Chapter 1
Introduction to financial accounting

Discussion questions

1 What is the basic purpose of financial accounting?

The basic purpose of financial accounting is to produce useful information which is used in many and varied ways. People use the information generated by financial accounting to improve their decision-making in allocating scarce resources.

2 Distinguish between financial performance and financial position.

Financial performance means generating new resources from day-to-day operations over a period of time. Financial position is the organisation's set of financial resources and obligations at a point in time.

3 What is the difference between financial and management accounting?

Managerial accounting is a branch of accounting that is oriented towards helping managers and others *inside* the enterprise. Financial accounting has a more external focus, and is often used by parties *external* to the enterprise, such as, shareholders, investors, bankers, legislators and employees etc.

4 Who are the main parties that comprise the social setting of accounting?

The main parties that comprise the social setting of accounting are:

- the information users (the decision makers)
- the information preparers, who put the information together to facilitate the users' decision-making
- the auditors, who assist the users by enhancing the credibility of the information, providing a professional opinion that the information is fair and appropriate.

5 What is meant by credible periodic reporting? What prevents organisations from making financial statements increasingly credible? (Consider cost–benefit implications.)

Credible periodic reporting means that trustworthy and competently prepared financial reports are provided on a regular basis. The cost involved in making the reports absolutely accurate and perfect would be enormous, and may outweigh the benefit obtained in achieving the highest level of credibility possible. The information has to be worth its cost!

6 List four important users of financial accounting and describe the use that each user would make of the information.

The important users that could be listed are shown in the table below:

User	Usage of the financial accounting information
Owner	To evaluate the success of the business, and whether or not the business is functioning well, and is achieving its financial goals.
Potential owner	To gain an insight into the enterprise, and make a decision as to whether or not to invest in the enterprise. Also to use the past financial results as an indicator of the future functioning of the business.
Creditors and potential creditors	To ascertain the ability of the enterprise to repay any debts or potential debts that the enterprise may have.
Managers	To ascertain whether or not the business has achieved its financial goals, and to provide a basis for development of future business goals and business plans. Also to compare the results of their enterprise with those of its competitors, using financial information as a common denominator.
Employees	Out of interest to gain further insight into the functioning of the business they work for. Also to assess: whether or not the business is able to pay wages as they fall due, the employers future demand for the employees' services, and to use the information in bargaining for wage increases.
Regulators and other government bodies and agencies	To check that the enterprise is functioning well, and is not carrying on business in any manner that may contravene any laws or regulations. Also, to provide some knowledge of businesses, which may be used to develop new regulations, or modify existing regulations.
Financial and market analysts	The results would be scrutinised in depth, and further analysed to provide deep insight into the enterprise. This information could then be used by the analysts to make investment decisions, or the information could be sold to interested parties. The financial results of many enterprises could be analysed and compared to gain an understanding of the market as a whole.
Competitors	To allow them to compare themselves with other enterprises, to see how they are functioning in comparison. Also to gain insight into their operations, and to use that information to improve their business, by gaining ideas from their competitors' business.
Accounting researchers	To evaluate how accounting is practised in the practical business environment, and to use this information as a basis for theories, and the development of new accounting standards.
Miscellaneous third parties	Usage depends on the specific party using the information. e.g. Journalists use the information to evaluate businesses and compare various enterprises, so that they can write articles relating to certain industries and/or businesses and/or economic trends e.g. Politicians make judgements about industry efficiency or taxation levels e.g. Judges may evaluate the enterprise's ability to pay if it loses a lawsuit

7 Do all users of financial accounting have the same information needs? Why, or why not?

Users of financial statements do not all have the same information needs. They are all different people, with differing objectives, preferences and capabilities, so they are likely to need different information to meet these differences in decision-making. Probably most users share an interest in fair, timely information, but the details of that information depend on the decision(s) each user is making.

8 List some similarities and differences between the need for financial information between shareholders and bankers.

Similarities

Both parties would be interested in past profits and cash flows to provide them with the relevant information.

Differences

Shareholders are particularly interested in dividends and potential growth in share price; bankers are more concerned with the ability of the company to repay its debt.

9 List five situations in which judgement is required by the preparers of financial information.

The following are some suggested situations where judgement is required by preparers of financial information, however this list is not exhaustive!

- deciding which accounting policies to use
- deciding on the level of depth of information that is provided in financial reports
- deciding on when to provide financial information, including how often, as well as at what time of the year
- deciding on how to technically keep the records, for example, using computers versus human effort, what the various records will look like, etc.
- deciding on whether or not to be ethical in reporting the financial information
- deciding in which period a transaction occurs
- deciding on how to measure a transaction, for example a property that cost $100 000 ten years ago may be worth $500 000 today. Therefore, how do preparers decide on the value of assets/ liabilities to be reported.

10 What does an audit achieve?

An audit enhances the credibility of an organisation’s financial statements. An auditor provides an opinion on whether the financial statements are fairly presented.

11 Describe what is meant by accrual accounting. How does it differ from cash accounting?

Accrual accounting includes the impact of transactions on the financial statements in the time periods where revenues and expenses occur rather than when the cash is received or paid. Cash accounting only accounts for revenues and expenses when cash is paid or received by the enterprise.

12 Who uses accrual accounting?

Most businesses and organisations use accrual accounting.

13 Which of the following terms would you see in financial statements prepared under (a) accrual accounting and (b) cash accounting: accounts payable, accounts receivable, cash and inventory?

Term	a) Accrual accounting	b) Cash accounting
Accounts payable	Yes	No
Accounts receivable	Yes	No
Cash	Yes	Yes
Inventory	Yes	Yes

14 What are the three key financial statements, and what relevant information do they provide to users of accounting reports?

The key financial statements and the information they provide are:

- **i** a balance sheet which shows the financial position at a point in time;
- **ii** an income statement which measures financial performance over a defined period (such as a month or a year) by deducting expenses from revenues during the period to obtain profit for the period;
- **iii** a statement of cash flows which shows the sources and uses of cash during the period. Operating, financing and investing activities are included in this statement.

15 Explain, in simple terms, each of the following financial accounting assumptions:

- a accounting entity
- b accounting period
- c monetary
- d historical cost
- e going concern
- f materiality.

a. Accounting entity: under this concept the accounting entity is separate and distinguishable from its owners. For example, the accounting entity of a sole trader is differentiated from the financial affairs of the owner. Similarly, a company is a separate entity from its shareholders. If either the sole trader or a shareholder of a company goes out and buys a new set of golf clubs, it may affect their personal finances but does not affect the accounting entity. Accounting entities do not necessarily correspond to legal entities. For example, as noted above, the personal financial affairs of the sole trader can be separated from the finances of the business, even though there is no legal distinction. This concept puts a boundary on what transactions are to be recorded for any particular accounting entity. It also allows the owner to evaluate the performance of the business.

b. Accounting period: the life of a business needs to be divided into discrete periods to evaluate performance for that period. Dividing the life of an organisation into equal periods to determine profit or loss for that period is known as the accounting period concept. The time periods are arbitrary but most organisations report at least annually, with large companies preparing half-yearly and quarterly financial statements for outside purposes and at least monthly (sometimes more frequently) for management purposes.

c. Monetary: accounting transactions need to be measured in a common denominator that in Australia is, not surprisingly, the Australian dollar. This allows comparisons across periods and across different companies. Transactions that cannot be reasonably assigned a dollar value are not included in the accounts. This concept also assumes that the value of the monetary unit is constant over time, which ignores inflation.

d. Historical cost: under this concept, assets are initially recorded at cost. As you will see in later chapters many assets such as inventory will still be recorded at cost in the Balance Sheet in subsequent periods even though their value has increased. Some other assets such as property, plant and equipment can be revalued periodically. Thus, in reading a Balance Sheet it is important to note at what valuation the assets are being recorded.

e. Going concern: financial statements are prepared on the premise that the organisation will continue operations in the foreseeable future. If this is not the case then it is necessary to report the liquidation values of an organisation's assets.

f. Materiality: under this concept, all transactions are recorded, but items that have a small dollar value are expensed rather than included as an asset on the Balance Sheet. For example, a box of pens that costs $13 and has a useful life of two years would be treated as a stationery expense rather than as an asset.

16 Do you think lecturers should have the right to use their own judgement in determining subject grades, or should those grades be based on objectively set exams administered by someone other than lecturers? Why? Do you think companies' management should have the right to choose the accounting policies and methods by which their performance is measured? Why? How do these two cases differ, if at all?

At this point, students have little 'accounting' knowledge, having read only the introductory ideas of Chapter 1. The purpose of this question is to have the students think about information and control over it in a context they can relate to and, in the process, suggest to the students that they may have more to say about accounting issues than they thought because accounting is basically just a kind of information. Instructors should encourage wide discussion of the questions raised and might try to draw out of the students some of the fundamental issues the book will deal with.

Some points in favour of lecturers' setting grades or management choosing accounting policies:

- **i** Being in charge of the course/company, the lecturer/manager has the expertise to set grades/choose policies competently.
- **ii** Being close to the situation, the lecturer/manager will appreciate the practical issues and nuances behind a coherent and fair result.
- **iii** It is to the lecturer's/manager's advantage to do the job well so as to avoid getting into trouble with students/shareholders, being sued, etc.
- **iv** Society gives professionals (educators or managers) some rights over others because there are advantages to society (e.g. motivating good people to enter professions, encouragement of expertise) and professionals agree to be ethical in return.
- **v** Having someone else do it may produce bureaucracy, red tape and general insensitivity to the needs of each subject/company.
- **vi** The lecturer's/manager's actions can be monitored or reviewed ('audited') and penalties assessed for improper behaviour.

Some points against lecturers' setting grades or management choosing accounting policies:

- **i** As the result reflects on the lecturer's/manager's performance, she/he may try to 'look good' instead of letting the measures be objective.
- **ii** The lecturer/manager may be influenced by incentives or constraints beyond the grades or accounting figures (e.g. a wish to do research instead in order to

get tenure or an eye on the possibility of being hired by another company) and so the results may improperly reflect those incentives or constraints.

iii Even with the best will, the lecturer/manager does not have the same perspective on the matter as do the students/shareholders and so may not produce the results they would have preferred.

iv Lots of damage from inappropriate behaviour can result before that behaviour is detected and curtailed.

v Being a good lecturer/manager is a different task from being a good grader/accountant, so the lecturer/manager may not in fact have great expertise in setting grades/accounting policies.

vi The lecturer/manager may have unconscious (or conscious) decision-making biases or prejudices that may produce results that are on average fair but may help or hurt individual students/shareholders.

As the above presentation of points has suggested, students should be encouraged to see the similarities in the two cases. As their knowledge develops, students may see more differences, but many points remain fundamentally similar because they concern basic information issues such as the following (to be examined in the book):

– fitting the information to the problem
– serving the user's needs
– motives of the information producer
– expertise of the information producer
– monitoring (auditing) information production
– performance evaluation
– rules and standards to control the process
– ethics and professionalism.

Problems

Problem 1.1

Calculate accrual accounting profit

John Smith set up his own catering business on 1 July 2015. During the 12 months up to 30 June 2016 the following transactions occurred:

1 John put $10 000 of his own money into the business.
2 He borrowed $20 000 from the bank for one year at 5 per cent per annum, with interest to be paid at the end of the loan.
3 He paid $10 400 in wages and owed $3000 in wages for work done.
4 He bought catering equipment for $6000, which has an expected useful life of three years.
5 He paid other expenses of $12 300.
6 John sent bills for $60 000 to customers for work performed between 1 July 2015 and 30 June 2016. By 30 June he had received $45 000 and expected the other $15 000 by August.

Using the concepts of accrual accounting, calculate John's profit for the year ended 30 June 2016.

Answer 1.1

Revenue	60 000
Expenses	
Interest (20 000 x 0.05)	(1 000)
Wages (10 400 + 3000)	(13 400)
Depreciation (6,000 ÷ 3)	(2 000)
Other	(12 300)
Profit	$31 300

Problem 1.2

Prepare a balance sheet and calculate profit

1 Given the following balances, prepare a balance sheet as at 30 June 2016 for Palm Tree Limited.

	$
Bank loan	40 000
Share capital	160 000
Wages payable	60 000
Accounts payable	80 000
Inventory	140 000
Cash at bank	50 000
Buildings	200 000
Retained profits	90 000
Accounts receivable	40 000

2 The company did not declare any dividends during the year. Its balance in retained profits at the start of the year was $60 000. What is the profit for the year?

Answer 1.2

1

Palm Tree Limited
Balance sheet
as at 30 June 2016

	$
Assets	
Cash at bank	50 000
Accounts receivable	40 000
Inventory	140 000
Buildings	200 000
Total assets	430 000
Liabilities and shareholders' equity	
Liabilities	
Bank loan	40 000
Wages payable	60 000
Accounts payable	80 000
Total liabilities	180 000
Shareholders' equity	
Share capital	160 000
Retained profits	90 000
Total shareholders' equity	250 000
Total liabilities and shareholders' equity	430 000

2 Profit for year ended 30 June 2016 = Retained profits at end of year – Retained profits at start of year
= 90 000 – 60 000
= $30 000

Problem 1.3

Content of financial statements

Consider the list of accounts given and categorise them as an asset, liability or shareholders' equity item that would appear on the balance sheet or a revenue or expense that would appear on the income statement by ticking the appropriate column.

	Asset	Liability	Stockholders' Equity	Revenue	Expense
Buildings					
Accounts payable					
Rent expense					
Retained profits					
Sales					
Accounts receivable					

Equipment					
Cost of goods sold					
Inventory					
Share capital					
Provision for employee entitlements					

Answer 1.3

	Asset	Liability	Stockholders' Equity	Revenue	Expense
Buildings	✓				
Accounts payable		✓			
Rent expense					✓
Retained profits			✓		
Sales				✓	
Accounts receivable	✓				
Equipment	✓				
Cost of goods sold expense					✓
Inventory	✓				
Share capital			✓		
Provision for employee entitlements		✓			

Problem 1.4

What are various people's interests in financial accounting?

Briefly describe what each of the following people would likely want to learn from the financial statements of BrandX Ltd, and how each might be affected if the statements showed good or bad financial performance or financial position.

1 The chief executive officer (CEO) of the company
2 The company's chief accountant
3 The chairperson of the company's board of directors (the board evaluates the president's performance on behalf of the shareholders)
4 The partner of auditing firm Dimbleby & Co, for whom BrandX is a client
5 The local manager of tax collections for the Australian Taxation Office
6 John Flatstone, who owns 100 shares of BrandX
7 Mildred Evans, who is thinking of buying some shares of the company
8 The local manager of Big Bank, which has made a large loan to BrandX

Answer 1.4

	Person	Information wanted	How affected
1	CEO	Profitability Financial stability or growth	Salary, bonus and tenure
2	Chief Accountant	Profitability Liquidity	Salary Continuity of employment
3	Chairperson of Board of Directors	Adequacy of capital, profitability, growth, market share	Recommend dividend Recommend share issue Recommend borrowing of funds

4	Partner of auditing firm	Whether financial statements are fairly presented	Provide: unqualified opinion except for opinion adverse opinion inability to form opinion
5	Local manager of tax collections	Taxable income	Whether calculated in accordance with legislation
6	Shareholder	Profitability Dividends proposed Market price of shares Prospects of bonus issue	Sell shares or buy additional shares
7	Potential shareholder	As for shareholder	Purchase shares
8	Local bank manager	Liquidity Profitability Regular payment of interest	Require payment of loan Seize assets given as security

Problem 1.5

What are various people's interests in financial accounting?

Briefly describe what each of the following groups would like to know from the financial statements of the Swans Football Club.

1 The CEO
2 The players
3 The supporters
4 The suppliers of meat pies and beer for home games

Answer 1.5

1
- The profit for the period which is revenue minus expenses. Profit will be one of the performance indicators for the CEO. If the club is making a loss there will be issues about the financial viability of the club.
- Financial position: as provided by the balance sheet. A strong balance sheet will make it easier for the CEO to carry out their strategic initiatives, e.g. new training facilities.

2
- Cash flow is critical as the players' payments depend on it.
- The higher the profit the more likely the players can argue for pay increases.

3 The supporters are most concerned about the long term viability of the club. They may take a more long term perspective than even the CEO and players. The balance sheet is important here. Obviously they are also interested in the profitability and cash flow of the club. These will impact the short term viability including their ability to buy new players.

4 The key here is the number of people attending the game. It is likely to be correlated with sales revenue. The more profitable the club, the more likely it can look after its players and fans and therefore get people to the ground.

Problem 1.6

Users and their needs

Accounting information is demanded by a wide range of users, including shareholders, company management, suppliers, bankers, trade unions, the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO). Which user is likely to seek each of the following types of information?

1 The likelihood of the company meeting its interest payments on time
2 The profitability of each division in the company
3 The financial position and performance of a company issuing shares to the public for the first time
4 The prospects for future dividend payments
5 The probability that the company will be able to pay for its purchases on time
6 The profitability of the company based on the tax law
7 The profitability of the company since the last contract with employees was signed

Answer 1.6

User	**Type of Information**
Bankers	The likelihood of the company meeting its interest payment on time
Company Management	The profitability of each division of the company
ASIC	Financial position and performance of a company issuing shares to the public for the first time
Shareholders	Prospects for future dividend payments
Suppliers	Probability that the company will be able to pay for its purchases on time
Australian Tax Office	Profitability of company based on tax law
Trade Unions	Profitability of company since last contract with employees was signed

Problem 1.7

Accrual profit

Brick Limited made cash sales of $550 000 and credit sales of $370 000 ($220 000 of which had been collected by year-end). It also paid $410 000 in expenses and owed $230 000 at year-end. What was the accrual profit?

Answer 1.7

Sales	
Cash sales	550 000
Credit sales	370 000
Total sales	920 000
Expenses	
Total expenses (410 000 + 230 000)	640 000

Accrual profit = Total sales – Total expenses
= 920 000 – 640 000
= 280 000

Problem 1.8

Accrual profit

1 During the year that ended 30 June 2016, French Horn Ltd made cash sales of $100 000, credit sales of $200 000 ($50 000 of which were still to be collected at year-end), and received $25 000 owing from credit sales, which occurred in May 2015. What is French Horn's sales revenue for the year ended 30 June 2016?
2 Also during the year ended 30 June 2016, French Horn paid $60 000 and owed $10 000 in employee wages. Of the $60 000 paid, $5000 related to wages payable as at 30 June 2015. What is the total of French Horn's accrual accounting expenses?
3 What is French Horn's accrual accounting profit for the year ended 30 June 2016?

Answer 1.8

1 Sales revenue for the year ended 30/06/16
= $100 000 + $200 000
= $300 000

2 Accrual accounting expenses for the year ended 30/06/16
= $60 000 + $10 000 – $5000
= $65 000

3 Accrual accounting profit for the year ended 30/06/16
= Revenue – accrued expenses
= $300 000 – $65 000
= $235 000

Problem 1.9

Calculate accrual accounting profit

Fred Jones started a consulting business on 1 March 2016. During the period up to 30 June 2016, the following transactions occurred.

1 Fred put $10 000 of his own money into the business.
2 He borrowed $30 000 from the bank at 10 per cent per annum for one year with interest to be repaid at the end of the loan.
3 He sent bills for $35 000 to customers for work performed. By 30 June he had received $30 000 and expected the other $5000 in July.
4 He bought a computer for $8100 that has an expected useful life of three years.
5 He paid $12 000 in wages.
6 He paid other expenses of $20 000.
7 He received a $500 bill for advertising (appeared in newspapers in May; will be paid in July).

Using the concepts of accrual accounting, calculate Fred's profit for the four months ending 30 June 2016.

Answer 1.9

		$	$
Revenue			35 000
Less expenses			
	Interest (30 000 x 10/100 x 4/12)	1000	
	Depreciation (8,100 x 4/36)	900	
	Wages	12 000	
	Advertising	500	
	Other expenses	20 000	34 400
Net profit			600

Problem 1.10

Comparing net profits and cash flow

Kingsford Customs was founded on 1 July 2016. At the end of first year's operations, the following summary of its activities has been prepared by the owner.

1 Borrowed cash of $60 000 from CAA Bank.
2 Employees earned $96 800 of wages, of which $40 000 is to be paid in the next accounting period.
3 Performed customised services that generated sales revenue of $243 300, of which $100 000 remained uncollected at the end of the year.
4 Other operating expenses, including phone bills and electricity that amounted to $26 800, were incurred during the year. Of this amount, $10 000 remained unpaid at the end of the year.

Show the effect on net profit and cash of each of the above transactions for this accounting period.

Answer 1.10

	Net Profit	Cash
1	-	+60 000
2	-96 800	-56 800
3	+243 300	+143 300
4	-26 800	-16 800

Problem 1.11

Contents of financial statements

Match each item with the financial statement it would appear in by ticking the appropriate column.

Item	Balance Sheet	Income Statement	Statement of Cash Flows
Wages expense			
Cash paid for equipment			
Cash at bank			
Equipment			
Cash flow from customers			
Accounts payable			
Cash paid to employees			
Sales revenue			

Answer 1.11

Item	Balance Sheet	Income Statement	Statement of Cash Flows
Wages expense		✓	
Cash paid for equipment			✓
Cash at bank	✓		✓
Equipment	✓		
Cash flow from customers			✓
Accounts payable	✓		
Cash paid to employees			✓
Sales revenue		✓	

NB: Transactions often affect more than one statement, e.g. cash paid for equipment would also result in a change in the balance sheet; sales revenue would also affect the balance sheet (either cash or accounts receivable; if cash the cash flow statement would also be affected).

Problem 1.12

Contents of financial statements

Match each item with the financial statement that it would appear in by ticking the appropriate column.

Item	Asset	Liability	Shareholders' Equity	Revenue	Expense
Administrative expenses					
Cash at bank					
Marketing expenses					
Buildings					
Income taxes payable					
Loans from banks					
Accounts payable					
Retained profits					
Accounts receivable					
Income tax expense					
Cost of goods sold					
Sales Revenue					
Inventories					

Answer 1.12

Item	Asset	Liability	Shareholders' Equity	Revenue	Expense
Administrative expenses					✓
Cash at bank	✓				
Marketing expenses					✓
Buildings	✓				
Income taxes payable		✓			
Loans from banks		✓			
Accounts payable		✓			
Retained profits			✓		
Accounts receivable	✓				
Income tax expense					✓

Cost of goods sold					✓
Sales Revenue				✓	
Inventories	✓				

Problem 1.13

Classification of items

Listed below are balances for 2016.

	$
Accounts receivable	80 000
Sales	250 000
Electricity	30 000
Retained profits	50 000
Loan	200 000
Transportation costs	10 000

1 Classify each account as an asset, liability, revenue, expense or equity.
2 Prepare an income statement for the period ending 31 December 2016.

Answer 1.13

1

Account	Classification
Accounts receivable	Asset
Sales	Revenue
Electricity	Expense
Retained profits	Equity
Loan	Liability
Transportation costs	Expense

2

Income Statement
For the year ending 31 December 2016

	$	$
Sales		250 000
Electricity	30 000	
Transportation costs	10 000	40 000
Net profit		210 000

Problem 1.14

Matching financial statement items to statement categories

Raindrop Holdings Ltd is a public company. Below are items taken from its recent consolidated balance sheet and consolidated income statement. Note that different companies use slightly different titles for the same item. Mark each item in the following list as an asset (A), liability (L) or shareholders' equity (SE) that would appear on the balance sheet, or revenue (R) or expense (E) that would appear on the income statement.

1 Property plant and equipment
2 Sales revenue
3 Trade and other payables
4 Advertising costs
5 Provisions
6 Inventories
7 Prepayments
8 Revenue received in advance
9 Reserves
10 Cash and cash equivalents
11 Depreciation
12 Cost of sales

Answer 1.14

1 A
2 R
3 L
4 E
5 L
6 A
7 A
8 L
9 SE
10 A
11 E
12 E

Problem 1.15

Matching cash flow statement items to categories

The following items were taken from a recent cash flow statement. Note that different companies use slightly different titles for the same item. Mark each item in the list as a cash flow from operating activities (O), investing activities (I) or financing activities (F).

1 Cash paid to employees
2 Cash borrowed from the bank
3 Cash proceeds received from sale of investment in another company
4 Income taxes paid
5 Repayment of loan principal
6 Cash received in return for issue of share capital
7 Cash received from customers
8 Purchases of property, plant and equipment
9 Cash paid to suppliers
10 Cash paid for dividends to shareholders
11 Repayment of loan interest

Answer 1.15

1 O
2 F
3 I
4 O
5 F
6 F
7 O
8 I
9 O
10 F
11 O

Problem 1.16

Accounting equation

Mr Smiles opened his fruit shop at the beginning of last year. By the end of that year he had the following assets and liabilities:

	$000
Assets	
Cash	350
Fruit	600
Total Assets	950
Liabilities	
Supplies Payable	280
Wages Payable	128
Total Liabilities	408

1 What is Mr Smiles' shareholders' equity in his fruit shop at the end of the year?
2 If Mr Smiles' initial investment was $500 000, what was his profit for the year?

Answer 1.16

1 Shareholders' equity = Assets – Liabilities
= $950 000 – $ 408,000
= $542,000

2 Closing balance of shareholders' equity = Opening balance of shareholders' equity + Profits – distributions

Therefore, Profit = c/b shareholders' equity – o/b shareholders' equity + distributions

Mr Smiles' profit = $542,000 – $500 000
= $42,000

Problem 1.17

The accounting equation

Cardigan Ltd has total assets of $150 000 and liabilities that add up to $70 000 as at 30 June 2015.

1 What is Cardigan's shareholders' equity as at 30 June 2015?
2 During the year to 30 June 2016, Cardigan's total assets increase by $63 000 while total liabilities increase by $25 000. What is the amount of Cardigan's shareholders' equity on 30 June 2016?
3 Now assume that in the year to 30 June 2016, Cardigan's total liabilities increase by $20 000 and its shareholders' equity decreases by $12 000. On 30 June 2016, what is the level of Cardigan's total assets?
4 Assume that in the year to 30 June 2016, Cardigan's total assets double while its shareholders' equity remains unchanged. What are its total liabilities as at 30 June 2016?

Answer 1.17

1	Cardigan's shareholders' equity as at 30/06/15	= Assets – Liabilities
		= $150 000 – $ 70 000
		= $80 000
2	Cardigan's assets as at 30/06/16	= $150 000 + $63,000 = $213 000
	Cardigan's liabilities as at 30/06/16	= $ 70 000 + $25,000 = $ 95,000
	Cardigan's shareholders' equity as at 30/06/16	= Assets – Liabilities
		= $213,000 – $ 95,000
		= $118,000
3	Cardigan's shareholders' equity as at 30/06/16	= $80 000 – $12,000 = $68,000
	Cardigan's liabilities as at 30/06/16	= $70 000 + $20 000 = $90 000
	Cardigan's assets as at 30/06/16	= Shareholders' equity + Liabilities
		= $68,000 + $90 000
		= $158,000
4	Cardigan's assets as at 30/06/16	= $150 000 x 2 = $300 000
	Cardigan's shareholders' equity as at 30/06/16	= $80 000
	Cardigan's liabilities as at 30/06/16	= Assets – Shareholders' equity
		= $300 000 – $80 000
		= $220 000

Problem 1.18

The accounting equation

Use the accounting equation to answer the following questions.

1 Pillow Ltd halved its liabilities during the year. At the beginning of the year, the amount of total assets was $80 000 and owners' equity was $50 000. What is the amount of Pillow's total liabilities at the end of the year?
2 Buffalo Ltd began the year with assets of $60 000 and liabilities of $25 000. Net profit for the year was $43 000. What is the amount of owners' equity at the end of the year?

3 During the last financial year, Sparkle Industries tripled the amount of its assets. At the end of the year, total liabilities amounted to $57 000 while owners' equity was $15 000. What was the amount of total assets at the beginning of the year?

Answer 1.18

1	Liabilities = Assets – Owners' equity		
	Pillow's opening balance of liabilities	= $80 000 – $50 000	= $30 000
	Pillow's closing balance of liabilities	= $30 000 / 2	= $15 000
2	Closing balance of Owners' equity	= Opening balance of Owners' equity + Net profit	
		= (O/b assets – O/b liabilities) + Net profit	
	Buffalo Ltd's closing bal. of Owners' equity	= ($60 000 – $25 000) + $43 000	
		= $78 000	

3 Assets = Liabilities + Owners' equity

Sparkle Industries closing balance of assets = $57 000 + $15 000 = $72 000

Sparkle Industries opening balance of assets = $72 000 ÷ 3 = $24 000

Problem 1.19

Income statement

Given the following information, prepare an income statement for Gerke Ltd for the year ended 30 June 2016.

	$
Rent expense	30 000
Cost of goods sold	100 000
Sales	250 000
Wages	75 000
Advertising	25 000
Training expense	8000

Answer 1.19

Gerke Ltd
Income Statement for the year ended 30 June 2016

		$
Sales revenue		250 000
Less cost of goods sold		100 000
Gross profit		150 000
Less operating expenses		
– wages	75 000	
– rent	30 000	
– advertising	25 000	
– training	8 000	138 000
Net profit		12 000

Problem 1.20

Income statement

Given the following balances, prepare an income statement for the year ended 30 June 2016 for Bush Traders.

	$
Sales	48 000
Cost of goods sold	21 000
Wages	8000
Electricity	4000
Travel	2000
Advertising	1000

Answer 1.20

Bush Traders
Income Statement for the year ended 30 June 2016

		$
Sales revenue		48 000
Less cost of goods sold		21 000
Gross profit		27 000
Less operating expenses		
– wages	8 000	
– electricity	4 000	
– travel	2 000	
– advertising	1 000	15 000
Net profit		12 000

Problem 1.21

Prepare a balance sheet and calculate profit

1 Given the following balances, prepare a balance sheet as at 30 June 2016 for Bricks Ltd.

	$
Bank loan	100 000
Share capital	400 000
Accounts payable	60 000
Taxes payable	40 000
Inventory	150 000
Cash	50 000
Land and buildings	500 000
Retained profits	200 000
Accounts receivable	100 000

2 The company did not declare any dividends during the year. Its balance in retained profits at the start of the year was $120 000. What is the profit figure for the year?

Answer 1.21

1

Bricks Ltd
Balance Sheet as at 30 June 2016

Assets		$
	Cash	50 000
	Accounts receivable	100 000
	Inventory	150 000
	Land and buildings	500 000
	Total assets	800 000
Liabilities and shareholders' equity		$
	Liabilities	
	Accounts payable	60 000
	Taxes payable	40 000
	Bank loan	100 000
	Total liabilities	200 000
	Net assets	600 000
Shareholders' equity		
	Share capital	400 000
	Retained profits	200 000
Total shareholders' equity		600 000

2 $200 000 – $120 000 = $80 000

Problem 1.22

Analysing revenues and expenses and preparing an income statement

Assume you are the owner of Double Cafe, a coffee shop in Sydney's CBD. At the end of June 2016, you find (for June only) this information:

1. Sales, as per cash register records, of $47 000, plus sales on credit (two birthday parties) of $750.
2. The cost of goods sold during June had cost $16 000, consisting of coffee, cups and cakes.
3. During the month, according to the cheque book, you paid $14 000 for salaries, rent, advertising and other expenses; however, you have not yet paid the $680 monthly bill for electricity for June.

On the basis of the data given (disregard income taxes), what was the amount of net profit for June? Show computations.

Answer 1.22

Revenue (47 000 + 750)	47 750
Cost of Goods Sold	(16 000)
Gross profit	31 750
Expenses (14 000 + 680)	(14 680)
Net profit	17 070

Problem 1.23

Calculate shareholders' equity

Gomez Limited has the following assets and liabilities.

	$
Loan	180 000
Cash	90 000
Accounts Payable	110 000
Accounts receivable	170 000
Equipment	200 000

1 Classify each balance as an asset or a liability.
2 Calculate shareholders' equity.

Answer 1.23

1

Assets	$	Liabilities	$
Cash	90 000	Loan	180 000
Accounts receivable	170 000	Accounts payable	110 000
Equipment	200 000		
Total assets	460 000	Total liabilities	290 000

2 Shareholders' equity = Assets – Liabilities
= $460 000 – $290 000
= $170 000

Problem 1.24

Calculate shareholders' equity

Given the following information relating to Stripes Ltd, what is the balance of shareholders' equity?

	$
Land and buildings	2 800 000
Accounts payable	250 000
Cash and cash equivalents	340 000
Inventoy	410 000
Bank loan	600 000
Taxes payable	104 000

Answer 1.24

Shareholders' equity = Assets – Liabilities
= ($2 800 000 + $340 000 + $410 000)
- ($250 000 + $600 000 + $104 000)
= $3 550 000 - $954 000
= $2 596 000

Problem 1.25

Identify some accounting concepts and principles

Identify the accounting concepts or principles that relate to each of the following sentences and explain what effect the concepts or principles have on financial statements:

1 Users of financial statements should be able to believe that the numbers represent real events.
2 Financial statements should avoid undue optimism about the future.
3 It is hard to say absolutely if a company is performing well or badly, but you can evaluate its relative performance.
4 Financial accounting should be helpful both in understanding the past and looking ahead to the future.
5 The content of financial statements should not depend on who prepares them.

Answer 1.25

Here are some ideas in response to the sentences. You may well think of several other concepts/principles and probably will make additional points about some of them.

1 The concept/principle related to this is reliability. Some effects on financial statements of this are: accountants are careful that all cash transactions and day-to-day events such as credit sales and purchases are reflected in the financial statements; considerable care is taken to minimise errors and omissions in the accounting system that underlies the financial statements; and auditors ensure that important financial statement data can be traced back to underlying events and evidence.

2 Three concepts/principles related to this are conservatism, reliability and matching. Conservatism results (or should result) in financial statements that contain prudent, not overly optimistic estimates of future cash inflows and outflows regarding present assets and liabilities. Reliability has the effect of keeping conservatism in check so that the financial statements are not pessimistic (which would be unfair to present owners and managers). Matching says that estimates affecting revenues should be done on comparable bases to those affecting expenses so that the net profit makes sense, so it puts some bounds on conservatism too.

3 Three concepts/principles related to this are conformance with GAAP, consistency and comparability. Conformance with GAAP ensures that the company's information is prepared in ways the user might expect, to permit meaningful analyses of its performance. The objective of consistency over time results in highlighting inconsistencies so that the user can consider their effects on the information. The goal of comparability refers directly to the idea of 'relative performance' because if the previous two principles are met, the company can be evaluated by comparison to others like it, or to others the user might consider investing in or lending to.

4 Three concepts/principles related to this are disclosure, decision relevance and understandability. Disclosure has the effect of helping users understand how the accounting numbers were computed. This helps to make estimates of future effects. Decision relevance is a reminder that the financial statements should be useful both in past-oriented decisions (such as evaluating management's performance or calculating bonuses) and in future-oriented decisions (such as whether to invest in or lend to the company).

Understandability requires that reports be prepared so they are comprehensible to the recipients.

5 Two concepts/principles related to this are reliability, and conformance with GAAP. The goal of both is partly to minimise the effects of human error, biases and wishes on the information by promoting objective, careful methods of preparing it and making it possible (in principle) for anyone else who prepares it to come up with, and agree with, the same information.

Problem 1.26

Accounting assumptions

Consider the following statements relating to how we might account for certain transactions or events. What accounting assumption or principle underlies each?

1 'Inventory is recorded at cost unless the net realisable value of inventory is below cost. In that case, inventory is written down to the net realisable value.'
2 'Accounting financial statements are primarily based on historical costs. They should, however, be primarily about the contemporary cash value of a company's net assets.'
3 'At the end of each period, a company has to calculate any salaries that have accrued, and recognise an expense and a liability for that amount.'
4 'If a company changes its depreciation policy, it needs to disclose (in the notes to the financial statements) the nature of the change, and its financial effects.'
5 'Many businesses do not record "freight in" as part of the acquisition cost of inventory, but any freight charges of the period, which are normally small amounts, are expensed in the gross profit section of the income statement.'

Answer 1.26

1 Conservatism
2 Historical cost (see chapter 1)
3 Accounting period (see chapter 1)
4 Consistency
5 Materiality

Problem 1.27

Qualitative characteristics

The Framework for the Preparation and Presentation of Financial Statements examines the characteristics of accounting information that make this information useful for decision-making. It also points out that various limitations, which are inherent in the measurement and reporting process, may necessitate trade-offs between these limitations and the positive characteristics of useful information.

1 Briefly describe the following characteristics of useful accounting information:
a relevance
b reliability
c understandability
d comparability.

2 For each of the following pairs of information characteristics, give an example of a situation in which one of the characteristics may be sacrificed in return for a gain in the other:

a relevance and reliability
b relevance and comparability
c relevance and understandability.

3 What criterion should be used to evaluate trade-offs between information characteristics?

Answer 1.27

1 **a** Relevance is one of the two primary decision-specific characteristics of useful accounting information. Relevant information is capable of making a difference in a decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. Information must also be timely in order to be considered relevant.

b Reliability is one of the two primary decision-specific characteristics of useful accounting information. Reliable information can be depended upon to represent the conditions and events that it is intended to represent. Reliability stems from representational faithfulness and verifiability. Representational faithfulness is correspondence or agreement between accounting information and the economic phenomena it is intended to represent. Verifiability provides assurance that the information is free from bias.

c Understandability is a user-specific characteristic of information. Information is understandable when it permits reasonably informed users to perceive its significance. Understandability is a link between users, who vary widely in their capacity to comprehend or utilise the information, and the decision-specific qualities of information.

d Comparability means that information about enterprises has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different enterprises at a particular point in time.

2 There are a multitude of answers possible here. The suggestions below are intended to serve as examples.

a Forecasts of future operating results and projections of future cash flows may be highly relevant to some decision-makers. However, they would not be as reliable as historical cost information about past transactions.

b Proposed new accounting methods may be more relevant to many decision-makers than existing methods. However, if adopted, they would impair consistency and make trend comparisons of an enterprise's results over time difficult or impossible.

c Occasionally, relevant information is exceedingly complex. Judgement is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.

3 Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision-making.

Problem 1.28

Primary assumptions made in preparing financial statements

Kelly opened a photography business in a small shop that she rented from a large retailer, Eastfield Limited. She paid the first month's rent of $400 by writing a cheque from her personal account. Kelly took some of her own photography equipment and materials (worth $5000) into the shop, and also bought some new cameras so that she could take pictures of her customers with the best available technology. The cameras had a recommended retail price of $2500 but she was able to buy them on sale for $2200, charging them to her personal credit card. Kelly's first customer paid her $900 for a set of portraits, so she opened a bank account for the company. Her other customers have not yet paid her, owing a total of $3100. At the end of the first month of business, Kelly prepared the following financial statements.

KELLY'S PROFESSIONAL PHOTOGRAPHY
BALANCE SHEET AS AT 31 MAY 2016

	$		$
Cash	900		
Equipment	2500	Shareholders' Equity	3400
	3400		**3400**

KELLY'S PROFESSIONAL PHOTOGRAPHY
INCOME STATEMENT FOR THE MONTH ENDED 31 MAY 2016

Sales			4000
Rent	400		
Equipment	2500		2900
Net profit			**1100**

Identify the assumptions that Kelly has violated, and explain how each event should have been handled. Prepare a corrected balance sheet and income statement.

Answer 1.28

Assumptions violated:

1 Accounting entity is separate and distinguishable from its owners. The photography equipment and materials worth $5000 should be shown as a business asset and included in Kelly's capital.

2 Historical cost – assets are initially recorded at cost. The cameras should be recorded at their cost to Kelly, $2200, not their recommended retail price.

3 Accounting period. Cameras have been shown as both an asset and an expense. As their life is longer than one month they should not be expensed.

4 Accounts receivable have been omitted from the balance sheet.

5 Share capital comprises:

	$
Rent paid	400
Equipment & materials	5000
Cameras	2200
	7600

Kelly's Professional Photography
Balance Sheet as at 31 May 2016

	$		$
Assets		Shareholders' equity	
Cash	900	Share capital	7 600
Equipment	7 200	Retained profits	3 600
Accounts receivable	3 100		
Total assets	11 200	Total shareholders' equity	11 200

Kelly's Professional Photography
Income Statement for the month ended 31 May 2016

	$
Sales revenue	4 000
Less operating expenses	
Rent	400
Net profit	3 600

Problem 1.29

Discuss ethical problems

Discuss the examples of ethical problems given at the end of section 1.4. What ethical issues do you see? What do you think the chief accountant, the auditor and the general manager should do?

Answer 1.29

Employee lawsuit and chief accountant

Ethical issue: The chief accountant has a responsibility to the users of the financial statements and to the company.

- Users of financial statements need information that is useful for decision-making. The question that arises here is whether the potential effects of the lawsuit will affect the decisions of users of the financial statements.
- The chief accountant also has a responsibility to the company. Will disclosure of the lawsuit in financial statements affect the outcome of the lawsuit? Will disclosure result in other lawsuits by previously dismissed employees?
- The chief accountant may also fear that disagreement with the general manager may jeopardise his own employment with the firm.

What should the chief accountant do?

- Ensure that all of the facts are known.

Why does the general manager deny any impropriety?

- The general manager may have been advised by the enterprise's lawyers that the lawsuit was unlikely to be successful.

Why does the chief accountant personally feel the claim is justified? What is the amount of the potential claim? Is it large enough to make a difference to the users of the financial statements?

- Once the chief accountant has all of the facts, it may be desirable to discuss the issue with the general manager again. He/she may also want to make the general manager aware of the accounting rules governing disclosure of potential losses.
- During the course of the audit, bring the matter to the attention of the enterprise's auditors.
- Also note that the enterprise's auditors are required to communicate with the enterprise's lawyers to determine whether there are any existing or potential lawsuits. The information provided by the lawyers would include the amount and likelihood of any gains or losses.

External auditor and possible cheating

Ethical issue: The auditor cannot apprise the other client that that client may be being cheated because this would violate the first client's confidentiality.

- If the enterprise is cheating one customer, it may be cheating others and may in general be dishonest. Since auditors performing an audit rely in part on representations of management, the potential dishonesty may jeopardise the effective conduct of the audit.
- Being associated with an enterprise whose management is dishonest may harm the reputation of the auditor.
- On the other hand, if the auditor ends the involvement with the enterprise, this will result in a loss of audit fees.

What should the auditor do?

- Get all of the facts.
- Determine whether the enterprise is actually cheating the customer.
- If the enterprise is actually cheating the customer, determine whether the cheating is the result of an inadvertent error. If the enterprise is not purposely cheating the customer, the auditor can bring the error to the attention of management and the problem will be solved.
- If the enterprise is purposely cheating the customer, determine what level of management is involved. If top management is not involved and is unaware of the circumstances the auditor can bring the matter to the attention of top management. At this point, top management would (hopefully) do something to rectify the situation.
- If the enterprise is purposely cheating the customer and top management is involved, the situation becomes more difficult. The auditor should do a number of things at this time, including seeking advice and discussing the situation with top management. Further action by the auditor is dependent on the response of management and whether the incident is isolated or not.
- If discussions with management result in the feeling that management is dishonest, the auditor should resign, by addressing a letter of resignation to the Board of Directors setting out the reasons for resignation.

The general manager's bonus

Ethical issue: The general manager's performance is evaluated based on performance of the company.

- The proposed change will not change the total amount of depreciation expense charged to income over the life of the relevant assets; it will only change the timing of the recognition of those expenses. As a result, it will not change the amount of cash generated from operations of the enterprise before considering the amount of the general manager's bonus. The proposed change will increase the amount of cash paid out to the general manager by way of bonus. Should the general manager get a higher bonus, if nothing has really changed?

- On the other hand, the proposed change to the depreciation method may result in providing the users of financial statements with information which is useful. Perhaps the new depreciation method results in better matching of expenses with revenues. Or, perhaps the new depreciation method is similar to depreciation methods used by other enterprises in the same industry. This would result in enhanced comparability between enterprises and may be more useful to users of the financial statements.

What should the general manager do?

- The general manager should determine whether the proposed change results in information which is more useful to users of the financial statements. If this is the case, the accounting change should be implemented. If not, the change should not be implemented.
- If the change is implemented, the general manager must decide whether to request that the bonus calculation ignore the change. It may be the case that some aspect of the general manager's performance has resulted in the possibility of decreasing depreciation expense. For example, if the general manager ensured that the relevant assets were well maintained to the point that the useful life of the assets was extended, the general manager should be rewarded for this performance and the bonus calculation should *not* ignore the change. If the change in depreciation is unrelated to the general manager's performance, the general manager should request that the bonus calculation should ignore the change.
- It is often the case that bonus plan parameters are such that changes of this nature are taken into account in determining bonus amounts. If this is the case, the amount of the general manager's bonus won't change with the implementation of new policy.

Cases

CASE 1A Woolworths Limited

Refer to the extracts of the 2014 annual report of Woolworths Limited in the *Financial Accounting* book's appendix. All questions relate to the consolidated accounts.

1 Provide indicators that Woolworths uses accrual accounting.
2 What were total assets at 29 June 2014?
3 What were total liabilities at 29 June 2014?
4 What was shareholders' equity at 29 June 2014?
5 State the accounting equation in dollar figures at 29 June 2014.
6 What was the net profit before tax?
7 What was the net profit after tax?
8 What were the largest cash inflow and outflow relating to operating activities?
9 Give two reasons why the cash flow from operations is a different figure from operating profit after tax.
10 Did its total assets increase or decrease over the last year?
11 How much inventory (in dollars) did Woolworths have as at 29 June 2014?
12 On what date does Woolworths' most recent reporting year end?
13 For how many years does it present complete:
   a balance sheets?
   b income statements?
   c cash flow statements?
14 Are its financial statements audited by an independent firm? Who is the auditor for the company?

Answer 1A

1 Indicators that Woolworths use accrual accounting:

Trade and Other Receivables
Trade and Other Payables
Provisions
Depreciation
Amortisation
Prepayments
Accruals
Unearned Revenue
Note 1

2 Total assets at 29 June 2014 = 24 205.2m

3 Total Liabilities at 29 June 2014 = 13 679.8m

4 Shareholders' equity at 29 June 2014 = 10 525.4m

5 Accounting equation in dollar figures at 29 June 2014

A	=	L	+	OE
24 205.2m		13 679.8m	+	10 525.4m

6 Net profit before tax = 3 515.1 m

7 Net profit after tax = 2 458.4 m

8 Largest cash inflow = Receipts from customers = 65 851.8 m

Largest cash outflow = Payments to suppliers and employees = 60 918.3 m

9 Cash flow from operations is a different figure to operating profit after tax because the latter is calculated on an accrual basis and includes a number of items omitted from the cash flow from operations including:

- revenue earned but received in other periods
- expenses incurred but paid for in other periods
- expenses not involving cash outlays including depreciation and bad debts.

In addition the cash flow from operations includes revenues and expenses relating to prior or subsequent periods.

10 Total assets increased to 24 205.2m in 2014 from 22 250.2m in 2013.

11 Woolworth Limited had $4 693.2 million worth of inventory as at 29 June 2014.

12 29 June 2014

13 **a** two years

b two years

c two years

14 Yes, they are. There is auditor's declaration (by Deloitte) in the report.

CASE 1B Accrual and cash profit in measuring performance

Wings Ltd is an airline services company with a plant near Sydney Airport and service centres in several states. It provides meals, serviettes and other food-related items, cleaning, interior maintenance and several other services to various airlines. The company has been fairly successful, though recessions and the deregulation of air services have put significant pressure on its operations. When the company began in the late 1970s, it had a relatively weak financial position (mainly because of borrowing to get set up) and its financial performance, while satisfactory, has not enabled it to reduce its debt load very much. It seems that every time the company gets a little ahead, new equipment must be purchased or new product lines developed, and the company finds itself borrowing again.

A recent year provides a good example. The company's accrual profit was $188 000 and its cash profit was $241 000. (The difference resulted because of a depreciation expense of $96 000 and uncollected revenue being $43 000 higher at the end of the year than at the beginning. In the company's financial statements, the phrase 'net profit for the year' was used to describe the accrual profit and 'cash generated by operations' described the cash profit.) The general manager had looked forward to using some of the cash to pay debts, but late in the year the company had to buy new food-handling and wrapping equipment for $206 000 to meet revised standards announced by its airline customers. Therefore, the company ended up only a few thousand dollars ahead in cash, not enough to make much of a dent in its debts.

The general manager has a regular half-yearly meeting with the company's external auditor to discuss accounting and auditing issues. After the above results were known, the general manager phoned the auditor and made the following comments: 'I thought I'd ask you to think about a few things before our meeting next week. When it comes to our accounting, I think the company has too many masters and too many measures. What I mean is first that too many people are concerned with what our financial statements say. Why can't we just prepare financial statements that meet my needs as general manager? Why do we have to worry about all the other people outside the company? Sometimes I'm not even sure who all those other people are, since you accountants and auditors often just talk about "users" without being too clear what you mean. Also, I'm confused by the existence of both a "net profit" figure and a "cash generated by operations" figure in our financial statements. Why can't we just have one or the other to measure our performance?'

The general manager raised issues that will be addressed frequently as this book develops your understanding. But for now, what would you say to the general manager?

Answer 1B

The purpose of this case is to have the students think about the various types of users of financial statements and how the needs of these users can be served by a single set of general purpose financial statements. The discussion might proceed as follows:

- Definition of a user: someone who makes decisions on the basis of financial statements.
- List of possible users:
  - owners or potential owners
  - creditors and potential creditors
  - managers
  - employees
  - taxation authorities, regulators and other government bodies
  - financial and market analysts
  - competitors
  - accounting researchers
  - miscellaneous third parties.

Why should the general manager provide information to the users?

- At this point you might want to go through the list of users and discuss why the general manager would want to provide information to each type of user.

Some examples:

- We know that the company is at least in part, financed by debt. The creditors will, therefore, be concerned about the company's ability to pay back the debt.
- If the company were a sole proprietorship with no debt, perhaps the only users would be the owner manager and the taxation authorities.
- User's main demand is for credible periodic reporting of an organisation's financial position and performance.
  - A large publicly traded company may have to meet the needs of all of the users mentioned above.
  - It would be very costly to provide different information to all of the different users.
  - Therefore, financial accounting measures performance over time using standard ways of determining whether a company has done well.
  - This information is not necessarily useful for insiders (i.e. management).

- Net profit versus Cash from operations
  - In accrual accounting, attempts are made to measure the value of incomplete transactions. Accrual accounting is used to determine net profit. (You may want to provide examples here: e.g. uncollected revenue at year-end increased by $43 000.)
  - Discuss why it is valuable to provide information about completed transactions. In doing this, refer to users of financial statements. For example, owners and potential owners may want to predict future performance of the firm on the basis of past performance in making investment decisions. Another example is assessment of management performance.
  - Cash from operations measures the amount of cash generated from the day to day activities of the company over a period in time.
  - Why would any of the users noted above find this information useful?
  - Example: creditors may use this information to assess the ability of the company to pay interest and principal on debt.

CASE 1C Audit and ethics issues

Read the following extract.

> The overall objective of the financial statement audit is to add credibility to management's financial reports…
>
> ### Essential Component
>
> Every financial market, and subsequently all financial regulators, relies on the existence of meaningful and reliable financial statements. The **external audit** provides the essential component of independent assurance, which is necessary for the provision of reliable financial statements…
>
> The high quality audit delivered in 2009 is a totally different service than the audit that would have been offered as little as 10 years ago. What has remained constant over this time is the value of the independent assurance provided by the audit process…
>
> ### Expectation Gap
>
> There is a segment of the market that sees an external audit as the guarantee against poor management behaviour, questionable business decisions and, ultimately, against corporate failure… We are all well aware that a corporate failure does not always equate to an audit failure.
>
> Source: Richard Deutsch, 'Audits add Credibility', *Charter*, September 2009.

1. What is meant by independent assurance?
2. Give some examples of lack of independence.
3. Comment on the statements in the paragraph headed 'Expectation Gap'.
4. How do management's and auditors' responsibilities differ?
5. Why is the integrity of management important to the financial reporting process?

Answer 1C

1 The person giving the assurance is independent of those preparing the financial statements. This would include having no conflict of interest: e.g. owning shares in the company, lending/borrowing money for the company, having a spouse or other family member in a key executive role.

2
- the company accounts for 70% of the audit firm's total revenue
- owning shares in the company
- also being an employee/director of the company.

3 The expectation gap is that users of financial statements often expect more from an audit report than is actually provided; i.e. the audit report does not guarantee the company will not fail or there is no material misstatement in the financial statements. The audit report gives an opinion on whether the financial statements are free from material misstatement.

4 Management prepare the financial statements while auditors express an opinion on the financial report.

5 Management need to make judgments in the preparation of financial statements. It is important that they have integrity and that those judgments are not biased towards their self-interests.