below:

Cash at bank	\$ 22 800	Advertising expense	\$ 36 000
Accounts receivable	117 600	Insurance expense	8 000
Supplies	26 400	Rent expense	33 000
Equipment	125 900	Supplies expense	12 900
Accounts payable	33 700	Telephone expense	12 200
Naoko Sato, Capital	?	Electricity expense	17 000
Decorating services income	386 000	Wages expense	111 000

Required

- A. Prepare an income statement for the business for the year ended 30 June 2010.
- B. Prepare a balance sheet in narrative format as at 30 June 2010.

Problem 2.3 DETERMINING MISSING ELEMENTS IN ACCOUNTING EQUATION •

Calculate the two missing amounts for each independent case below.

Case	Total assets	Total liabilities	Equity	Total income	Total expenses	Profit (loss)
A	\$80 000	\$46 000	?	\$82 000	?	\$38 000
B	\$90 000	?	\$57 000	\$83 000	\$64 000	?
C	?	\$44 000	\$57 000	\$90 000	?	(\$10 000)

Problems offer a higher grade of activity that builds on the knowledge and skills required to complete the 'Exercises' section. A star rating provides a scale of rigour and difficulty for each problem.

Case studies that relate to decision making, critical thinking, communicating/group activities, ethics and financial reporting are presented in this section. It is expected that these case studies will help you develop the analytical and professional skills that will be relevant to your future careers.

use the financial statements for decision making. So long as he has cash in the bank, Johan is satisfied with how his business is operating. Unfortunately, Johan's accountant has suddenly left the country and retired to South America.

Johan is negotiating a contract with a supplier of building materials who wants to see his financial statements to ensure that Johan can meet his payments each month. Johan has asked you to prepare financial statements. Based on his last tax return and the contents of his shoebox for this year, you have established the following items:

Cash in the shoebox (with the receipts and invoices)	\$ 500
Cash in the bank account	3 800
Building services provided	590 000
Amounts owed by customers	80 000
Wages paid to employees	180 000
Wages owed to the employees	3 500
Equipment	68 000
Building supplies used	310 000
Building supplies on hand	18 000
Amounts owed to suppliers	30 000
Motor vehicle	32 000
Motor vehicle expenses	5 600
Electricity and telephone expense	4 000
Cash used by Johan for personal expenditure	5 790

Required

- A. Using the information above, provide an income statement and a balance sheet in narrative form for Schutz Building Services for the current period.
- B. How would the financial statements you produce help the supplier of building materials decide whether or not to trade with Johan? What parts of the financial statements would be positive indicators that Schutz Building Services would pay for supplies on time and what items may cause some concern for the supplier?

CRITICAL THINKING CASE

Sporting glory — the great intangible

Read the following article from *Australian CPA*.

While rugby stars are heroes to many, when checking the books they become a complex intangible. Rosalind Whiting and Kyla Chapman investigate the merits of Human Resource Accounting in professional sport.

Australia, New Zealand and rugby union — a combination guaranteed to stir patriotic feelings across the Tasman! But what if we add accounting to this equation? Rugby players are the teams' most valuable assets, so should we be placing their value on the balance sheet? And if so, does it make any difference to the decisions that users of financial statements make?

Human resource accounting in professional sport. Professional sport has been prevalent in the United Kingdom and the United

States for nearly 200 years. However, professional sport arrived later to Australia and New Zealand. In particular, the Kiwis only entered this arena in 1995 when the New Zealand Rugby Football Union (NZRFU) signed the Tri Nations sponsorship deal and removed all barriers preventing rugby union players being paid for their services. Player contract expenses in New Zealand now amount to over NZ\$20 million annually, according to the NZRFU.

In the United Kingdom and the United States, the professional teams' financial accounts quite often incorporate human resource accounting (HRA). HRA is basically an addition to traditional accounting, in which a value for the employees is placed on the balance sheet and is amortised over a period of time, instead of expensing costs such as professional development.

There is debate about the merits of this process and the arguments are in line with those we have been hearing about intangibles in general. More recently, there has been worldwide movement towards recognising acquired identifiable intangible assets at fair value in the financial statements. So why not include an organisation's human resources? While (thankfully) most people agree that employees are valuable, there are accounting difficulties with the concept of ownership or control of the employees (asset definition) and the reliability of measurement.

Despite these concerns, one area where HRA does have some international acceptability is in accounting for professional sport, mainly because of the measurable player transfer costs. But there is still some variability in the reporting of human

resource value, ranging from the capitalisation of signing and transfer fees to player development costs or, in the case of the authors' knowledge, HRA is not currently practised with Australia and New Zealand's professional sports teams. The absence of transfer fees between clubs when trading players may explain this.

Decision making. Accountants are required to provide information that assists users in assessing an organisation's financial and service

performance and in making decisions about providing resources to, or doing business with, the firm.

The big question is whether HRA information is more useful to the decision maker than the alternative expensing treatment. Supporters of HRA argue that capitalised information is useful for strategic planning and management of employees, and provides a more accurate measure of the firm's status and total performance.

Those against HRA say it is too subjective to be useful and that it just imposes

another cost on the organisation. Some detractors argue that it makes unprofitable organisations appear profitable simply because smart people work there. But those who believe in the efficiency of the market would argue that investors are not naive, and decisions would be unaffected by the way in which human resource information is presented.

Source: Excerpts from Rosalind Whiting and Kyla Chapman, 'Sporting glory — the great intangible', *Australian CPA*, February 2003, pp. 24–6.

Required

Discuss whether rugby players are 'valuable assets' of a business, or an expense. Use the definitions of assets and expenses in this book to show which of the elements of the financial statements 'human resources' should be classified under.

COMMUNICATION/GROUP ACTIVITY

Preparing balance sheets

In groups of three or four, consider the following people and their situations:

- a student who has just completed secondary school and started at university and is living at home with parents.
 - an adult who works full time.
- For each situation, prepare a list of assets the person would typically own, and estimate the cost of each asset in dollars. Then prepare a list of liabilities, and estimate the cost of each liability in dollars. Using the accounting equation, calculate the equity of each of the two people and draw up a balance sheet for each. Display them on overhead transparencies and compare them with those developed by other groups in the class.

ETHICAL ISSUES

Bribing government officials

Read the following article and answer the questions.

Why take the rap when you kill someone if you can pay someone else to take it for you? That's the advice doled out to Singapore's businessmen operating in Asia's parish nation, Burma, in a new business guide book recently published by a respected Singapore diplomat and trade adviser. The book, *Myanmar In My Heart*, by Matthew Sim, has been published by Times Publishing, a division of the Singapore government-connected Fraser and Neave group, a big Singapore beverage company with interests in Burma, or Myanmar, as it is known in the region.

The book makes stunning reading, particularly as its audience is a country that famously attributes much of its success to the Asian economy least tolerant of corruption.

Singapore has strict laws governing corruption. One cabinet minister recently took his own life after being suspected of kickbacks, including corrupt practices. The Sim book recommends effective methods of bribing Burmese government officials, money-laundering, procuring prostitutes and avoiding prosecution in fatal traffic accidents...

Under the chapter heading, Committing Manslaughter When Driving, Mr Sim asks what an international businessman does when he has accidentally killed a pedestrian, before describing two ways of avoiding prosecution if Burmese throw themselves in front of a car. Firstly, the international businessman could give the family of the deceased some money as compensation and dissuade them from pressing charges. Secondly, he could pay a Myanmar citizen to take the blame by declaring that he was the driver in the fatal accident.

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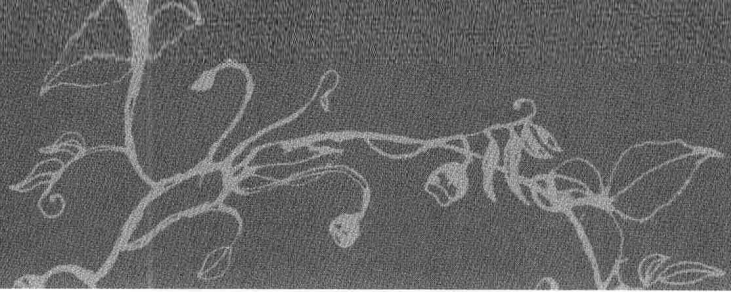
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Exercise 03-13

The ledger of Welch Rental Agency on 31 March of the current year includes the following selected accounts before adjusting entries have been prepared:

	Debit	Credit
Prepaid Insurance	\$ 3,400	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		\$ 8,400
Notes Payable		20,000
Unearned Rent		9,900
Rent Revenue		60,000
Interest Expense	0	
Wage Expense	14,000	

An analysis of the accounts shows the following:

- The equipment depreciates \$450 per month.
- One-third of the unearned rent was earned during the quarter.
- Interest of \$500 is accrued on the notes payable.
- Supplies on hand total \$900.
- Insurance expense at the rate of \$350 per month.

Instructions

Prepare the adjusting entries at 31 March, assuming the following:

- 31 Mar. Depreciation Expense Accumulated Depreciation—Equipment
- 31 Mar. Unearned Rent Rent Revenue
- 31 Mar. Interest Expense Interest Payable
- 31 Mar. Supplies Expense Supplies
- 31 Mar. Insurance Expense Prepaid Insurance

Review Score

1. 31 Mar. Depreciation Expense Accumulated Depreciation—Equipment

2. 31 Mar. Unearned Rent Rent Revenue

3. 31 Mar. Interest Expense Interest Payable

4. 31 Mar. Supplies Expense Supplies

5. 31 Mar. Insurance Expense Prepaid Insurance

References

The Basics of Adjusting Entries

LEARNING OBJECTIVE 3.3

Explain why adjusting entries are needed.

In order for income to be recorded in the period in which it is earned, and for expenses to be recognised in the period in which they are incurred, adjusting entries are made at the end of the accounting period. In short, *adjusting entries* are needed to ensure that the income recognition and matching principles are followed.

Adjusting entries make it possible to report on the balance sheet the appropriate assets, liabilities and owner's equity at the statement date and to report on the income statement the proper net profit (or loss) for the period. If adjusting entries are not made, the net profit for the period will be incorrectly reported, as will the assets and liabilities on the balance sheet. Failing to make adjusting entries will over or underestimate the elements in the financial statements. However, the trial balance—the first pulling together of the transaction data—may not contain up-to-date and

- ⊕ Access different resources when you study

Link to contextual help such as solutions to exercises, chapter reviews and demonstration problems, simulations and video for visual review or help when you need it most.

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Exercise 03-13

The ledger of Welch Rental Agency on 31 March of the current year includes the following selected accounts before adjusting entries have been prepared:

	Debit	Credit
Prepaid Insurance	\$ 3,400	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		\$ 8,400
Notes Payable		20,000
Unearned Rent		9,900
Rent Revenue		60,000
Interest Expense	0	
Wage Expense	14,000	

An analysis of the accounts shows the following:

- The equipment depreciates \$450 per month.
- One-third of the unearned rent was earned during the quarter.
- Interest of \$500 is accrued on the notes payable.
- Supplies on hand total \$900.
- Insurance expense at the rate of \$350 per month.

Instructions

Prepare the adjusting entries at 31 March, assuming that adjusting entries are made quarterly. Additional accounts are:

- 31 Mar. Depreciation Expense Accumulated Depreciation—Equipment
- 31 Mar. Unearned Rent Rent Revenue
- 31 Mar. Interest Expense Interest Payable
- 31 Mar. Supplies Expense Supplies
- 31 Mar. Insurance Expense Prepaid Insurance

Review Score

1. 31 Mar. Depreciation Expense Accumulated Depreciation—Equipment

2. 31 Mar. Unearned Rent Rent Revenue

3. 31 Mar. Interest Expense Interest Payable

4. 31 Mar. Supplies Expense Supplies

5. 31 Mar. Insurance Expense Prepaid Insurance

Solution

Exercise E3-3

- 31 Mar. Depreciation Expense (\$450*3) 1,350
- 31 Mar. Unearned Rent 9,900
- 31 Mar. Interest Expense (\$9,900*1/3) 500
- 31 Mar. Supplies Expense 1,900
- 31 Mar. Insurance Expense (\$350*3) 1,050

⊕ Get immediate feedback on questions

⊕ Develop problem-solving skills

Algorithmically generated exercises and problems allow you to take the same assignment with differing variables.

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The adjusted trial balance of Hungry Joe's at 31 December 2007, includes the following accounts: S. Giaro, Drawing \$6 000, S. Lucille, Capital \$15 600 (NOTE: this is the opening capital balance as of 1 January 2007). Prepare a statement of changes in equity for the year assuming net profit is \$13 600 for the year.

LUCILLE Ltd
Statement of changes in equity
For the Year Ended 31 December, 2008

Capital, 1 January	\$ 23,600
Add: Net income	13,600
	37,200
Less: Drawings	6,000
Capital, 31 December	\$ 31,200

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Read, Study & Practice >>> Chapter 2: The Recording Process

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Chapter 2: The Recording Process

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The Account

LEARNING OBJECTIVE 2.1

Explain what an account is and how it helps in the recording process

In order to keep track of business transactions, it is important to record each transaction. Each transaction recorded will result in an increase or decrease in one or more of the assets, liabilities and owner's equity accounts. A part of the accounting function is to group and classify these transactions into useful categories so that the results can be accumulated and summarised for reporting purposes. To facilitate the accumulation of financial data, transactions are recorded in accounts.

An **account** is an individual accounting record of increases and decreases in a specific asset, liability or owner's equity item. For example, Softbyte (the business discussed in chapter 1) would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries Expense and so on. In its simplest form, an account consists of three parts: (1) the title of the account, (2) a left or debit side and (3) a right or credit side. Also, accounts will allow for recording the date of the transaction and an explanation of the transaction. A simplified format of account that resembles the letter T, referred to as a **T-account**, is shown in figure 2.1 (page 40). Later in the chapter a three-column form of account will be used.

Title of account	
Left or debit side	Right or credit side
Debit balance	Credit balance

⊕ Keep track on how you're doing

Your lecturer has access to Assessment and Homework Management tools so they can monitor your progress and provide additional support if you — or your class — require.

Student Name	Class Section Name	Raw Score (Graded)	Total Progress (Ungraded)	Total Surveys answered	Assignment ID	02-02	LD-Chp 3	Chp 1 LD	CG-3	7/8/07	GSU2	Test 3	Wk 3 MQ	Wk 1 quiz	Wk 3
1. A. Australia	Aus Rep Demo Class	0.00 / 144	0%	0 / 0	-730	-727	-720	-720	0/10	-78	-78	-78	-78	-78	-78
2. CURTIN, LUKE	Aus Rep Demo Class	0.00 / 144	0%	0 / 0	-730	-727	-720	-720	-710	-78	-78	-78	-78	-78	-78
3. GEAR, JACOB	Aus Rep Demo Class	0.75 / 144	0%	0 / 0	-730	-727	-720	-720	0.75/10	-78	-78	-78	-78	-78	-78
4. GEAR, JACOB	Aus Rep Demo Class	20.36 / 144	0%	0 / 0	-730	5/27	-720	15.36/20	-710	-78	-78	-78	-78	-78	-78
5. GEAR, JACOB	Aus Rep Demo Class	1.25 / 144	0%	0 / 0	-730	-727	-720	-720	1.25/10	-78	-78	-78	-78	-78	-78
6. GEAR, JACOB	Aus Rep Demo Class	4.60 / 144	0%	0 / 0	-730	-727	-720	-720	2.24/9	0.36/8	2/8	-78	-78	-78	-78
7. JAKS, ANDREA	Aus Rep Demo Class	0.00 / 144	0%	0 / 0	-730	-727	-720	-720	-710	-78	-78	-78	-78	-78	-78
8. LARSEN, LOUISE	Aus Rep Demo Class	2.00 / 144	0%	0 / 0	-730	2/27	-720	-720	-710	-78	-78	-78	-78	-78	-78
9. REDDINGTON, VICTORIA	Aus Rep Demo Class	1.13 / 144	0%	0 / 0	-730	-727	-720	-720	-710	-78	-78	-78	1.13/6	-78	-78
Class Section Averages:		3.34/144	0%	0.00/0	0/30	0.78/27	0%	1.71/20	0.22/10	0.25/9	0.04/8	0.22/8	0.13/6	0/7	0/10