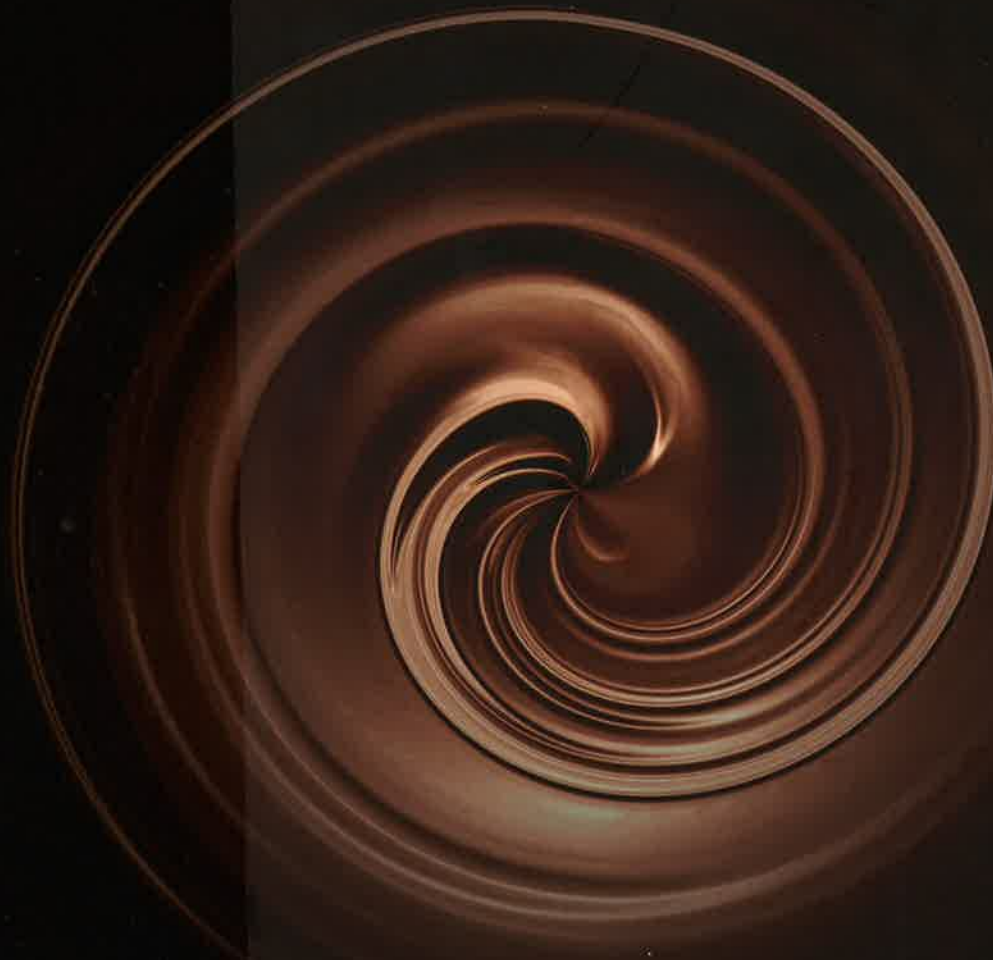


ACCOUNTING

INFORMATION FOR BUSINESS DECISIONS



REVISED ASIA-PACIFIC EDITION

Billie M Cunningham Loren A Nikolai John D Bazley
Marie Kavanagh Geoff Slaughter Sharelle Simmons

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ACCOUNTING

INFORMATION FOR BUSINESS DECISIONS



Billie M Cunningham, Loren A Nikolai, John D Bazley,
Marie Kavanagh, Geoff Slaughter, Sharelle Simmons



Accounting: Information for Business Decisions

Revised 1st Edition

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PREFACE

For students

There is a saying that 'knowledge is power'. But for that to be true, knowledge must be based on an objective, independent thought process that tests new information against evidence, assumptions, bias and other points of view. In other words, in order for you to gain new 'knowledge', you must 'think through' the related issues and ideas, understand them, satisfy yourself that they are reasonable and make them a part of your personal knowledge base. Furthermore, you must be willing to re-evaluate that knowledge, and perhaps change it, as new issues and ideas arise.

In business the saying is true – knowledge is power. Those who have it hold a competitive advantage over those who don't. Those who understand business information, and know how to interpret and use it, make the best business decisions.

A business's accounting reports, generated by its accounting system, are a major source of business information. When reading these reports you must evaluate the information they contain by looking for supporting evidence, assumptions and bias, and by considering other points of view. Furthermore, you must know how to *interpret* the information contained in these reports. To do this, you must understand how a business's accounting system develops these reports, and what concepts, principles and assumptions underlie the accounting information in these reports. With this in mind, we designed this book to address these issues.

After you graduate, you may work in business and use accounting information to make decisions as an 'internal user'. Alternatively, you may consider investing in a business or have some other reason to use its accounting information to make decisions as an 'external user'. Your ability to use the material in this book to later help you make effective business decisions (regardless of your career choice) depends on you making it a part of your own knowledge base. This means that you should 'think through' the issues and ideas as you read about them, making sure that you understand them before you read further. This will require some effort on your part. As you read the book, read it critically. Test it in your mind. Does it make sense to you?

To help you learn this material and think about what you are learning, throughout the book we have placed questions labelled with a 'stop light' that we think are worth your time and effort to answer. Each time you encounter one of these questions, stop, think through the question and answer it honestly. Base your answer on what you have learned in your life experiences, on your knowledge of accounting, business and the world – and on your own commonsense. By pausing in your reading and answering these questions, you will have time to process what you are reading and an opportunity to build new knowledge into your already-existing knowledge base.

Besides answering these questions as you read the book, think about questions you have or what else you would like to know about the subject at hand. Pursuing the answers to these questions in class or online will help you add to your knowledge base and the quality of your later decisions.

We hope you find this book interesting and fun to read, and that the examples based around chocolate sweeten your accounting experience! We also hope you find the book useful in increasing your knowledge of accounting, your appreciation of the power of using accounting information for making business decisions and your ability to use accounting information for your own business decisions now and in the future.

Caution

This textbook has a number of themes that revolve around chocolate, and this preface is no exception. While this book has many of the great accounting ingredients you are used to (and all that you will need), it also 'breaks the mould' as it incorporates a number of phrases and terms well known to chocolate lovers (and we know that includes accountants!). Our intent is that you will get a number of cravings while reading this preface, not the least of which is the desire to consume and learn from the book and to share its great taste and contents with your colleagues and your students.



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Two great flavours that combine to make one great text . . .

In the real world, today's students will face an accounting environment where management accounting and financial accounting issues are integrated every day. The traditional – and artificial – separation of these topics in textbooks tends to lead students to a perception that the two areas are unrelated. We also believe that traditional and highly technical 'preparer-oriented' accounting textbooks (1) isolate accounting from general business decisions, (2) lose students' interest and (3) reinforce a common misconception that accounting is best left solely to accountants. Such a separation misses the big picture that financial literacy knowledge and understanding is a 'life skill' and accounting systems provide economic information to all users. This textbook integrates management accounting and financial accounting topics in a way that is more reflective of the world the students in your first year accounting class will face outside of the classroom.

Sometimes you feel like a debit, sometimes you don't . . .

A major focus of this textbook is on using management accounting and financial accounting information in various business settings. We wrote this book at a 'non-technical' level for all business and non-business students – not just those intending to be accounting majors. Because all of us authors are heavily involved in teaching second and third level accounting, we are aware of the needs of your accounting majors. So we discuss recording, storing and reporting accounting information. We begin with a non-procedural approach to explain transactions in terms of the accounting equation (with entries into account columns) to illustrate the effect of these transactions on the financial statements. In Chapter 5 we discuss the rules for double entry and cover the accounting cycle, from journal entries (using debits and credits) through the post-closing trial balance. We designed it so that you may use it anywhere you see fit in the process of teaching from this book. We assure you that our accounting majors who have used this elementary accounting text are well prepared to enter our second and third level accounting classes.

Ingredients and nutritional information (key features of this text)

AN INTRODUCTION TO BUSINESS APPROACH

Chapter 1 takes an 'introduction to business's approach to orient students to the business environment – that is, the operations of a business, the different functions of business, managers' responsibilities and the types of information, management reports and financial statements the business's accounting system provides for use in internal and external decision making. This chapter provides students with a basic understanding of business so they can more effectively envision the context in which accounting information is collected and used, and the types of decisions users make in this context. This approach allows students to see the 'big picture' more clearly.

Professional skills

Chapter 1 is unique for accounting textbooks, and we integrate that uniqueness into the rest of the book. It introduces students to professional skills, such as critical thinking, and demonstrates how they are used in decision making and problem solving. This book emphasises the type of analytical thinking that successful



accountants and other business people use in a world that is constantly changing and increasing in complexity. We believe that as you use analytical thinking in your decision process regarding this textbook, you will not only decide to adopt this book but will also be able to use it in a way that will foster your students' growth.

In keeping with Chapter 1, the remaining chapters introduce students to various aspects of accounting and are designed to help them develop their thinking skills. STOP questions throughout the textbook (identified by a traffic light) ask students to take a break from reading to think about an issue and/or consider the outcome of a situation. We also ask them why they think what they think. The end-of-chapter materials include both structured and unstructured questions and problems that emphasise the use of creative and critical thinking skills by the students. Therefore some of the questions and problems do not have a 'correct' answer; rather the focus is on the approach or process that students use to solve them. With the increasing complexity of business activities, we think our inclusion of critical thinking materials will better prepare students to understand the substantive issues involved in new or unusual business practices. An added feature of the book is the SUSTAINABILITY icons that draw attention to the 'green' features of this book as it seeks to assist students to understand triple bottom line.

The simpler things

Earlier we mentioned a 'non-technical' approach. Although we explain identifying, measuring, recording and reporting of economic information, we discuss these activities at a basic level in Chapter 4 (increases and decreases in account balances) and do not include a discussion of debit and credit rules and journal entries in the main body of the text. We do emphasise the double-entry accounting system through the use of the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$) and its linkage to the income equation ($\text{Income} = \text{Revenues} - \text{Expenses}$). We use account columns to record transactions, but we explain the increases or decreases in relation to the accounting equation rather than as debits and credits. At the same time, we also emphasise the effects of the transactions on a business's financial statements and the impact they have on analysis of the business, for example its risk, liquidity, financial flexibility and operating capability. We chose this approach to better help students gain an understanding of the logic of the accounting system and its interrelationships, the effects of transactions on a business's financial statements, and the use of accounting information in decision making without getting them 'bogged down' in the mechanics of the system. For those wanting to incorporate the mechanics of the system, as we mentioned earlier, we do provide a thorough coverage of the double-entry system and the complete accounting cycle in Chapter 5.



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Because you've kept us apart for too long . . .

We also mentioned earlier that this book integrates management accounting and financial accounting topics in a way that is more reflective of the world students will face outside of the classroom. In blending our discussion of management accounting and financial accounting, we address several management accounting topics prior to discussing specific financial accounting topics. In this regard the chapters are designed to reflect actual practice in that a business must plan and understand its activities before it communicates its plans to external users, and it must operate and evaluate its operations (internal decision making) before it communicates the results of its operations to external users. Therefore, in keeping with the 'introduction to business's theme and the logical sequencing of business activities, we discuss accounting for planning first, and then operating and evaluating (controlling) – discussing management accounting and financial accounting where they logically fit into this framework.

For instance, Chapter 2 covers cost-volume-profit (C-V-P) analysis for planning purposes. After students have an understanding of cost and revenue relationships, we introduce them to budgeting in Chapter 3. The discussion of the master budget includes projected financial statements, which links the coverage back to the financial statements in Chapter 1. Chapter 4 then introduces accounting for the operations of a business. Chapters 7 to 9 describe a business's major financial statements and discuss how internal and external users would use these statements to analyse the business.

Besides integrating management accounting and financial accounting topics, this book also integrates business issues and values with international issues, where appropriate. Sustainability is also a key theme. This approach reinforces the idea that societal, environmental and global issues are not topics that can and should be dealt with separately from the other issues, but rather are an integral and significant part of business in today's world.

Plain – and with fruit and nuts (a scaffolded approach)

This textbook also uses a building-block approach. It begins with starting and operating a small retail chocolate store – a sole proprietorship – and then progresses through the operations of a more complex business in the form of a chocolate manufacturer – a company. This allows students to learn basic concepts first, and then to broaden and reinforce those concepts later in a more complex setting. Several of the same topics re-emerge, but each time they are refined or enhanced by a different business structure or a different user perspective.

For example, because of its location at the beginning of the semester, the Chapter 2 discussion of C-V-P analysis is simple. This topic would be covered again in greater depth in second and third year courses after students have a better understanding of costs in a manufacturing setting. Each time we revisit an issue, we discuss the uses of accounting information for both internal and external decision making, as appropriate.

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Likewise, we use a scaffolded approach to arranging the end-of-chapter materials according to levels of learning. To indicate these levels, we have divided these materials into sections on *Testing your knowledge*, *Applying your knowledge* and *Making evaluations*. These categories are arranged so that the answers to questions require students to use increasingly higher-order thinking skills as they move from one category of question to the next. The *Testing your knowledge* section includes questions that test students' knowledge of specifics – terminology, specific facts, concepts and principles, classifications and so forth. The *Applying your knowledge* section includes questions, problems and situations that test students' abilities to translate, interpret, extrapolate and apply their knowledge. The *Making evaluations* section includes questions, problems and cases that not only test students' abilities to apply their knowledge but also their abilities to analyse elements, relationships and principles, to synthesise a variety of information and to make judgements based on evidence and accounting criteria.



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New and improved flavour

In this Asia-Pacific edition, and as a result of our own use of the book and feedback from other users, we have made the book even better. The major new features of the textbook include:

- 1 A sustainability theme running through the text is a key feature that differentiates it from other introductory accounting texts.
- 2 Chapter 10 has been specifically designed to give students a taste of the impact of environmental and energy issues on business, and on how to record and manage them. It also broadens students' perspectives by introducing them to the Global Reporting Initiative (GRI) to make them truly aware of the knowledge and skills they will need in the global business arena.
- 3 We highlight the importance of developing a range of skills other than technical skills, such as judgement, critical thinking, ethical and sustainability skills, and teamwork. Activities throughout each chapter, end-of-chapter materials and case studies provide a range of approaches.
- 4 Chapter appendices keep some topics available to those who wish to teach them. Most are included in the end-of-chapter materials but the appendix on periodic and perpetual inventory is provided online.
- 5 We have revised many 'real' business examples in the text, and have also updated all of the 'real' business problems in the end-of-chapter materials.

We believe these features enhance the 'flavour' of the book and make its topics even more relevant and understandable to our students.

Real-World/World-Wide/Total World

Life is not a 'textbook case'. That's why we not only integrate management accounting and financial accounting topics, but also include information about real-world businesses as examples for many of these topics. We include analyses of the financial information of some of these businesses in the text and in the end of chapter materials. The Weblinks section of each

chapter gives students the opportunity to connect to some of these businesses via the Internet for further evaluation.

Suggestions for navigating a business website

Use a search engine like Yahoo or Google to locate the home page of the business, then locate the financial statements, annual reports and other financial information by finding a link on the home page to About Us, Business Information, Investors, Investor Relations, Investor Information or a combination of these terms.

After clicking on this link, you will be sent to the financial information of the business. Sometimes the business will show a 'condensed' annual report containing only 'summary' financial statements. If you want complete financial information about the business for a specific year, you will need to find that year's annual report.

Generally you can access the home page of an organisation, such as the CPA, in a similar way. From the home page, you may find that you check several links before you find the proper section. Unfortunately, because organisations' websites tend to be less standardised than those of businesses, you may find yourself using the 'trial and error' method of finding information on those websites.

RESOURCES GUIDE

FOR THE STUDENT

As you read this text you will find a number of features in every chapter to enhance your study of accounting, and to help you understand its applications.

Key questions

- 1 Why is it necessary to have an understanding of business before trying to learn about accounting?
- 2 What factors are making the business environment to change?
- 3 How does accountants' professional responsibilities in a complex business environment?
- 4 What is the purpose of corporate, and what factors does it include?
- 5 What types of organisations do businesses include?
- 6 What information does the accounting system provide to support management decisions?
- 7 How does accounting provide support and information to people working in business, why are accountants called business?
- 8 What roles do ethics and professional play in the business environment?
- 9 What are the implications of the accounting system?
- 10 How can people learn to think critically?
- 11 How can critical thinking help people make better business decisions?
- 12 What are the legal aspects to business writing and business writing?

Key questions are listed at the start of each chapter to give you a clear sense of what the chapter will cover.

3 How does accounting information contribute to the planning process?

Key questions appear again in the margin where the material relating to the key question is covered.

For milk and eggs, are retailers, Retailers sell their goods. **Woolworths, Toys 'R' Us, and Dick Smith** are include shoe shops, online bookshops and car dealers

Business names that are bolded and underlined in the text are real businesses with comprehensive websites that you can peruse for further research.

FINANCIAL STATEMENT EFFECTS

Decreases current assets and total assets, and decreases current liabilities and total liabilities on **balance sheet**. Increases other items, which increases net income. Also increases operating expenses, which decreases net income on **income statement** (and therefore decreases owner's equity on **balance sheet**). **Increases and decreases cash flows from operating activities on cash flow statement.**

Margin notes provide additional information and useful reminders.

GLOSSARY

A complete **glossary** can be found at the back of the book.



Sustainability icons highlight the 'green' features of this book, to assist you in understanding the triple bottom line.



'Stop' questions encourage you to take a break from reading to think about an issue or consider the outcome of a situation.

Key terms

- break-even point (p. 63)
- capital (p. 52)
- contribution margin per unit (p. 64)
- cost-volume-profit (C-V-P) analysis (p. 55)
- fixed costs (p. 56)
- line of credit (p. 54)
- long-term capital (p. 54)

Merchandising businesses purchase goods (some resale to their customers. Some merchandising businesses are electrical suppliers or beverage distributors, are used to goods to retailers or other commercial users, like

Key terms are highlighted in the text where they first appear, and listed at the end of each chapter.

At the end of each chapter you'll find several tools to help you to review the chapter and key questions, and also to help extend your learning.



The end of chapter **Summary** highlights the important concepts covered in the chapter and links them back to the key questions.

Weblinks

Here is an opportunity to gather information on the Internet about real-world issues related to the topics in this chapter (for suggestions on how to navigate various businesses' websites to find their financial statements and other information, see the related discussion in the Preface at the beginning of the book). Answer the following questions.

Go to the Weblinks and Labs website.

1. What credit control policies does each company exercise?
2. Which inventory methods does each company use?
3. What controls does each company exercise over its inventory?

Useful **weblinks** are listed at the end of each chapter.

Dear Dr Decisive

My mum and I haven't had a major disagreement since I was 16, but now we can't see eye-to-eye (and it isn't even about my social life). It all started from a comment that her friend made when visiting us the other day. The comment was something like "It's so hard to know how to interpret the financial reports my accountant gives me the other day for my shop. It do have this—this thing had a huge profit last year but it ended up with less cash this year than it did last year!" Well, that led to a discussion between my mum and her friend, but I just couldn't leave well enough alone. I thought they were "barfing up the wrong end, so I had to interrupt my mum or else. Here's the issue: it's possible for a **business** to have a positive cash flow from operations in the same year, but it has a net loss or to have a **negative** cash flow from operations in the same year. That it has a net income? I think it isn't possible. Income and cash flows may be different, but they will both be either positive or negative. When changes in fact, she has gone so strongly that she says if you say I am right, she will make the amount of the monthly cheque she sends me in the meantime, I am. "Knowledge Rich, but Cash Poor"

The **Dr Decisive** letter in each chapter asks you to apply your accounting knowledge and critical thinking skills to solve an everyday problem.

Integrated business and accounting situations

Answer the following questions in your own words.

Testing your knowledge

- 6.1 What is a business' working capital, and what is included in its two components?
- 6.2 Why does a business manage its working capital?
- 6.3 Define cash for a business.
- 6.4 Briefly discuss the amounts over cash sales.
- 6.5 Briefly discuss the amounts over collections of cash from accounts receivable.
- 6.6 Briefly discuss the amounts over cash payments.
- 6.7 **What is a bank reconciliation?**
- 6.8 Identify the causes of the difference between the ending cash balance in a business' records and the ending cash balance reported on its bank statement.
- 6.9 Briefly explain what is meant by the terms *deposits in transit* and *outstanding cheques*.
- 6.10 Briefly explain what are included in deposits made directly by the bank and charges made directly by the bank.
- 6.11 Prepare an outline of a bank reconciliation for a business.
- 6.12 Briefly explain what a petty cash fund is and how it works.
- 6.13 Why do businesses make sales on credit?
- 6.14 Briefly discuss the amounts over accounts receivable.

Integrated business and accounting situations

at the end of every chapter help you to revise and consolidate the concepts you have learned by testing your knowledge, applying your knowledge and making evaluations.



ONLINE

Visit <http://login.cengagebrain.com> and login using the code card in the front of this book for access to the *Accounting: Information for Business Decisions* Coursemate website. You'll find an eBook, quizzes, flashcards, crosswords, a complete list of weblinks from the text, and more tools to help you excel in your studies.

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The solutions manual provides instructors with suggested solutions to all the end-of-chapter questions in the text.

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Chapter-by-chapter PowerPoint presentations cover the main concepts addressed within the text and can be

edited to suit your own requirements. Use these slides to enhance your lecture presentations and to reinforce the key principles of your subject, or for student handouts.

TEST BANK

A chapter-by-chapter test bank of questions covers the learning objectives and key topics. Available in Word format, you can customise the test bank to meet your students learning requirements.

ARTWORK

These digital files of graphs, tables, and exhibits from the book can be used in a variety of media. Add them into your course management system, use them within student handouts or copy them into lecture presentations.

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CHAPTER 1

INTRODUCTION TO BUSINESS ACCOUNTING AND THE ROLE OF PROFESSIONAL SKILLS

Business is a game, the greatest game in the world if you know how to play it.

Thomas J Watson Sr

Key questions

- 1 Why is it necessary to have an understanding of business before trying to learn about accounting?
- 2 What factors are causing the business environment to change?
- 3 How does someone become a successful businessperson in a complex business environment?
- 4 What is private enterprise and what forms does it take?
- 5 What are the three most common forms of business organisations and their basic characteristics?
- 6 What types of regulations do businesses face?
- 7 What information does the accounting system provide to support management activities?
- 8 How does accounting provide support and information to people making decisions who are external to the business?
- 9 What roles do ethics and sustainability play in the business environment?
- 10 What skills do accountants of the 21st century require?
- 11 How can people learn to think critically?
- 12 How can critical thinking help people make better business decisions?
- 13 What are the logical stages in problem solving and decision making?

What are you planning to do when you graduate from university – maybe become an accountant or a veterinarian, work your way up to marketing manager for a multinational business, manage the local food bank or open a sporting goods store? Regardless of your career choice, you will be making business decisions, both in your personal life and at work. We have oriented this book to students like you who are interested in business and the role of accounting in business. You will see that accounting information, used properly, is a powerful tool for making good business decisions. People inside a business use accounting information to help determine and manage costs, set selling prices and control the operations of the business. People outside the business use accounting information to help make investment and credit decisions about the business. Just what kinds of businesses use accounting? All of them! So let's take a little time to look at what business means.

Business affects almost every aspect of our lives. Think for a moment about your normal daily activities. How many businesses do you usually encounter? How many did you directly encounter today? Say you started the day with a quick trip to the local convenience store for milk and eggs. While you were out, you noticed that your car was low on fuel, so you stopped at the corner petrol station. On the way to class, you dropped some clothes off at the drycleaners. After your first class, you skipped lunch so that you could go to the bookshop and buy the calculator you need; after buying a chocolate bar for sustenance, you headed to your next class. In just half a day, you have already interacted with four businesses – the convenience store, the petrol station, the drycleaners and the bookshop – and managed your own personal financial requirements; that is, having enough money to pay for these things.



Actually, you encountered a fifth business, your university. Why would you describe your university as a business?

1 Why is it necessary to have an understanding of business before trying to learn about accounting?

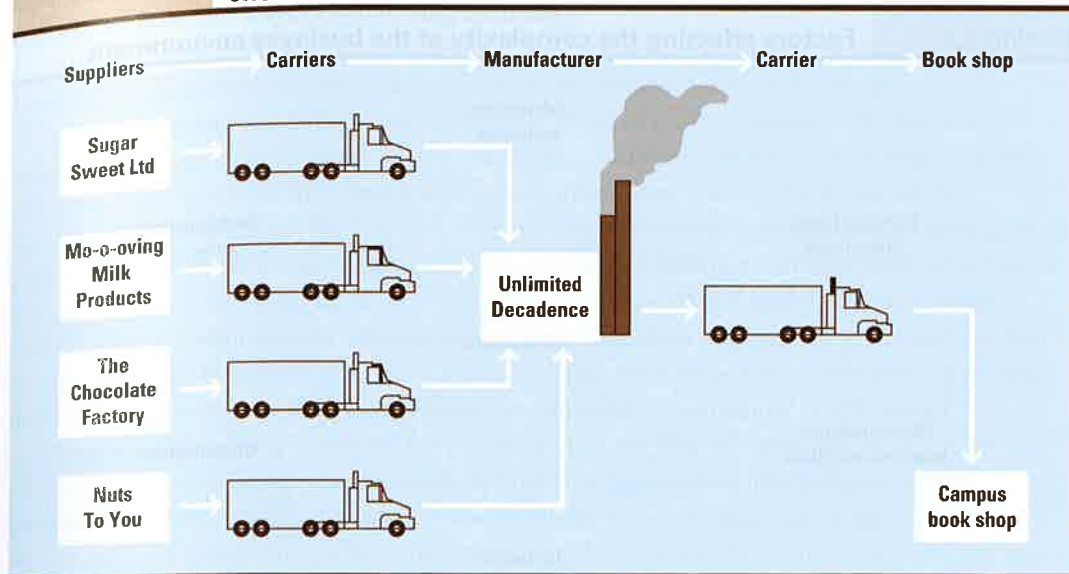
Although you were directly involved with four businesses, you were probably affected by hundreds of them. For example, two different businesses manufactured the calculator and the chocolate bar you purchased at the bookshop. Suppose that Unlimited Decadence Corporation manufactured the chocolate bar that you purchased. As we illustrate in Exhibit 1.1, Unlimited Decadence purchased the chocolate bar ingredients from many other businesses (suppliers). Each supplier provided Unlimited Decadence with particular ingredients. Shipping businesses (carriers) moved the ingredients from the suppliers' warehouses to Unlimited Decadence's factory. Then, after the chocolate bars were manufactured, a different carrier moved them from Unlimited Decadence to the bookshop.

Making and shipping the calculator would follow the same process. You can see that many businesses are involved with manufacturing, shipping and selling just two products. Now think about all the other products that you used during the morning and all the businesses that were involved with the manufacture and delivery of each product. Before leaving your home this morning, you could easily have been affected by hundreds of businesses. All these businesses have a role to play in providing goods and services to final customers.

Products and services affect almost every minute of our lives, and businesses provide these products and services to us. As you will soon see, accounting plays a vital role for businesses by keeping track of a business's economic resources and activities, and nowadays measuring the environmental and social impacts of the business (more on this and sustainability in Chapter 10).

Exhibit 1.1

Businesses involved with the manufacture and sale of chocolate bars



The business’s financial position and the results of its activities are then reported to people who are interested in how well it is doing. (This is similar to the way statistics are gathered and reported for cricket players and other athletes.)

In this chapter we will introduce you to accounting by first looking at different forms of business enterprise and the environment in which they operate. Regulatory issues associated with forming, operating and reporting on the activities of a business, and the role of ethics and sustainability in the management of a business, are discussed. We will highlight knowledge and skills required to engage in business and the role that accounting information plays in problem solving, making judgements and decision making within a business.



What do you think is the role of accounting and accountants in operating a business?

THE CHANGING BUSINESS ENVIRONMENT

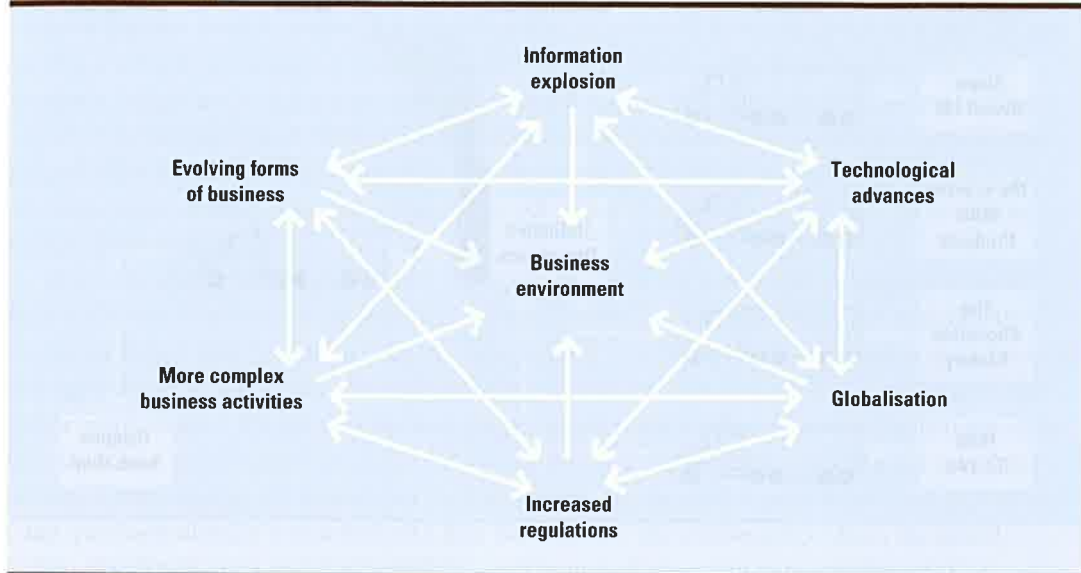
Why is the business environment changing so rapidly? As Exhibit 1.2 illustrates, a combination of many interwoven factors in this environment contributes to its complexity and excitement.

One contributor to the rapidly evolving business environment is the information explosion. More information is being generated than ever before, and this information is available to more people than ever. On the information superhighway, networks such as the Internet make available an almost endless list of information that includes library listings, books, journal articles, financial reports, catalogues and directories of businesses, organisations and people with similar interests. Because of the amount and accessibility of information, and because new information may replace existing information, business managers must be able to use their skills

2 What factors are causing the business environment to change?

to evaluate and manage this information to their advantage. We will discuss this idea more thoroughly later in the chapter.

Exhibit 1.2 Factors affecting the complexity of the business environment



Consider how *technological advances* have affected the transmission of information. Many businesspeople have extended their workday by using mobile phones, text-messaging, Blackberries, web conferences/online meetings, Skype or Webex to conduct business online. Fax and scanning machines, and email through computer networks facilitate information transmittal to and from multiple global sites. Huge databases, such as airline flight schedules and rate structures, are now stored in computer files and accessed by millions of users around the world. Satellites allow videoconferencing. This development has made the world more competitive. Businesses and individuals who, in the past, had difficulty travelling or communicating around the globe (perhaps because the infrastructures of their countries could not accommodate their needs) have enthusiastically 'thrown their hats in the ring'.

Technological advances affect not only the products we use and the way business is conducted, but also the way the products are manufactured. For example, advanced technologies have allowed the production process in many businesses to become fully automated. In many of our factories, computers are used to plan, operate and monitor manufacturing processes and to make adjustments to these processes as needed. Robots are now common workers on many production lines, for example, car manufacturers such as **Toyota**.

The *globalisation* of business activities and economies is providing more opportunities for businesses and individuals to conduct business by creating a larger, more diverse marketplace. At the same time, it is providing new business challenges. For example, when businesses begin to sell their products in other countries, they must translate their product names and advertising slogans into different languages. This type of translation is not as straightforward as it might first appear. Consider the dilemma **Kentucky Fried Chicken** faced when it tried to translate its slogan 'finger-lickin' good' into Taiwanese. The literal translation was, 'Eat your fingers off'.



Source: Shutterstock

Do you think this behaviour is acceptable in all cultures? Why or why not?

Businesspeople must also translate transactions involving foreign currencies (for example, Japanese yen to AUD dollars). Furthermore, they must learn to negotiate other cultures, economies, laws and ways of conducting business.

Another factor adding to the complexity of the business environment is the increase in regulations that companies must address. These are discussed later in the chapter.

More complex business activities also contribute to the changing business environment. For example, business owners and managers are finding more creative methods of financing their activities, new outlets for investing their excess cash, a larger variety of alternatives for compensating their employees and more complicated tax laws with which they must comply. In addition, the way companies conduct business is evolving. Where businesses used to be 'bricks and mortar', they now exist on the Internet. It is now common and convenient to conduct business using e-commerce, where businesses and consumers buy and sell goods and services over the Internet. E-commerce takes three forms: business-to-business or B2B (**Cisco Systems**), business-to-consumer or B2C (**Amazon.com**) or consumer-to-consumer or C2C (**eBay**).

Finally, *evolving forms of business* are cropping up in the new business environment. For example, numerous variations of the simple business organisation (sole proprietorships, partnerships and companies) now exist. Each of these forms of organisation has legal advantages and disadvantages that the others don't have, and each addresses a particular aspect of the business environment. A business owner chooses the form of business that most closely meets the business's needs.



How has the use of email and the Internet affected the way in which we communicate and do business?

Factors affecting the complexity of the business environment

The factors discussed above not only contribute to the complexity and excitement of the business environment, but also challenge the assumptions on which businesses and their employees operate. For example, the assumption that a university graduate will go out into the world, pursue a lifelong career and never return to university is no longer valid. Many people now change careers (careers, not just jobs!) several times before they retire. Often, in order to make a change, they return to study between careers to 'retool' or to expand their education to include new skills. Even people who stay in the same career expand their education (through continuing professional education, short courses, conferences and seminars) to improve their knowledge and abilities.

It is easy to see that a person entering or remaining in this dynamic environment must be dynamic also. In the following sections, we will discuss the characteristics, attitudes and skills that help people succeed in the business world. While reading these sections, keep in mind that these are attributes and abilities that people learn over a period of time and continue to develop for the rest of their lives (similar to the way athletes learn and improve their athletic skills).

3 How does someone become a successful businessperson in a complex business environment?

THE SUCCESSFUL BUSINESSPERSON

Imagine a successful businessperson. Perhaps the person, with sleeves rolled up and hands dirty, is working hard on some project. Or maybe he or she, business-suited and with briefcase in hand, is heading for a meeting. You may have a picture of what this businessperson looks like, but what really determines success is harder to see. It's more a matter of approach than of image.

The successful businessperson thrives on change, seeing it as an opportunity rather than an obstacle. However, treating change as an opportunity is more than just a matter of attitude (more than simply seeing the glass as 'half full'). It also involves being *prepared* for the opportunity; the successful businessperson is both willing and able to change. Therefore, this person is devoted to lifelong learning, realising that continuous learning is the only way to keep up with and be prepared for the fast-paced change we described earlier. This means that the businessperson must be willing to read industry or professional journals, attend conferences and/or take courses to stay up-to-date.

To be able to adapt to change (or 'go with the flow'), the successful businessperson develops certain other qualities as well. He or she welcomes others' viewpoints, appreciates differences among people, takes educated and thoughtful risks, anticipates environmental trends and identifies the potential problems and opportunities associated with these trends, and willingly abandons old plans if new information or technology makes them less workable. This doesn't mean that the successful businessperson is a chameleon, changing colours every time the business environment changes, but it does mean that he or she is flexible and adaptable.



What qualities can people develop to better prepare themselves for problem solving and decision making in the rapidly changing business environment?

4 What is private enterprise and what forms does it take?

PRIVATE ENTERPRISE

Businesses in Australia, New Zealand and most other countries operate in an economic system based on private enterprise. In this system, individuals (people like us, rather than public institutions like the government) own businesses that produce and sell services and/or goods for a profit. These businesses generally fall into three categories: service businesses, merchandising businesses and manufacturing businesses.

Service businesses

Service businesses perform services or activities that benefit individuals or business customers. The dry-cleaning establishment where you dropped off your clothes this morning provides the service of cleaning and pressing your clothes for you. Businesses like **Stefan Hair Fashions**, **LJ Hooker Real Estate**, **Qantas Airlines** and professional practices such as accounting, law, architecture and medicine are all service businesses. Other businesses in the private enterprise system produce or provide goods, or tangible, physical products. These businesses can be either *merchandising businesses* or *manufacturing businesses*.

Merchandising businesses

Merchandising businesses purchase goods (sometimes referred to as *merchandise* or *products*) for resale to their customers. Some merchandising businesses, such as plumbing supply shops, electrical suppliers or beverage distributors, are *wholesalers*. Wholesalers primarily sell their goods to retailers or other commercial users, like plumbers or electricians. Some merchandising businesses, such as the bookshop where you bought your calculator and chocolate bar or the convenience store where you bought your milk and eggs, are *retailers*. Retailers sell their goods directly to the final customer or consumer. **Woolworths**, **Toys 'R' Us** and **Dick Smith** are retailers. Other examples of retailers include shoe shops, online bookshops and car dealerships.

Manufacturing businesses

Manufacturing businesses make their products and then sell these products to their customers. Therefore, a basic difference between merchandising businesses and manufacturing businesses involves the products that they sell. Merchandising businesses buy products that are physically ready for sale and then sell these products to their customers, whereas manufacturing businesses make their products first and then sell the products to their customers. For example, the bookshop is a merchandising business that sells the chocolate bars it purchased from Unlimited Decadence, a manufacturing business. Unlimited Decadence, though, purchases (from suppliers) the chocolate, corn syrup, dairy products and other ingredients to make the chocolate bars, which it then sells to the campus bookshop and other retail stores. **Ford Australia**, **Black & Decker** and **BlueScope Steel Ltd** are examples of manufacturing businesses. Exhibit 1.3 shows the relationship between manufacturing businesses and merchandising businesses and how they relate to their customers.

The line of distinction between service, merchandising and manufacturing businesses is sometimes blurry because a business can be undertaking activities in more than one area. For example, **Dell Computer Corporation** manufactures personal computers, sells the computers it manufactures directly to business customers, government agencies, educational institutions and individuals, and services those computers (through installation, technology transition and management).

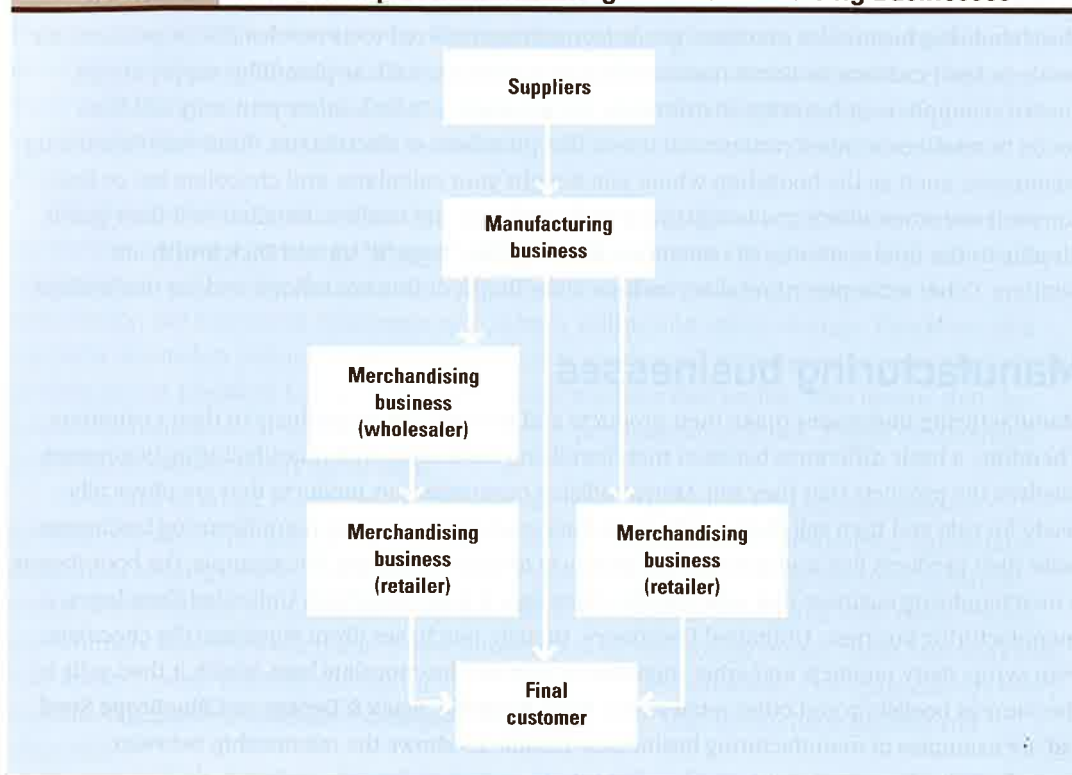


Do you think a supplier to a manufacturing business is a merchandising business or a manufacturing business? Why?

Whether a business is a service, merchandising or manufacturing business (or all three), for it to succeed in a private enterprise system it must be able to obtain cash to begin to operate and then to grow. As we will discuss in the next sections, businesses have several sources of cash.

Entrepreneurship and sources of capital

Owning a business involves a level of risk, along with a continuing need for **capital**. Although capital has several meanings, we use the term here to mean the funds a business needs to operate or to expand operations. In the next two sections we will discuss the risk involved with owning a business and possible sources of capital.

Exhibit 1.3 Relationship of manufacturing and merchandising businesses

ENTREPRENEURSHIP

Businesses in a private enterprise system produce and sell services and goods for a profit. So profit is the primary objective of a business. Profit rewards the business's owner or owners for having a business idea and for following through with that idea by investing time, talent and money in the business. The business owner hires employees, purchases land and a building (or signs a lease for space in a building) and purchases (or leases) any tools, equipment, machinery and furniture necessary to produce or sell services or goods, *expecting, but not knowing for sure, that customers will buy what the business provides*. An individual who is willing to risk this uncertainty in exchange for the reward of earning a profit (and the personal reward of seeing the business succeed) is called an **entrepreneur**. Entrepreneurship, then, is a combination of three factors: the business owner's idea, the willingness of the business owner to take a risk and the abilities of the business's owner and employees to use capital to produce and sell goods or services. But where does the business get its capital?

SOURCES OF CAPITAL

One source of capital for a business is the entrepreneur's (or business owner's) investment in the business. An entrepreneur invests money 'up front' so that the business can get started. The business uses the money to acquire the resources it needs to function. Then, as the business operates, the resources, or capital, of the business increase or decrease through the profits and

losses of the business. It is important to the sustainability of the business that it generates sufficient funds to allow expansion as opportunities arise.

When an entrepreneur invests money in a business, he or she hopes to eventually get back the money he or she contributed to the business (a return of the contribution). Furthermore, the entrepreneur hopes to periodically receive additional money above the amount he or she originally contributed to the business (a return on the contribution). The entrepreneur would like the return on the contribution to be higher than the return that could have been earned with that same money on a different investment (such as an interest-bearing savings account).

Borrowing is another source of capital for a business. To acquire the resources necessary to grow or to expand the types of products or services it sells, a business may have to borrow money from institutions like banks (called *creditors*). This occurs when the cash from the business's profits, combined with the business owner's contributions to the business, is not large enough to finance its growth. But borrowing by a business can be risky for the owner or owners. In some cases, if the business is unable to pay back the debt, the owner must personally assume that responsibility.

Borrowing can also be risky for a business. If the business cannot repay its debts, it will be unable to borrow more money and will soon find itself unable to continue operating. In addition to earning a profit, then, another objective of a business is to remain **solvent**. Remaining solvent means that the business can pay off its debts.



Why are reliable sources of capital important to the sustainability of a business?

THE FORMS THAT BUSINESSES TAKE

Several types of organisations use accounting information in their decision-making functions but do not have profit-making as a goal. These organisations are called *not-for-profit organisations* and include many educational institutions, religious institutions, charitable organisations, councils, governments and some hospitals. Since making a profit is not a goal of these organisations, some aspects of accounting for these organisations' activities are unique and beyond the scope of this book.



Can you list two non-profit organisations?

In this book we emphasise *business* organisations. These business organisations, or *businesses*, are a significant aspect of the Australian, New Zealand and world economies. As Exhibit 1.4 shows, a business may be organised as one of the following general types of business organisations: (1) sole proprietorship, (2) partnership or (3) company.

Choosing a business's legal form is an important decision for the business owner to make. For example, as a business owner, this decision determines how laws and regulations affect your personal responsibility to pay the business's debts. When choosing among legal forms, you need to know the characteristics and advantages and disadvantages of each. Once you select a legal form and start operating your business, laws and regulations specific to your type of organisation will affect some of your business decisions. In this section we discuss the three most common forms of business organisations: sole proprietorships, partnerships and companies/corporations.

5 What are the three most common forms of business organisations and their basic characteristics?

Sole proprietorship

A **sole proprietorship** or **sole trader** is a business owned by one person who is the sole investor of capital into the business. Because Anna Cox is the only investor in Sweet Temptations, this business is an example of a sole proprietorship. In general, sole proprietorships are small businesses that focus either on selling merchandise or on performing a service. Many of the small shops you see are sole proprietorships.

The owner of a sole proprietorship usually also manages the business. The owner makes the business's important decisions, such as when to purchase equipment, how much debt to incur and which customers are extended credit. In Australia and NZ, tax laws and regulations require each owner of a sole proprietorship to report and pay taxes on his/her business's taxable income. The business's taxable income is included in the owner's individual income tax return; there is no separate income tax return for a sole proprietor. So, the owner adds the income from the sole proprietorship to his or her other sources of income, such as wages earned from other jobs and interest received from bank deposits. In the case of Sweet Temptations, Anna Cox includes with her personal income tax return a schedule that reports Sweet Temptations's taxable income. She includes this amount in her total personal taxable income. Anna calculates her personal income tax liability based on all her sources of income.

Australian and NZ laws state that an owner of a sole proprietorship must assume personal responsibility for the debts incurred by the business. This requirement is referred to as **unlimited liability**. Unlimited liability may be a problem for the owner of a sole proprietorship because if the business cannot pay its debts, the business's creditors may force the owner to use his or her personal assets to pay them. So, if the sole proprietorship becomes insolvent, the owner may lose *more than* the amount of capital he or she invested in the business. Thus, unlimited liability adds additional financial risk for the owner of a sole proprietorship.

The life of a sole proprietorship is linked directly to its individual owner. Basically, a sole proprietorship ceases to exist when the owner decides to stop operating as a sole proprietor. If the owner of a sole proprietorship decides to sell the business, the owner's sole proprietorship dissolves and the new owner(s) must choose the new business's form of business organisation. Because of these characteristics, a sole proprietorship is said to have a **limited life**.

Partnership



Have you ever shared the purchase and use of an item with someone? Maybe you share a computer or an apartment? How do you decide how much money each contributes? How do you split the costs of software, rent or insurance?

By definition, a sole proprietorship is owned by only one person. What if two or three people come up with a great idea and want to start a business? What if the owner of a sole proprietorship wants someone else to invest in her business? One option is for the individuals to operate their business as a partnership. A **partnership** is a business owned by two or more individuals who each invest capital into the company.

Individuals must make many decisions before starting a partnership. These decisions include the following: the dollar amount each partner will invest; the percentage of the partnership each individual will own; how to allocate and distribute partnership income to each

partner; how business decisions will be made; and the steps to be taken if a partner withdraws from the partnership or if a new partner is added.

To limit disagreements, partners should always sign a contract, called a **partnership agreement**, before their business begins operations. This is a good idea even if partners are best friends or close relatives. This agreement specifies the terms of the formation, operation and termination of the partnership. It defines the nature of the business, the types and number of partners, the capital contributions required of each partner, the duties of each partner, the conditions for admission or withdrawal of a partner, the method of allocating income to each partner and the distribution of assets when the partnership is terminated.¹

Characteristics of partnerships



What concerns would you have about joining a partnership? Why?

Partnerships have many characteristics that are similar to those of sole proprietorships. Each partner is required by tax laws and regulations to report his or her share of the partnership's income on his or her individual income tax return. Laws and regulations regarding unlimited liability also apply to partnerships. In addition, a partnership has a **limited life**. It terminates whenever the partners change (i.e., when a partner leaves the partnership or when a new partner is added).

There is a basic difference between partnerships and sole proprietorships in that a partnership requires two or more owners. Several partnership characteristics relate to the co-ownership feature. To understand these characteristics, assume that Anna Cox invites her friend, Sandev Patel, to form Sweet Temptations as a partnership. If Sandev is like most other people, the first thing he would think is 'What would I be getting myself into?' Because of a partnership's legal and business characteristics, he may be getting into more than he thinks. One important characteristic to know is that all the partners jointly own all the assets owned by a partnership; this is called **joint ownership**. Therefore, if Sandev contributes his property to the partnership, it no longer belongs to him alone.

Before entering a partnership, you should also know that each partner is an agent of the partnership. An **agent** is a person who has the authority to act for another. Thus a partner has the power to enter into and bind the partnership – and, therefore, all the partners – to any contract within the scope of the business. For example, either Anna or Sandev can bind the partnership to contracts for purchasing inventory, hiring employees, leasing a building, purchasing fixtures or borrowing money. All of these activities are within the normal scope of a retail chocolate business.

The fact that each partner can obligate the partnership to honour contracts affects the unlimited liability requirements. **Unlimited liability** for a partnership means that each partner is liable for all the debts of the partnership. A creditor's claim is on the partnership, but if there are not enough assets to pay the debt, each partner's personal assets may be used to pay the debt. The only personal assets that are excluded are a partner's assets protected by bankruptcy laws, such as a personal residence. If one of the partners uses personal assets to pay the debts of the partnership, that partner has a right to claim a share of the payment from the other partners.

¹ See <http://www.dynamicbusiness.com.au/articles/articles-entrepreneur-profile/australian-bureau-statistics-count-australian-businesses-2141.html>.



Given the partnership characteristics we just discussed, if you were about to form a partnership, what specific items would you want to include in your partnership agreement?

Partnership equity

Accounting for the owners' equity of a partnership differs from accounting for the owner's equity of a sole proprietorship (and a corporation). Business transactions that do not affect owners' equity are recorded in the same way regardless of the organisational form. But because a partnership's ownership is divided among the partners, its accounting system has a *capital* account for each partner in which it records the partner's investments, withdrawals and share of the partnership's net income.

A partnership's net income is computed in the same way as is the net income for a sole proprietorship. However, because there is more than one owner in a partnership, the net income must be allocated to each partner. Before their business begins operations, the partners need to decide how to split the partnership's net income among themselves and list this allocation in the partnership agreement. Two factors that usually affect the distribution of income among partners are (1) the dollar amount of capital contributed by each partner and (2) the dollar value of the time each partner spends working for the partnership. These factors are important because the portion of net income allocated to each partner represents the return on his or her investment of capital or time. A partnership includes a schedule at the bottom of its income statement that shows how, and how much, net income is allocated to each partner.

Company/corporation

Recall that Unlimited Decadence is a company that manufactures chocolate bars and sells them to businesses like Sweet Temptations. Although a company is made up of individual owners, the law treats it as a separate 'being'. A **company/corporation** is a separate legal entity that is independent of its owners and is run by a board of directors. Hence, it has a *continuous* life beyond that of any particular owner. Therefore, it has a number of advantages. Because of the legal separation of the owners and the company, ownership in a company may be easily passed from one individual to another. Briefly, here's how it works. In exchange for contributing capital to the company, owners of a company receive shares of the company's share *capital*. Hence, they are called **shareholders**. These shares of stock are the 'ownership units' of the company and are *transferable*. That is, the current shareholders can transfer or sell their shares to new owners. The share capital of many companies can be sold on organised stock markets, such as the **Australian Stock Exchange**, the **New York Stock Exchange**, the **London Stock Exchange** and the **NASDAQ Stock Market, Inc.**, so shareholders of these companies can sell their shares to new owners more easily.

Because a company is a separate legal entity, a shareholder has no personal liability for the company's debts. Therefore, each shareholder's liability is limited to his or her investment. Companies tend to be larger than sole proprietorships and partnerships, so to operate, they need more capital invested by owners. Since transferring ownership is easy and since shareholders have *limited liability*, companies can usually attract a large number of *diverse investors* and the large amounts of capital needed to operate. Companies also can attract *top-quality managers* to operate the different departments, so shareholders are not involved in the company's operating decisions.

There also are several disadvantages of a company. As a separate legal entity, a company must pay income taxes on its taxable income. It reports this income on a company income tax

return. The maximum income tax rate for companies is currently 30 per cent. If some, or all, of the after-tax income of the company is distributed to shareholders as dividends, the shareholders again may be taxed on this personal income.

As the owners (shareholders) of a company have limited liability, a company (particularly a smaller one) may find it more difficult to borrow money. Since the creditors can't go to the owners for payment, they may think there is more risk of not being paid. Companies also are subject to more government regulation. For instance, the Federal and State Governments have laws to protect creditors and owners. For example, the laws of the state in which it is incorporated usually limit the payment of dividends by a company. Since creditors cannot go to the owners of a company for payment of its debts, limiting the company's dividend payments is a way of protecting creditors – the company may have more resources with which to pay its debts. In addition, if a company's share capital is traded in the share market, the company must file specified reports with the Australian Securities and Exchange Commission. However, the advantages of a company usually exceed the disadvantages when a business grows to a reasonable size.

Exhibit 1.4 summarises the characteristics of each type of business organisation.

Characteristics	Sole Proprietorships	Partnerships	Company/Corporations
Number of owner(s)	Single owner	Two or more owners (partners)	Usually many owners (stockholders)
Size of businesses	Small	Most are small; some professional partnerships (e.g. law firms) have several hundred partners.	Many are very large; some may have stock traded on an exchange.
Examples of businesses that typically have this legal form	Small retail shops; local service or repair shops; single practitioners such as CPAs, lawyers, doctors	Law firms; CPA firms; real estate agencies; family-owned businesses	Manufacturing companies; multinational companies; retail store chains; fast-food chains
Who makes business decisions	Owner	Depends on partnership agreement. Small partnerships will have all partners involved in business decisions; large partnerships will have managing partners. Partners are agents.	Decided by board of directors. Large Company/Corporations are managed by business professionals who often own little or no stock.
Liability of owner(s)	Unlimited	Unlimited	Limited
Life of organisation	Limited	Limited	Continuous

THE REGULATORY ENVIRONMENT OF BUSINESS

Businesses affect each of us every day, but they also affect each other, the economy and the environment. Just as individuals must abide by the laws and regulations of the cities, states and countries in which they live and work, all businesses, regardless of type, size or complexity, must deal with regulatory issues.

Think again about that chocolate bar you had as a snack today. When Unlimited Decadence Corporation was formed, the business had to do more than build a factory, purchase equipment and ingredients, hire employees, find retail outlets to sell the chocolate bar and begin operations. It also had to deal with the regulatory issues involved with opening and operating

6 What types of regulations do businesses face?

even the smallest of businesses. Furthermore, its managers must continue to address regulatory issues as long as they continue to operate the business.



Suppose a business is about to open a factory down the street from your house. What concerns do you have? What regulations might help reduce your concerns?

Many different laws and authorities regulate the business environment, covering issues such as consumer protection, environmental protection, employee safety, employment practices and taxes. Businesses must comply with different sets of regulations depending on where their factories and offices are located. These regulations are imposed by local, state and federal government.

In Australia, taxation is regulated by the Australian Taxation Office (ATO). Each business must withhold taxes from its employees' pay and send these taxes to the ATO. Furthermore, the ATO also collects the 10 per cent Goods and Services Tax (GST) from business activities through a Business Activity Statement (BAS). Businesses offset the GST they pay on business inputs such as inventory against the GST they collect on the sales of goods to customers. The ATO also taxes the profits of the businesses themselves. The type of business determines who actually pays the taxes on profits. Companies must pay their own income taxes to the ATO because, from a legal standpoint, they are viewed as being separate from their owners. Sole proprietorships and partnerships, however, do not pay taxes on their profits. Rather, owners of these types of businesses include their share of the business profits along with their other taxable income on their personal income tax returns. This is because the tax law does not distinguish the owners of sole proprietorships and partnerships from the businesses themselves.



What is the difference between income tax and Goods and Services Tax?

LAWS AND OTHER GOVERNMENT AGENCIES

A variety of laws and government departments and agencies (in addition to the ATO) regulate businesses. Federal departments and agencies oversee the administration of laws governing areas such as competition (the Australian Competition and Consumer Commission administers the *Competition and Consumer Act 2010*), fair work practices (Fair Work Australia), occupational health and safety (Safe Work Australia), workplace discrimination (Australian Human Rights Commission), sustainability and control of pollution to air, land or water (environmental protection agencies in each state), and the like.



Exhibit 1.5 Common regulatory issues businesses face

Local government issues	State issues	Federal issues	International issues
<ul style="list-style-type: none"> • Zoning/planning restrictions • Council rates (taxes) • Environmental regulations • Council by-laws 	<ul style="list-style-type: none"> • Stamp duty • Payroll tax • Occupational health and safety • Professional/occupational licences • Industry-specific regulations • Workplace discrimination 	<ul style="list-style-type: none"> • Federal taxes, including GST • Competition • Occupational health and safety • Fair work standards • Workplace discrimination • Company name and registration (including ABNs and ACNs) 	<ul style="list-style-type: none"> • Foreign licensing • Exports and imports • Taxes/customs duties • Multinational production and marketing • Property ownership • Cash restrictions

International regulations

When a business conducts business internationally, it also must abide by the laws and regulations of the other countries in which it operates. These laws and regulations address such issues as foreign licensing, export and import documentation requirements, tax laws, multinational production and marketing regulations, domestic ownership of business property and expatriation of cash (how much of the business's cash can leave the country). Of course, these laws and regulations differ from country to country, so a business operating in several countries must abide by many laws and regulations. Exhibit 1.5 lists some of the more common regulatory issues facing businesses operating in different jurisdictions.



Suppose that as a manager of a manufacturing business, you have the opportunity to have many parts of your product manufactured in another country where the labour is much cheaper and the environmental regulations are less stringent. What are the pros and cons of taking advantage of this opportunity?

THE ACCOUNTING SYSTEM

A business is responsible to many diverse groups of people, both inside and outside the business. For example, its managers and employees depend on the business for their livelihood. Customers expect a dependable product or service at a reasonable cost. The community expects the business to be a good citizen and to be mindful of the impact of its activities on the environment. Owners want returns on their investments, and creditors expect to be paid back. Governmental agencies expect businesses to abide by their rules.

People in all of these groups use accounting information about the business to help them assess a business's ability to carry out its responsibilities, and to help them make decisions involving the business. This information comes from the business's accounting system. An **accounting system** is a means by which accounting information about a business's activities is identified, measured, recorded and summarised so that it can be communicated in an accounting report. Two branches of accounting, management accounting and financial accounting, use the information in the accounting system to produce reports for different groups of people. Management accounting provides vital information about a business to internal users; financial accounting gives information about a business to external users. These two terms will be discussed in more detail later in this chapter.

7 What information does the accounting system provide to support management activities?



What are the main functions of an accounting system?

Management accounting information

Management accounting information helps managers inside the business plan, operate and evaluate a business's activities. Managers must operate the business in a changing environment. They need information to help them compete in a global market in which technology and methods of production are constantly changing. Therefore, managers can request 'tailor made' information in whatever form is useful for their decision making, such as

in dollars, units, hours worked, products manufactured, numbers of defective units or service agreements signed. Moreover, in a world exploding with new information, managers must manage that information in a way that will let them use it more efficiently and effectively. The accounting system provides information about segments of the business, products, tasks, plants or individual activities, depending on what information is important for the decisions managers are making.

Financial accounting information

Financial accounting information is organised for the use of interested people outside of the business. External users analyse the business's financial reports as one source of useful financial information about the business. For these users to be able to interpret the reports, businesses reporting to outsiders follow specific guidelines, or rules, known as *generally accepted accounting principles (GAAP)*, discussed in more detail later. Financial accounting information developed by the accounting system is expressed in dollars in Australia, New Zealand and the USA and in different currencies (such as the yen, euro and peso) in other countries.

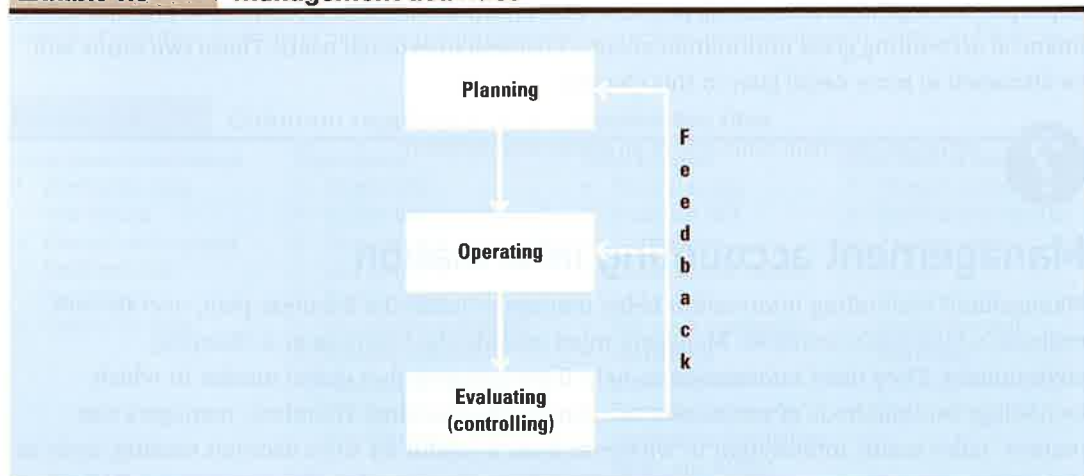


What is the difference between financial accounting and management accounting?

MANAGEMENT ACTIVITIES

Managers play a vital role in a business's success – by setting goals, making decisions, committing the resources of the business to achieving these goals and then by achieving these goals. To help ensure the achievement of these goals and the success of the business, managers use accounting information as they perform the activities of planning the operations of the business, operating the business and evaluating the operations of the business for future planning and operating decisions. Exhibit 1.6 shows these activities.

Exhibit 1.6 Management activities



Planning

Management begins with planning. **Planning** establishes the business's goals and the means of achieving these goals, and is a key requirement for business sustainability. Managers use the planning process to identify what resources and employees the business needs and to set standards, or 'benchmarks', against which they later can measure the business's progress toward its goals. Because the business environment changes so rapidly, plans must be ongoing and flexible enough to deal with change before it occurs or as it is happening.

Managers of multinational businesses must also consider such factors as multiple languages, economic systems, political systems, monetary systems, markets and legal systems. In such businesses, managers must also plan and encourage online communication between and among branches in several countries.

Operating

Operating refers to the set of activities that the business engages in to conduct its business according to its plan. For Unlimited Decadence, these are the activities to ensure that chocolate bars are made and sold.

In operating the business, managers and work teams must make day-to-day decisions about how best to achieve goals. For example, accounting information gives them valuable data about a product's performance. With this information, they can decide which products to continue to sell and when to add new products or drop old ones. If the business is a manufacturing business, managers and work teams can decide what products to produce and whether there is a better way to produce them. With accounting information, managers can also make decisions about how to set product selling prices, whether to advertise and how much to spend on advertising, and whether to buy new equipment or expand facilities. These decisions are ongoing and depend on managers' evaluations of the progress being made toward the business's goals and on changes in the business's plans and goals.

Evaluating

Evaluating is the management activity that measures actual operations and progress against standards or benchmarks. It provides feedback for managers to use to correct deviations from those standards or benchmarks, and to plan for the business's future operations. Evaluating is a continuous process that attempts to prevent problems or to detect and correct problems as quickly as possible.

The more countries in which a business operates, the more interesting the evaluating activity becomes. Managers must pay particular attention to the cultural effects of evaluation methods and feedback in order to achieve effective control.



Which of the three functions do you think is the most important, and why?



Do you think these people are engaged in planning activities, operating activities or evaluating activities? Why?



Even coaches of professional sports teams perform the activities of planning, operating and evaluating. If a team's goal is to win the grand final, how would the head coach implement each of these activities?

Planning, operating and evaluating all require information about the business. The business's accounting system provides much of the quantitative information managers use.

ACCOUNTING SUPPORT FOR MANAGEMENT ACTIVITIES

The **accounting system** identifies, measures, records, summarises and then communicates economic information about a business to *internal* users for management decision making. **Internal users** include individual employees, work groups or teams, departmental supervisors, divisional and regional managers, and 'top management'. Management accountants then provide information to internal users for planning the operations of the business, for operating the business and for evaluating the operations of the business.

Management accounting responsibilities and activities may vary widely from business to business and continue to evolve as management accountants respond to the need for new information – a need caused by the changing business environment.



Are there any guidelines for reporting to business managers?

Basic management accounting reports

Budgets, cost analyses and manufacturing cost reports are examples of management tools the accounting system provides. Exhibit 1.7 illustrates the relationships between management activities and these reports.



Suppose you are the manager of your business's sales force. What type of information would you want to help you do your job?

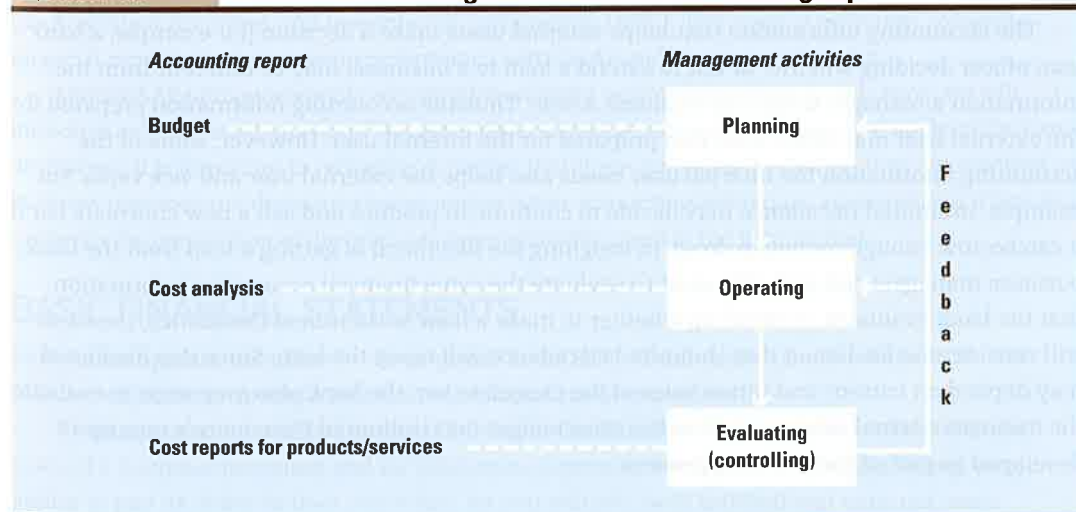
BUDGETS

Budgeting is the process of quantifying managers' plans and showing the impact of these plans on the business's operating activities and financial position. Managers present this information in a report called a *budget* (or *forecast*). (These will be discussed in more detail in Chapter 3.) Once the planned activities have occurred, managers can evaluate the results of the operating activities against the budget to make sure that the actual operations of the various parts of the business achieved the established plans. For example, Unlimited Decadence might develop a budget showing how many boxes of chocolate bars it plans to sell during the first three months of 2011. Later, after actual 2011 sales have been made, managers will compare the results of these sales with the budget to determine if their forecasts were 'on target' and, if not, to find out why differences occurred.

COST ANALYSIS

Cost analysis, or **cost accounting**, is the process of determining and evaluating the costs of specific products or activities within a business. Managers use cost analyses when making decisions about these products or activities. For example, Unlimited Decadence might use a cost analysis to decide whether to stop or to continue making the Divinely Decadent chocolate bar.

Exhibit 1.7 Activities of managers and related accounting reports



The cost analysis report might show that the chocolate bar is not profitable because it earns less than it costs to make. If this is the case, the fact that this chocolate bar does not make a profit will be one factor in the managers' decision. The business's managers also will have to resolve the ethical issue of whether to make redundant the employees who produced the chocolate bar.



Suppose you are a manager of a business that makes a food product thought to create major health problems after long-term use. What facts would you consider in trying to decide whether the business should drop the product or continue producing it?

COST REPORTS FOR PRODUCTS AND SERVICES

A cost report might show that total actual costs for a given month were greater than total budgeted costs. However, it might also show that some actual costs were greater than budgeted costs while others were less than budgeted costs. The detailed information will be useful for managers as they analyse why these differences occurred, and then make adjustments to the business's operations to help the business achieve its plans.

ACCOUNTING SUPPORT FOR EXTERNAL DECISION MAKING

8 How does accounting provide support and information to people making decisions who are external to the business?

Management accounting gives people inside a business vital information about the business and its performance, but the business also must provide business information about its performance to people outside the business. **Financial accounting** involves identifying, measuring, recording, summarising and then communicating economic information about a business to *external users* for use in their various decisions. **External users** are people and groups outside the business who need accounting information to decide whether or not to engage in some activity with the business. These users include individual investors, stockbrokers and financial analysts who offer investment assistance, consultants, bankers, suppliers, labour unions, customers, and local, state and federal governments and governments of countries in which the business conducts operations.

The accounting information that helps external users make a decision (for example, a bank's loan officer deciding whether or not to extend a loan to a business) may be different from the information a manager within the business needs. Thus the accounting information prepared for the external user may differ from that prepared for the internal user. However, some of the accounting information the internal user needs also helps the external user and vice versa. For example, Unlimited Decadence may decide to continue to produce and sell a new chocolate bar if it can borrow enough money to do so. In weighing the likelihood of getting a loan from the bank, business managers will probably want to evaluate the same financial accounting information that the bank evaluates. In deciding whether to make a loan to Unlimited Decadence, the bank will consider the likelihood that Unlimited Decadence will repay the loan. Since this likelihood may depend on current and future sales of the chocolate bar, the bank also may want to evaluate the business's actual sales, as well as the sales budget that Unlimited Decadence's managers developed as part of the planning process.



Say you have been offered a job at Unlimited Decadence. What economic information concerning Unlimited Decadence would you want to know about to help you decide whether to accept the job offer?

Guidelines for reporting to people outside the business

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Generally accepted accounting principles, or GAAP, are the currently accepted principles, procedures, practices and standards that businesses use for financial accounting and reporting in Australia, New Zealand and all over the world. These principles, or 'rules', must be followed and establish minimum disclosure requirements in the external reports of businesses that sell shares to the public and to many other businesses as well. GAAP covers such issues as how to account for inventory, buildings, income taxes and capital stock; how to measure the results of a business's operations; and how to account for the operations of businesses in specialised industries, such as the banking industry, the entertainment industry or the insurance industry. Without these agreed-upon principles, external users of accounting information would not be able to understand the meaning of this information. (Imagine if we all tried to communicate with each other without any agreed-upon rules of spelling and grammar!)

Several organisations contribute to GAAP through their publications (called pronouncements or standards). Accounting standards are important to protect the interests of investors, managers and the general public by establishing acceptable accounting procedures and the content of financial reports.

The Australian Accounting Standards Board (AASB) sets standards for Australian companies and government bodies. However, since 2005 the regulation of financial accounting and reporting has become globalised. International Financial Reporting Standards (IFRS) generated by the International Accounting Standards Board (IASB) are used globally in accordance with the objectives of the governing body. Companies whose shares are traded publicly in Australia report to the Australian Securities and Investments Commission (ASIC). This agency examines corporate financial reports to ensure their conformance with GAAP and the *Corporations Act*.

Many GAAP pronouncements are complex and very technical in nature. In this book, we will introduce only the basic aspects of the generally accepted accounting principles that apply to the issues we discuss. It is important to recognise, however, that these principles do change; they are modified as business practices and decisions change and as better accounting techniques are developed. They also underpin the preparation of the financial statements discussed in the next section.

BASIC FINANCIAL STATEMENTS

Businesses operate to achieve various goals. To do this, a business must first achieve its two primary objectives: *earning a satisfactory profit* and *remaining solvent*.

Profit (commonly referred to as *net income*) is the difference between the cash and credit sales of a business (*revenues*) and its total costs (*expenses*). **Solvency** is a business's long-term ability to pay its debts as they come due. As you will see, both internal and external users

analyse the *financial statements* of a business to determine how well the business is achieving its two primary objectives.

Financial statements are accounting reports used to summarise and communicate financial information about a business. A business's accounting system produces three major financial statements: the income statement, the balance sheet and the cash flow statement. It also produces a supporting financial statement: the statement of changes in owner's equity. Each of these statements summarises specific information that has been identified, measured and recorded during the accounting process.

Income statement

A business's **income statement** (Profit and Loss Statement) summarises the results of its operating activities for a *specific time period* and shows the business's profit for that period. It shows a business's revenues, expenses and net income (or net loss) for that time period, usually one year. Exhibit 1.8 shows what kind of information appears in an income statement. **Revenues** are the amounts earned by charging a business's customers for the goods or services the business provided to them. **Expenses** are the costs of providing the goods or services. These amounts include the costs of the products the business has sold (either the cost of making these products or the cost of purchasing these products), the costs of conducting business (called *operating expenses*) and the costs of income taxes, if any. The **net income** is the excess of revenues over expenses, or the business's **profit**; a **net loss** arises when expenses are greater than revenues. We will discuss the income statement further in Chapter 7 and throughout the book. The net result, profit or loss, is transferred to owner's equity, providing a link between the income statement and owner's equity section in the balance sheet.

Balance sheet

A business's **balance sheet** summarises its financial position on a *given date* (usually the last day of the time period covered by the income statement). It is also called a *statement of financial position*. Exhibit 1.9 shows what kind of information appears on a balance sheet. A balance sheet lists the business's assets, liabilities and owner's equity as at a given date. **Assets** are economic resources that a business owns and that it expects will provide future benefits to the business. **Liabilities** are the business's economic obligations (debts) to its creditors – people outside the business such as banks and suppliers – and to its employees. The **owner's equity** of a business is the owner's

Exhibit 1.8 What a business's income statement shows

Revenues

Here's where the business shows what it charged customers for the goods or services provided to them during a specific time period.

Expenses

Here's where the business lists the costs of providing the goods and services during that period.

Net income

This is the difference between revenues and expenses.

Exhibit 1.9 What a business's balance sheet shows**Assets**

Here's where the business lists its economic resources, such as cash, money owed to it by clients, inventories of its products, equipment and buildings it owns.

Liabilities

Here's where the business lists the obligations it owes to creditors, such as banks and suppliers, and to employees.

Owner's equity

Here's where the business lists the owner's current investment in the assets of the business.

current investment in the assets of the business, which includes the owner's contributions to the business and any earnings (net income) that the owner leaves in (or invests in) the business. A company's owners' equity is called **shareholders' equity**. We will discuss the balance sheet further in Chapter 8 and throughout the book.

Statement of changes in owner's equity

A business's accounting system frequently provides a supporting financial statement, called a **statement of changes in owner's equity**, to explain the amount shown in the owner's equity section of the business's balance sheet. Exhibit 1.10 shows the kind of changes in owner's equity that appear on this statement. Net income earned during the period increases the owner's investment in the business's assets (and the assets themselves) as the owner 'reinvests' the profit of the business back into the business. Similarly, additional contributions of money by the owner to the business during the time period also increase the owner's investment in the business's assets (and the assets themselves). On the other hand, a net loss, rather than a net income, decreases the owner's investment in the business (and the business's assets), as does the owner's

Exhibit 1.10 What a business's statement of changes in owner's equity shows**Beginning owner's equity**

Here's where the business shows the owner's equity amount at the beginning of the period (the last day of the previous period). This amount also appears on the balance sheet on the last day of the previous period.

+ Net income

Here's where the business adds the net income from the current period's income statement (the profit that the business earned during the period).

+ Owner's contributions

Here's where the business adds any additional contributions to the business that the owner made during the period.

- Withdrawals by owner

Here's where the business subtracts any withdrawals of cash from the business that the owner made during the period.

Ending owner's equity

Here's where the business shows the resulting owner's equity amount that also appears on the business's balance sheet on the last day of the period.

choice to remove (or withdraw) money from the business ('disinvesting' the profit from the business). We will discuss this further in Chapter 7 and throughout the book.



What is the link between the income statement and the balance sheet?

Cash flow statement

A business's **cash flow statement** summarises its cash receipts, cash payments and net change in cash for a specific time period. Exhibit 1.11 shows what kind of information appears in a cash flow statement. We will discuss the cash flow statement further in Chapter 9 and throughout the book.

A business may publish its income statement, balance sheet and cash flow statement (and statement of changes in owner's equity), along with other related financial accounting information, in its **annual report**. Many businesses (mostly companies) do so.



Why is it important to analyse cash flows for a business in any given period?

9 What roles do ethics and sustainability play in the business environment?

ETHICS IN BUSINESS AND ACCOUNTING

A business's financial statements are meant to convey information about the business to internal and external users in order to help them make decisions about the business. But if the information in the financial statements does not convey a realistic picture of the results of the business's operations or its financial position, the decisions based on this information can have disastrous consequences.

Consider the fallout from **Enron Corporation's** 2001 financial statements.^a On 1 October 2001, Enron was the seventh-largest business in the United States, employing 21 000 people in more than 40 countries. It was also the largest energy trading business in the United States. *Fortune* magazine had ranked Enron 24th in its '100 Best Businesses to Work for in America' in the year 2000.^b Its stock was trading for about \$US83 per share. Two weeks later, after reporting incredible profits for its first two quarters (January to June) of 2001, Enron reported a third-quarter (July to September) loss, in part because of adjustments caused by previously misstated profits. But by 1 November, **JP Morgan Chase** and **Citigroup's** Salomon Smith Barney had attempted to rescue Enron by extending the business an opportunity to borrow \$US1 billion (above what Enron already owed them). On 19 November, Enron publicly acknowledged that its financial statements did not comply with GAAP in at least two areas.

Exhibit 1.11 What a business's cash flow statement shows

Cash flows from operating activities

Here's where the business lists the cash it received and paid in selling products or performing services for a specific time period.

Cash flows from investing activities

Here's where the business lists the cash it received and paid in buying and selling assets such as equipment and buildings.

Cash flows from financing activities

Here's where the business lists the cash it received and paid in obtaining and repaying bank loans, and from contributions and withdrawals of cash made by the business's owners.

This failure resulted in huge misstatements on Enron's financial statements: assets and profits were overstated, and liabilities were understated. On 2 December 2001 Enron declared bankruptcy.

The rapid demise of one of the largest, and what appeared to be one of the most successful, businesses in the world to the largest corporate failure in the United States created a wave of economic and emotional effects and ramifications around the world. Before Enron reported a third-quarter loss, its stock was selling for around \$US83 per share. After Enron reported its loss, its stock dropped to \$US0.70 per share – a total drop in market value of almost \$US60 billion. Most of those who had purchased shares of Enron stock lost money. Many lost hundreds of thousands of dollars! The Enron employees' pension plan, 62 per cent of which was Enron stock, lost nearly \$US2.1 billion, virtually wiping out the retirement savings of most of Enron's employees, many of whom were nearing retirement age. Close to 5600 Enron employees were laid off from their jobs. Enron left behind approximately \$US63 billion in debts, with JP Morgan owed \$US900 million and Citigroup up to \$US800 million. Many banks around the world were also affected by having lent money to Enron.

In addition to these after-effects, the Justice Department prosecuted the accounting firm **Arthur Andersen**, Enron's auditor. It claimed that Andersen had interfered with a federal investigation of Enron's collapse by shredding paperwork related to Andersen's audit of Enron. Two Andersen executives – a partner and an in-house attorney – had reminded employees of Andersen's document destruction policy during the time that the Justice Department was investigating Enron's failure, resulting in large-scale shredding of the Enron documents. A jury found Andersen guilty. As a result, Arthur Andersen, a highly respected accounting firm and bastion of integrity, relinquished its accounting licence, preventing it from conducting audits. Andersen, a once-thriving business of 28 000 employees shrivelled to 200. Ironically, too late for the employees who had lost their jobs, the US Supreme Court found that the jurors in this case had received improper instructions and it rejected the Justice Department's claim, vindicating Arthur Andersen.^c

Ethical behaviour on the part of all of Enron's managers would not have guaranteed the business's success. However, it could have prevented much of the damage suffered by those inside and outside the business, including those who depended on Enron's financial statements to provide them with dependable information about the business.



Do you think JP Morgan or Citigroup would have lent Enron as much money if Enron had not overstated its net income and assets, and understated its liabilities? Why or why not? What might Enron's employees have done differently if Enron's financial statements had been properly stated?

Enron was not the first, nor (unfortunately) will it be the last, business to get into trouble for misleading financial reporting. While it seems clear that some of what Enron's managers, and those of some other businesses, disclosed on their financial statements was wrong, many business and accounting issues and events in the business environment cannot be interpreted as absolutely right or wrong. Every decision or choice has pros and cons, costs and benefits, and people or institutions who will be affected positively or negatively by the decision. Even in a setting where many issues and events fall between the extremes of right and wrong, it is very important for accountants and businesspeople to maintain high ethical standards.



Can you think of a business from the Asia-Pacific region where in recent times ethical business practices seemed to be lacking?

Professional organisations' codes of ethics

The International Federation of Accountants (IFAC) is an independent, worldwide organisation. Its stated purpose is to 'develop and enhance a coordinated worldwide accountancy profession with harmonised standards'. As part of its efforts, it has developed a code of ethics for accountants in each country to use as the basis for founding their own codes of ethics. Because of wide cultural, language, legal and social diversity of the nations of the world, the IFAC expects professional accountants in each country to add their own national ethical standards to the code to reflect their national differences, or even to delete some items of the code at their national level. The code addresses objectivity, resolution of ethical conflicts, professional competence, confidentiality, tax practice, cross-border activities and publicity. It also addresses independence, fees and commissions, activities incompatible with the practice of accountancy, clients' money, relations with other professional accountants, and advertising and solicitation.

In Australia, the members of professional bodies such as CPA Australia, Institute of Chartered Accountants in Australia (ICAA) and the Institute of Public Accountants (IPA) adopt the Code of Ethics for Professional Accountants developed by the Accounting Professional and Ethical Standards Board (APESB), which is based on the IFAC code of ethics.^d

Ethics at the business level

In our society, we expect people to behave within a range of civilised standards. This expectation allows our society to function with minimal confusion and misunderstanding. Similarly, accounting information developed by businesses in an ethical environment allows our economy to function efficiently, and enables users to direct or allocate our resources productively. In both our personal and our business lives, ethics and integrity are our 'social glue'.



SUSTAINABILITY IN BUSINESS

We often hear reports about businesses' negative impacts on the environment and disregard for society. What is clear is that businesses must play a key role if we are to become globally sustainable. There are in fact many businesses working to become more environmentally sustainable as well as more socially responsible. It is clear these businesses are doing this because there is a range of benefits, including improving business reputation, reducing costs and strengthening communities in which they operate, but also because of improved profitability. The issue for accountants is that environmental and social impacts are often business costs. However, good environmental management and social responsibility tend to improve long-term profitability rather than reduce it. Given that investors place a high value on environmental responsibility and many people are now willing to pay more for products and services that are environmentally friendly, it is in the interest of businesses to be 'green'. Consider the key elements that impact on most businesses, the use of water and energy, and generation of waste. These are costs to the

business and thus more efficient management can lead to considerable cost savings, and often facilitate new income streams from recycling or reusing materials and emissions rather than putting them in landfill or into the atmosphere.

In many contexts sustainable business is taken as referring to green business or enterprise that has no negative impact on the global or local environment, community, society or economy. A sustainable business is one that ensures that all processes, products and activities, while maintaining a profit, address current environmental concerns. Business **sustainability** requires proactive business management and a strategic approach if the best results for the business are to be achieved. Business sustainability is an overarching concept that involves doing everything better and more efficiently, and makes good business sense because the benefits feed directly back into the bottom line. There are many factors that contribute to longevity in terms of business survival and growth, and improvement. The first is that a business needs to operate efficiently and productively in order to remain profitable and allow the business to grow. The second is that a business must engage responsibly and ethically with the triple bottom line issues it faces. There is more on this in Chapter 10.

THE ACCOUNTANT OF THE 21ST CENTURY

In this section we discuss the broad skills needed by businesspeople to do business effectively in a changing environment. These same skills, as well as others, also apply to accountants, and make accountants more effective in dealing with their clients. In the last decade, the professional bodies, academics and employers have reframed these broad skills into a set of core competencies that all university graduates entering the *profession of accountancy* should possess.

In Australia, the Threshold Learning Outcomes for accounting graduates were devised as part of the Learning and Teaching Academic Standards project, in consultation with the accounting community. These outcomes, as shown in Exhibit 1.12, have been defined under the following headings: Judgement, Knowledge, Application skills, Communication and teamwork, and Self-management. Each of these skills is discussed in the following sections.^e

Judgement, knowledge and application skills

The large accounting firms and the accounting community in general recognise that gathering information, interpreting it and effectively communicating it to others relies on the businessperson's knowledge base and ability to integrate theoretical and technical knowledge of accounting and other relevant areas. First, accountants must have accounting knowledge, including the ability to construct accounting data, as well as the ability to use this data to make decisions, to exercise judgements, to evaluate risks and to solve problems in a range of contexts. Knowledge of related areas, such as auditing and assurance, finance, economics, quantitative methods, information systems and applicable laws is also necessary. In addition to knowledge of accounting, accountants must have a knowledge base and skills that support *applying* accounting knowledge and technical skills to solve accounting problems. **General knowledge** encompasses knowledge about history and cultures; an ability to interact with people who have dissimilar

10 What skills do accountants of the 21st century require?

Exhibit 1.12 Threshold Learning Outcomes for Accounting

	Bachelor graduates in Accounting will be able to:
Judgement	Exercise judgement under supervision to solve routine accounting problems in straightforward contexts using social, ethical, economic, regulatory and global perspectives
Knowledge	Integrate theoretical and technical accounting knowledge which includes a selection of auditing and assurance, finance, economics, quantitative methods, information systems, commercial law, corporation law and taxation law
Application skills	Critically apply theoretical and technical accounting knowledge and skills to solve routine accounting problems
Communication and teamwork	Justify and communicate accounting advice and ideas in straightforward collaborative contexts involving both accountants and non-accountants
Self-management	Reflect on performance feedback to identify and action learning opportunities and self-improvements

Source: Learning and Teaching Academic Standards Project, Business, Management and Economics, Learning and Teaching Academic Standards Statement for ACCOUNTING, December 2010, Australian Learning and Teaching Council, p 10
http://www.altc.edu.au/system/files/altc_standards_ACCOUNTING_090211.pdf

ideas; a sense of the contrasting economic, political and social forces in the world; and experience in making value judgements. Accountants also need to have **organisational and business knowledge**, which includes an understanding of the effects of economic, social, cultural and psychological forces on businesses; an understanding of how businesses work; an understanding of methods and strategies for managing change; and an understanding of how technology helps organisations. An accountant must also be able to apply their skills to new situations and, in a logical manner, use their knowledge and skills to produce answers to accounting problems. The ability to apply knowledge to solve problems will also require a certain level of proficiency in information technology. There are many problems that require judgement, such as the choice of inventory and depreciation method, decisions about whether to capitalise or expense costs, or measures to be taken following a variance from budget.

Communication and teamwork skills

An accountant's job involves both collecting and communicating information. A key part of collecting information is knowing where to look for it. Although some information may be located in routine places, such as sales invoices, the accountant must be ready to look beyond the routine. Information may appear in written form (such as documents, written procedures, reports, journals and reference materials), in electronic form or in verbal form (such as conversations or presentations).

To gather information from both written and verbal sources, an accountant must be a proficient reader and listener, and possess an appropriate level of information technology proficiency. In this case, reading and listening mean more than they appear to at first glance. To be useful, the information gathered must be *relevant* to the decision at hand. The accountant must be able to interpret information, decide whether it is relevant and then filter out everything else. So the accountant cannot be just a casual reader or listener. Rather, the accountant must *analyse* the information he or she reads or hears, actively trying to understand it by considering both its context and its source. Context includes such aspects as the perspective or bias of the

information source, how the information was developed and what assumptions were made in developing the information. To gain this understanding the accountant must use critical thinking skills, which we will discuss later in the chapter.

Accountants also communicate information. They must be able to present their ideas coherently to people at different levels of the company (all the way up to the chair of the board of directors) and also to people outside the company, who have different interests and backgrounds as well as various levels of accounting and business understanding. These ideas may be presented formally or informally, in written or oral form. An accountant, then, must also be an effective speaker and writer. Accountants must be able to justify and communicate accounting advice and ideas in routine collaborative contexts involving both accountants and non-accountants.

Although working with numbers may be the most familiar aspect of an accountant's job (have you ever heard accountants referred to as 'number crunchers' or 'bean counters?'), working with people is *just as important*. Accountants collect information from some people and communicate it to others. They work on team projects, act as leaders within departments and also serve on teams that span the entire company. Since accountants advise managers and board members, they must possess the same interpersonal skills that a competent manager or board member possesses. These skills include the ability to lead and influence others, to motivate others, to withstand and resolve conflict, and to organise and delegate tasks.

Self-management skills

To be successful in business it is necessary to understand a range of business contexts. As the world of business changes constantly, it is also important that those involved in the business world, particularly accountants, take responsibility and be accountable for their own continuous learning in order to keep abreast of current issues. An ability to reflect on performance feedback is important in order to identify and action learning opportunities leading to self improvement.

Critical thinking skills are necessary and complementary skills for successful, efficient problem solving and decision making. However these skills do not necessarily come naturally. You might be an extremely creative thinker but not a good critical thinker. Similarly, you might be a very capable critical thinker but not very good at thinking 'outside the box'. The accountant needs to be an analytical thinker and must be innovative and able to apply critical thinking to problem solving and decision making within the business world.

CRITICAL THINKING

Most of us tend to consider thinking, like breathing, to be a natural function. We all do it. (After all, isn't thinking supposed to distinguish us from other animals?) However, *critical thinking* takes practice, just like tennis. Few people expect to be good at tennis their first time on the court. At first, *bad tennis* seems to be the norm. But with practice aimed at improving and at learning new forms and specific techniques, *better tennis* comes more naturally. In the same way, practising critical thinking, including new 'forms and techniques', makes it more natural. Awareness of our current thinking patterns helps us recognise our strengths and weaknesses; this knowledge gives us a starting point for modifying and improving our thinking performance.

11 How can people learn to think critically?

Critical thinking is the process that evaluates ideas. Critical thinking determines if any of the ideas will work, what types of problems there might be, whether ideas can be improved and which ones are better than others. To be a successful critical thinker, you have to be in the right frame of mind, use the thought processes and actions necessary for thinking critically, and constantly watch and monitor your thinking (much as a tennis player watches her game).

Characteristics of the critical thinker

Above all, the critical thinker values truth rather than the *appearance* of truth. For example, in looking for the truth, critical thinkers must be independent and objective. Being **independent** means that in the process of evaluating ideas, the critical thinker must rely on his or her own conclusions rather than those of others. This doesn't mean that the critical thinker is a know-it-all – just that he or she doesn't accept the beliefs of others without questioning where those ideas came from, what evidence supports them and what assumptions were made in developing the ideas.

Objectivity, the quality of being unbiased, is a very difficult characteristic to achieve, but one that critical thinkers must have if they value truth. All people select, organise and interpret information based on their own perceptions, beliefs and past experiences. Even when we are trying very hard to understand someone else's point of view, we tend to say to ourselves, 'Here is how I would feel if I were in that situation ... therefore, he must feel the same way'. We tend to unconsciously impose our own perceptions, beliefs and past experiences on our understanding of information, ideas and other people, which may bias the outcome. Besides being willing to consider new ideas and information, critical thinkers know that they may have biases and prejudices that keep them from true understanding, and that they must try to eliminate these biases from their thinking. By realising that their viewpoints are a product of their unique experiences, critical thinkers are better able to really listen for and try to understand other viewpoints.

In order to strive towards independent, objective thinking, critical thinkers develop openness to new and different ideas, as well as empathy for other points of view. Have you ever encountered a 'know-it-all'? Do you remember feeling frustrated that this person did not listen to your perspective or to your contributions to the conversation? As you have probably experienced, a 'know-it-all' assumes that there is no more to learn about a subject. Unfortunately, this assumption blocks that person's receptivity to new information and new perspectives about the subject. How much more could the 'know-it-all' learn by keeping an open mind? Furthermore, could this person make better decisions by acknowledging the limits of his or her own knowledge and by making use of all available relevant information?

Critical thinkers also *tolerate ambiguity* and willingly *defer judgement* until they can collect more information and consider and evaluate other solutions. Many problems involve complex issues with multiple interpretations and numerous good solutions. Critical thinkers must think creatively, and they do not accept the first solution generated as necessarily being the best solution. Critical thinkers recognise that 'good' ideas are often relative rather than absolute (for example, 'higher quality', 'more probable' and 'more objective'). So even though many ideas may satisfy the critical thinker's values and criteria, some ideas may be better than others.

Finally, critical thinkers *have the courage of their own convictions*. Have you ever had an idea that you *knew* was right (after analysing and evaluating other ideas and viewpoints), but nobody

else agreed with you? Conviction is what kept you from caving in to the majority opinion and keeps you going when the going gets tough. As we said before, many problems in business are complex and multifaceted. Identifying problems, finding solutions and overcoming all the obstacles and frustrations along the way takes perseverance.

You can develop and improve the critical thinking characteristics we have just discussed. Exhibit 1.13 lists some questions you can ask yourself when you are trying to think critically; these questions will help you improve your critical thinking.

Strategies of the critical thinker

To make sense of the world, to develop solutions to complex problems, to deal with ambiguous issues and to make decisions, the critical thinker must apply a variety of thinking and reasoning strategies to the thought process. First, the critical thinker must be able to define, clearly and precisely, the problem or issue at hand. Without a clear and precise definition of the problem, it is almost impossible to generate the best solution – how could you identify the relevant information for solving it?

APPLYING CRITICAL THINKING TO BUSINESS DECISIONS

Every day of our lives we must solve problems and make decisions ranging from minor issues, like what to have for breakfast, to major issues, like which career to choose. Think about your breakfast decision this morning. To choose what to have for breakfast you had to gather certain information, such as what type of food you had available to eat, how much of this food was available (did you ever pour a bowl of cereal only to find that there wasn't enough milk in the refrigerator?), what type of food you could tolerate in the morning, when your next meal would be, what activities you had planned for the day, the nutritional content of the food, which dishes were clean and how much time the food would take to prepare. After evaluating all the facts, you were able to make a decision.

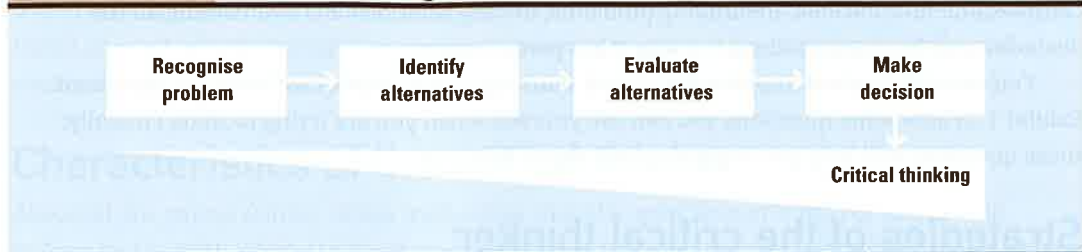
A simple problem like choosing what to have for breakfast does not require complex analysis (although you may need a quick shower first, to wake you up). However, many business problems can involve a jumble of information, opinions, considerations, risks and alternatives. A systematic method, including creative and critical thinking, is necessary to organise the

12 How can critical thinking help people make better business decisions?

Exhibit 1.13 Questions for critical thinkers to ask themselves

- If an issue is controversial, do I accept my initial reaction to it, or do I debate the issue in my head first?
- Do I tend to reject new evidence that contradicts my current opinion on a subject, or do I evaluate the new evidence and then decide whether to accept it or reject it?
- When I am trying to solve a problem, do I usually accept the first solution that 'works', or do I generate multiple solutions and then choose the best one?
- When others disagree with me, do I usually listen to them with an open mind and critically evaluate their ideas, or do I try to defend my own ideas?

Exhibit 1.14 Critical thinking and four stages in problem solving and decision making



problem-solving approach and to decide on a solution to the problem. Exhibit 1.14 illustrates the four stages in decision making and the particular impact of creative and critical thinking on each stage. Note that **creative thinking** might be more important in the earlier stages, while critical thinking is more important in the later stages. We will discuss these stages of decision making in the next four sections.

13 What are the logical stages in problem solving and decision making?

Recognising and defining the problem

The first stage in solving a problem is the recognition and definition of the problem for which a decision must be made. As we suggested earlier in the chapter, the chances of arriving at a successful solution to a problem are considerably reduced if the decision maker does not have a clear understanding of the problem. An incorrectly defined problem will lead to an unproductive course of action at best, and could actually create new problems or make the current problem worse. To fully understand the problem, the decision maker needs to gather the facts surrounding the problem, identify the objectives that would be achieved by solving the problem and clearly state the problem.

For example, consider the situation facing Josh Dooright, a manager at Unlimited Decadence Corporation. Josh's newly health-conscious boss, Graham Wheatley, has asked if it is possible to manufacture and sell a new fat-free, sugarless chocolate bar to be called 'Empty Decadence'. Josh doesn't want to make a hasty decision, so he uses his thinking skills to brainstorm a list of questions he has about the idea. Josh's first list looks like this:

- 1 Why does Wheatley want us to manufacture this new chocolate bar?
- 2 When must a decision be made?
- 3 Who inside the business would be affected by a decision to manufacture and sell this new chocolate bar? How would they be affected?
- 4 Who outside the business would be affected by a decision to manufacture and sell this new chocolate bar? In what ways would they be affected?
- 5 How can I break this decision down into smaller parts?
- 6 What additional information do I need to make a decision?
- 7 Where can I find additional information?



Why do you think it is important to know who will be affected by a business decision and how they will be affected?

Answers to these questions will no doubt lead to further, more probing questions such as the following:

- 8 Can we manufacture an incredibly delicious, sugarless, fat-free chocolate bar that meets the business's standards of excellence?
- 9 How long would it take to develop, market and manufacture this new chocolate bar?
- 10 Who would buy this new chocolate bar?
- 11 Will people stop purchasing the popular Pure Decadence chocolate bar and instead buy the new Empty Decadence chocolate bar? Or will people who typically avoid buying chocolate bars be tempted by the fat-free, sugarless qualities of the Empty Decadence, leaving sales of the Pure Decadence chocolate bar virtually unaffected, thereby increasing total customers and total sales?
- 12 What kind of competition would this new chocolate bar face?
- 13 At what price could the company sell the new chocolate bar?
- 14 What resources would the company need to acquire in order to manufacture this new chocolate bar? Are these resources available?
- 15 What would the additional costs be? Does Unlimited Decadence have access to additional financing, if necessary?
- 16 Would additional people need to be hired? What qualifications and skills should these people have? What is the probability of finding people with these qualifications and skills?
- 17 Would production of the new chocolate bar force Unlimited Decadence to comply with additional government regulations?
- 18 Would any of the ingredients, such as sugar substitutes or flavourings, pose health risks?
- 19 How can we package the product to limit waste or promote recycling?



In trying to decide whether or not it is possible to manufacture an incredibly delicious, sugarless, fat-free chocolate bar that meets the company's standards of excellence, what else might you ask?

Now that Josh has an initial list of questions, he brainstorms about where he might find answers to them. In this case, Josh's sources of information would include such people as suppliers, customers and potential customers (through market surveys), as well as the company's marketing managers, production managers, chief financial officer and accountants, environmental control managers, distribution managers and human resources managers. As we mentioned earlier in our discussion of critical thinking, Josh would need to analyse information from these sources for faulty logic, unsupported assumptions and emotional appeal, and would need to determine the credibility of these sources of information and the nature of evidence supporting the information. Josh would then need to synthesise the information received from separate sources into an understandable 'whole', or a clear statement of the problem.

In identifying the objectives that would be achieved by manufacturing and selling the new chocolate bar, Josh would need to determine what it is that his boss would like to achieve by having Unlimited Decadence manufacture the Empty Decadence chocolate bar. Josh surmises that Wheatley wants to:

- 1 satisfy customers who have a desire for chocolate but not the accompanying calories
- 2 enhance Unlimited Decadence's reputation for being an industry leader and an innovator

- 3 increase the market share (that is, get a greater percentage of all chocolate sales, perhaps by bringing in people who have a sweet tooth but who haven't been buying Unlimited Decadence products because of the fat and sugar)
- 4 increase profit for the company.

After using critical thinking skills to gather, analyse and synthesise the facts about the problem and the results that could be achieved by solving the problem (from all perspectives), Josh should have a better understanding of the problem. This understanding will allow Josh to state the problem more clearly and in more detail than he did in the original problem statement, perhaps even allowing for a division of the problem into smaller parts. Exhibit 1.15 shows the memo that Josh wrote to Wheatley outlining the problem.

Identifying alternative solutions

After the problem has been clearly defined and stated, the problem solver identifies alternative solutions. Generating numerous alternative solutions makes it more likely that at least one will be workable.

Discussing the problem and possible solutions with other people can help identify alternative solutions. By talking with people who are uninvolved with or unaffected by the problem or its solution, Josh is likely to get a more objective assessment of the problem or perhaps an entirely new perspective on it. **Brainstorming** with a group would generate plenty of ideas from which to choose workable solutions. Josh decides to call a meeting of several people from all areas of the company to join a brainstorming team.

After generating a list of ideas, the team must critically evaluate them to identify potentially workable solutions. To be workable, the solutions must fit within the boundaries or limits of the company. For instance, the chief financial officer tells the brainstorming team that the company

Exhibit 1.15 Josh's memo outlining the problem

24 September 2011
 TO: Graham Wheatley
 FROM: Josh Dooright
 SUBJECT: Empty Decadence

Dear Mr Wheatley

You asked me if it is possible to manufacture and sell a new fat-free chocolate bar to be called 'Empty Decadence'. I have thought about this for several days and would like to know whether I completely understand the assignment. I presume that you would like Unlimited Decadence to manufacture and sell a new chocolate bar while at the same time achieving the following objectives:

- 1 satisfy customers who have a desire for chocolate without the accompanying calories
- 2 enhance our reputation as an innovator and industry leader
- 3 increase our market share
- 4 increase our profit.

Am I on target? I would appreciate your response in the next day or two.

Thanks

Josh Dooright

can borrow only \$400 000 to launch the new product; the purchasing officer lists for the team all the available suppliers of ingredients; the production manager reminds the team that Valentine's Day orders will keep managers so preoccupied and production employees so swamped that work on the new product cannot begin until after 14 February; and the cleaning crew supervisor informs the team that because the company uses only pure mountain spring water to clean the machines every day, the factory must be located in the mountains. Given this new information, the team comes up with several workable alternatives:

- 1 Don't manufacture or sell the new Empty Decadence chocolate bar, and stay with the status quo. (This may be workable but it may not achieve Wheatley's objectives.)
- 2 Because \$400 000 is not enough to expand the factory, use post-Valentine's Day available space in the current factory to manufacture and sell only a small number of Empty Decadence chocolate bars to market test the concept before beginning full-scale production.
- 3 Drop the Decadent Thunderbolt chocolate bar product line (which many customers stopped purchasing because it kept them awake at night), and convert the production resources so they can be used for manufacturing the Empty Decadence chocolate bar. Manufacture and sell a large number of new chocolate bars (without test marketing the concept).



Can you think of other possible alternatives for solving this problem?

Weighing the advantages and disadvantages of each solution

After the team identifies potentially workable solutions, Josh must evaluate each of them. Critical thinking becomes paramount at this stage.

In this example, accounting information is useful in evaluating each solution because each is likely to have different economic effects. Accounting information that is relevant to Josh in weighing the advantages and disadvantages of each solution includes information about the solution's effect on the company's costs, profits and related income taxes, as well as its effect on the timing of cash receipts and payments. Furthermore, if the Decadent Thunderbolt product line is dropped, Josh must also consider the accompanying change in profits caused by dropping this product line, as well as the change in profits caused by the movement of the Decadent Thunderbolt customers to other chocolate bars.

After gathering accounting and other information for each alternative, Josh can list the advantages and disadvantages of each alternative. For example, Exhibit 1.16 shows Josh's list of advantages and disadvantages for alternative 2: '... manufacture and sell only a small number of Empty Decadence chocolate bars to market test the concept before beginning full-scale production.' Josh should evaluate the advantages and disadvantages of each workable solution in this way in order to fully understand each alternative solution.



Can you think of advantages and disadvantages of not manufacturing and selling the new chocolate bar?

Exhibit 1.16**Josh's list of advantages and disadvantages for manufacturing and selling only a small number of Empty Decadence chocolate bars**

Advantages	Disadvantages
<ul style="list-style-type: none"> • This alternative will require a smaller initial investment in factory equipment and personnel than would the full-scale production alternative. • With this alternative, Unlimited Decadence has less to lose if the Empty Decadence chocolate bar does not sell as predicted than it would lose if the full-scale production alternative is implemented and sales of the Empty Decadence chocolate bars are less than predicted. • Feedback from the test market can be used to improve the Empty Decadence chocolate bar before it is marketed nationally. • Positive market response to the Empty Decadence chocolate bar might open up new sources of financing for further expansion of the factory. • A new group of customers might be tapped because of the sugarless, low-fat nature of the Empty Decadence chocolate bar. 	<ul style="list-style-type: none"> • A market failure could damage the reputation of the business. The cost of additions to the factory and personnel could outweigh the money brought into the company through the sale of the Empty Decadence chocolate bar. • Company employees assigned to produce the Empty Decadence chocolate bar would be spending time that would otherwise be contributing to the production and sale of well-established chocolate bars. • While Unlimited Decadence is test marketing the Empty Decadence chocolate bar, the company's competitors could launch a successful full-scale market blitz with a similar chocolate bar.

Choosing a solution

The first three stages of the problem-solving process break down the problem in a systematic and detailed manner so that Josh becomes completely familiar with the problem and its possible solutions. After these first three stages, Josh must choose the best solution from the alternative workable solutions. Josh makes the product decision based to a great extent on the accounting information gathered in the previous stage, in which he evaluated the alternatives. However, even after the advantages and disadvantages of each alternative have been listed and quantified (when possible), the choice of a solution can be difficult. This is because individual advantages and disadvantages weigh differently in the decision and are hard to compare. One technique that is useful in ordering the alternatives is to rank them based on their effectiveness in achieving the desired results, and then also to rank them based on their desirability in terms of the company's value system. For example, suppose the company values an innovative image more than one of stability. In this case, the second and third alternatives would rank higher than the first. Another technique that is useful in choosing a solution is to combine the best features of multiple alternative solutions while eliminating some of the disadvantages that each alternative would have if it alone was selected.

The decision-making process is similar for people who are outside the company and are making decisions about the company. For example, assume Unlimited Decadence applies for a three-year bank loan of \$400 000. When this request is made, the banker recognises that a decision must be made about granting the loan. For the banker there are many alternatives, including refusing the bank loan, granting a loan of a smaller or greater amount for a shorter or longer time, or granting the loan as requested. The banker must have information concerning the cash in Unlimited Decadence's cheque and savings accounts, the cash Unlimited Decadence must spend to pay its bills and the amount it expects to collect from its customers, the timing of these payments and collections, and the way in which the bank loan would be used. By gathering the related accounting information, the banker can evaluate whether Unlimited

Decadence needs the bank loan, the appropriate amount and length of time of the loan, and the likelihood that Unlimited Decadence will repay the loan. The banker makes the loan decision, to a great extent, on the basis of accounting information provided by Unlimited Decadence.

Accounting information and decision making

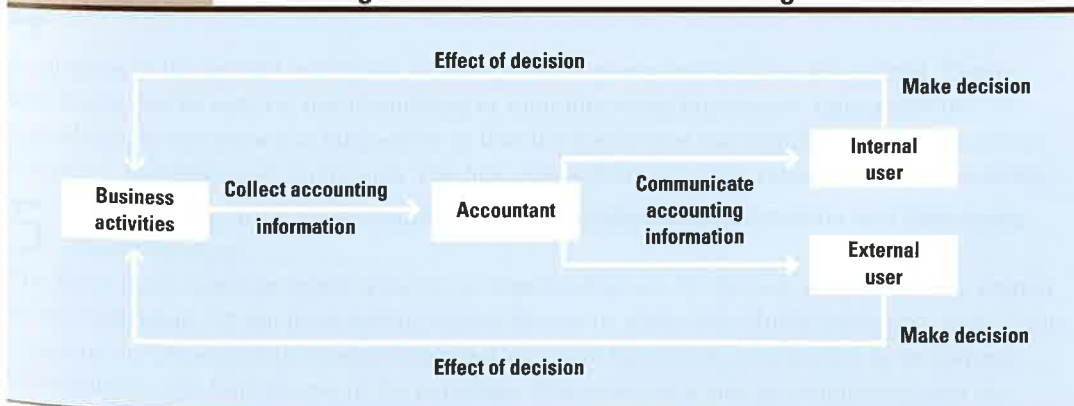
The role of accounting information in the decision-making process is further illustrated in Exhibit 1.17. As this exhibit illustrates, the accounting information system and decision making are *interactive*; that is, an accountant collects information about a company (locates, gathers, interprets and organises relevant information) and communicates this information to both internal and external users to assist them in making decisions. These decisions have an impact on the company's activities, which then have an impact on the company's resulting accounting information (as is reflected when the accounting information accumulation and communication process is repeated again).

For the bank loan and product decisions, you can see that the decisions made by both the internal and the external users will affect the accounting information accumulated and communicated about the company. Before either decision is reached, the information accumulated and communicated will be the information needed to make the decisions, as we discussed earlier. After the decisions are made, regardless of the alternative chosen (whether or not the bank grants a loan to Unlimited Decadence and whether or not Unlimited Decadence manufactures and sells the Empty Decadence chocolate bar), the result of the decision will affect Unlimited Decadence's future activities and, in turn, result in different accounting information about the company.

ORIENTATION OF THE BOOK

In the rapidly changing business environment, the businessperson must interpret, evaluate, synthesise and apply new information and technology. With this new information and technology come new problems, many of which have several reasonable solutions and many of which may not have obvious solutions or any solutions. In this environment, businesspeople and accountants are

Exhibit 1.17 Accounting information and decision making



not operating in a 'textbook world', where there are clear-cut right and wrong answers and where the relevant facts for making decisions are neatly laid out. Therefore, to help you prepare for this challenging environment, throughout this book we will illustrate the use of critical thinking and judgement skills for solving accounting-related problems. Then, in the Integrated Business and Accounting Situations at the ends of chapters, we will give you the opportunity to enhance your own thinking and judgement skills. In addition to solving problems that have specific 'correct' solutions, we will ask you to make decisions and to solve problems that may have several reasonable solutions or obscure solutions. We will also ask you to interpret, evaluate and synthesise information and to apply new information to new and different situations.

FRAMEWORK OF THE BOOK

Now that you have been introduced to business and accounting, and the skills required to be a good business manager or accountant in a global business environment, it is time to begin a more in-depth study of the use of accounting information in the business environment.

Beginning in Chapter 2 we will discuss, in more depth, accounting and its use in the management activities of planning, operating and evaluating, starting with a simple business. In later chapters, we will progress through more complex businesses. We will also discuss the use of accounting by decision makers outside the business.

As you read through the book you will begin to notice that the same topics re-emerge, but each time, a topic will be refined or enhanced by a different business structure, a different type of business or a different user perspective. You will also notice that we continue to discuss ethical and sustainability considerations. That's because ethical and sustainability considerations exist in all aspects of business and accounting. By constantly practising critical thinking, judgement and problem solving, we know you will also be developing self-management skills.

You will also notice that international issues appear again and again. Many businesses operating in Australia and New Zealand have home offices, branches and subsidiaries in other countries or simply trade with businesses in foreign countries. Managers must know the implications of conducting business in foreign countries and with foreign businesses. External users of accounting information also must know the effects of these business connections.

Summary

At the beginning of the chapter we asked you several questions. During the chapter, we asked you to STOP and answer some additional questions to build your knowledge about specific issues. Be sure you answered these additional questions. Below are the questions from the beginning of the chapter with a brief summary of the key points relating to the answers. Use your thinking skills to expand on these key points to develop more complete answers to the questions and to determine what other questions you have that might lead you to learn more about the issues.

1 Why is it necessary to have an understanding of business before trying to learn about accounting?

Accounting involves identifying, measuring, recording, summarising and communicating economic information about a business for decision making. It focuses on the resources and activities of businesses. Therefore, you need to understand businesses and the business environment in which they exist before trying to learn how to account for their resources and activities.

2 What factors are causing the business environment to change?

The business environment is dynamic and is becoming increasingly complex. More information is being generated than ever before, and this information is available to more people than ever before. Technology is advancing rapidly, affecting not only the products we use but also the way the products are manufactured and the way business is conducted. Business activities and economies are becoming globalised, the number of regulations is escalating, business transactions are becoming more complex and new forms of business are emerging.

3 How does someone become a successful businessperson in a complex business environment?

The successful businessperson must be willing and able to adapt to change. Because of the dynamic and complex business environment, the successful businessperson must be able to take change in their stride, be devoted to lifelong learning, be open to other viewpoints, be tolerant of differences, be willing to take educated and thoughtful risks, be able to anticipate environmental trends and identify the potential problems and opportunities associated with these trends, and be ready to abandon old plans and change course in light of new information.

4 What is private enterprise and what forms does it take?

Businesses in the private enterprise system produce goods and services for a profit. These businesses can be service, merchandising or manufacturing businesses. Entrepreneurs, or individuals, invest money in businesses so that the businesses can acquire resources, such as inventory, buildings and equipment. The businesses then use these resources to earn a profit.

5 What are the three most common forms of business organisations and their basic characteristics?

The three most common forms of business organisation are (1) the sole proprietorship, owned by one individual, (2) the partnership, owned by two or more individuals (partners), and (3) the company (or corporation), incorporated as a separate legal entity and owned by numerous shareholders who hold shares in the company. The owner of a sole proprietorship and the

partners in a partnership generally have unlimited personal liability for any debts incurred by the business. Sole proprietorships and partnerships have a limited life, as the business will cease to exist if there is a change in partners or owners.

6 What types of regulations do businesses face?

The activities of businesses must be regulated because these activities affect us, other businesses, the economy and the environment. All businesses, regardless of type, size or complexity, must contend with regulatory issues. Numerous laws and authorities regulate businesses on issues ranging from environmental protection to taxes. Each local government area, state and country has its own regulations. Owners of businesses must learn and comply with the regulations issued by the different levels of government where the businesses are located and in the areas where they conduct business.

7 What information does the accounting system provide to support management activities?

Accounting information helps people inside and outside businesses make decisions. It supports management activities by providing managers with quantitative information about their business to aid them in planning, operating and evaluating the business's activities. Accounting information supports external decision making by providing people outside of the business – such as investors, creditors, stockbrokers, financial analysts, bankers, suppliers, labour unions, customers and governments – with financial statements containing economic information about the performance of the business.

Managers strive to make their business successful through setting and achieving the goals of their business, making decisions and committing the resources of the business to the achievement of these goals. Planning provides the organisation and direction for the other activities. Operating involves gathering the necessary resources and employees and implementing the plans. Evaluating measures the actual progress against standards or benchmarks so that problems can be corrected.

8 How does accounting provide support and information to people making decisions who are external to the business?

So that external users can understand the meaning of accounting information, businesses follow agreed-upon principles in their external reports. These generally accepted accounting principles (GAAP) are the standards or 'rules' that businesses must follow. A business may publish its income statement, balance sheet and cash flow statement (and statement of changes in owner's equity), along with other related financial accounting information, in its annual report. This report must present a true and accurate record of the activities of the business to enable informed decisions to be made by interested parties, particularly external parties.

9 What roles do ethics and sustainability play in the business environment?

Since the world is a complex place, where issues are not always clear, decisions must be made in an ethical context with the best available information. Accounting information can be relied on only if it is generated in an ethical environment. Many groups have established codes of ethics. Adopting an ethical approach to business will also increase the business's chances of sustainability. Sustainability refers not only to environmental 'green' aspects of the business but also to planning for survival and growth using an effective business plan.

10 What skills do accountants of the 21st century require?

Besides being willing to change, businesspeople can develop skills that better prepare them for problem solving and decision making in this environment. Businesspeople can become broadly proficient in all forms of communication: speaking, writing, listening, reading and teamwork (working cooperatively with others). Businesspeople can also develop their interpersonal skills and personal management skills. These skills include the ability to lead and influence others, to motivate others, to withstand and resolve conflict, to organise and delegate tasks, and to prioritise and manage their own tasks. Judgement skills are another type of skill that businesspeople can develop. Beyond these skills, an ability to think critically and apply knowledge and skills to problems in order to make decisions is needed in a rapidly changing business environment.

11 How can people learn to think critically?

People can learn to think critically first by learning new forms and techniques of thinking and then by practising these techniques to improve their decision-making skills. An awareness of their current thinking patterns helps people recognise their strengths and weaknesses; this knowledge gives them a starting point for modifying and improving their thinking performance.

12 How can critical thinking help people make better business decisions?

The ideas generated by innovative thinking provide the raw materials of the decision-making process. Critical thinking helps decision makers analyse decision alternatives for faulty logic, unsupported assumptions and emotional appeal. Furthermore, it helps decision makers evaluate the relevance of evidence used to support decision alternatives, the credibility of the sources of evidence and the consistency of the evidence with the decision alternatives it supports. Finally, critical thinking helps decision makers be sure that all relevant information, all points of view and all workable solutions have been considered.

13 What are the logical stages in problem solving and decision making?

Many business problems are difficult and complicated. A systematic approach is necessary to organise the problem and to decide on a solution to the problem. The four stages in problem solving and decision making are: (1) recognise the problem, (2) identify alternatives, (3) evaluate the alternatives and (4) make the decision. The accounting information system plays a big part in the business decision-making process.

Key terms

accounting system (p. 15)

agent (p. 11)

annual report (p. 24)

assets (p. 22)

balance sheet (p. 22)

brainstorming (p. 34)

budgeting (p. 19)

capital (p. 7)

cash flow statement (p. 24)

company/corporation (p. 12)

cost accounting (p. 19)

cost analysis (p. 19)

- creative thinking (p. 32)
- critical thinking (p. 30)
- e-commerce (p. 5)
- entrepreneur (p. 8)
- evaluating (p. 17)
- expenses (p. 22)
- external users (p. 20)
- financial accounting (p. 20)
- financial statements (p. 22)
- general knowledge (p. 27)
- Generally Accepted Accounting Principles, or GAAP (p. 21)
- joint ownership (p. 11)
- income statement (p. 22)
- independent (p. 30)
- internal users (p. 18)
- liabilities (p. 22)
- limited life (p. 10)
- management accounting (p. 20)
- manufacturing businesses (p. 7)
- merchandising businesses (p. 7)
- net income (p. 22)
- net loss (p. 22)
- objectivity (p. 30)
- operating (p. 17)
- organisational and business knowledge (p. 28)
- owner's equity (p. 22)
- partnership agreement (p. 11)
- partnership (p. 10)
- planning (p. 17)
- profit (p. 21)
- revenues (p. 22)
- service businesses (p. 6)
- shareholders (p. 12)
- shareholders' equity (p. 23)
- sole proprietorship (p. 10)
- sole trader (p. 10)
- solvency (p. 21)
- solvent (p. 9)
- statement of changes in owner's equity (p. 23)
- sustainability (p. 27)
- unlimited liability (p. 10)

Weblinks

Here is an opportunity to gather information on the Internet about real-world issues related to the topics in this chapter (for suggestions on how to navigate various businesses' websites to find their financial statements and other information, see the related discussion in the Preface at the beginning of the book).

- Accounting Professional and Ethical Standards Board (APESB) Code of Ethics for Professional Accountants <http://www.apesb.org.au/issued-standards>
- CPA Australia (CPAA) <http://www.cpaaustralia.com.au>
- Institute of Chartered Accountants in Australia (ICAA) <http://www.charteredaccountants.com.au>
- Institute of Public Accountants (IPA) <http://www.publicaccountants.org.au>
- Australian Taxation Office (ATO) <http://www.ato.gov.au>
- Australian Competition and Consumer Commission (ACCC) <http://www.accc.gov.au>
- Australian Securities and Investments Commission (ASIC) <http://www.asic.gov.au>

Integrated business and accounting situations

Answer the following questions in your own words.

Testing your knowledge

- 1.1 How would you describe private enterprise?
- 1.2 What distinguishes a service business from a merchandising or manufacturing business?

- 1.3 How is a merchandising business different from a manufacturing business? How are the two types of business the same?
- 1.4 What is entrepreneurship?
- 1.5 Suppose you were an entrepreneur. Where might you go for business capital?
- 1.6 Describe the factors affecting the business environment and the impact of each of these factors.
- 1.7 What distinguishes a company from a partnership and a sole proprietorship?
- 1.8 What types of regulations must businesses comply with in different jurisdictions?
- 1.9 Given what you have learned from this chapter, how would you define accounting?
- 1.10 How would you describe the similarities and differences between management accounting and financial accounting? Why are they different, and why are they similar?
- 1.11 How do management accounting reports help managers with their activities?
- 1.12 What are generally accepted accounting principles?
- 1.13 How do financial accounting reports help external users?
- 1.14 Why have various business groups found it necessary to establish codes of ethics?
- 1.15 What does sustainability mean?
- 1.16 What is internal control?
- 1.17 In addition to knowledge of accounting, what other skills and knowledge prepare a university graduate to enter the profession of accountancy?
- 1.18 What is auditing?
- 1.19 What are three professional organisations of accountants and who are their members?
- 1.20 Think of a recent discovery, technological innovation, world event, regulation or other factor affecting the business environment (one not mentioned in the chapter). What effect has this factor had on the business environment? What future effect do you think this factor will have on the business environment?
- 1.21 What are the broad skills, as outlined by the accounting community, that are necessary for practising accounting and for effectively conducting business?
- 1.22 What is the difference between thinking and critical thinking?
- 1.23 What is the difference between being independent and being objective?
- 1.24 Why is it important to evaluate the credibility of a source of information?
- 1.25 How do general knowledge and organisational and business knowledge support decision making?
- 1.26 Describe the stages of problem solving. What pitfalls might you encounter at each stage?
- 1.27 Describe how accounting information is used in each of the stages of problem solving.

Applying your knowledge

- 1.28 How is Qantas Airlines an example of a service business? How is Toyota Motor Corporation an example of a manufacturing business?
- 1.29 How might knowledge of a business's cash receipts and payments affect a bank's decision about whether to loan the business money? What financial statement would the loan officer want to look at to begin to understand the business's cash receipts and payments?

- 1.30 What factors would you consider in deciding whether to operate your business as a sole proprietorship, a partnership or a company?
- 1.31 Suppose you are Samuel Cook, CEO of Unlimited Decadence Corporation, maker of chocolate bars. Unlimited Decadence currently operates in south-eastern Australia, and you are considering opening a factory and sales office in Queensland. What questions do you want answered before you proceed with this idea?
- 1.32 Refer to 1.31. Suppose, instead, that you are considering opening a factory and sales office in Tokyo. What questions do you want answered before proceeding with this idea? How do you explain the similarities and differences in these two sets of questions?
- 1.33 What are some examples of business information in which both internal and external users have an interest?
- 1.34 Suppose you are a manager of The Foot Note, a small retail store that sells socks. Give an example of information that would help you in each of the management activities of planning, operating and evaluating the operations of the store.
- 1.35 What are generally accepted accounting principles, and how do they affect the accounting reports of businesses in Australia? Why might the owner or owners of a business be concerned about a proposed new accounting principle?
- 1.36 A friend of yours, Timorous ('Tim' for short) Ghostly, who has never taken an accounting course, has been assigned a short speech in his public speaking class. In this speech, Tim must describe the financial statements of a business. Tim has come to you for help (with his teacher's permission). He says, 'Please describe what financial statements are, what the major financial statements are and what each financial statement includes'. Prepare a written response to Tim's request.
- 1.37 How do codes of ethics help businesspeople make decisions?
- 1.38 Consider the following opposing sides of an issue:
- a All businesses, even those in other countries, should have to follow generally accepted accounting principles.
 - b All businesses should not have to follow generally accepted accounting principles.
- Required:*
Identify reasons that support each side of the issue.
- 1.39 Suppose that your job is beginning to eat into your personal time. During the last six months you have noticed that you have been taking files home with you to work on after dinner and on the weekends. Even so, you are having trouble keeping up. After explaining this to your boss, she suggests that you find a way to work more efficiently. Furthermore, she points out that there are many people who would be glad to take over your job.
- Required:*
- a What are some alternative ways to approach your boss? What reasons, information and evidence might support your point of view?
 - b What reasons, information and evidence might support your boss's point of view? In what ways might these reasons affect the approach you take in presenting your problem to your boss?
- 1.40 You have just landed your dream job working for a gourmet food importer and distributor. Your new boss wants your opinion about whether to open a new branch

office in Sydney. You desperately want to make a good impression on your first assignment and want to be sure you have a good grasp of the situation before you form your opinion.

Required:

What questions do you want answered before you offer your opinion to your boss?
Where might you find the answers to your questions?

- 1.41 Suppose that your brother, the owner of The Last Custard Stand (a specialty dessert shop), has asked you for a substantial loan to help him expand his business.

Required:

What would you like to know about The Last Custard Stand before you make a decision about whether to loan the company money? How could the answers to each of your questions affect your decision? What accounting information could your brother provide you that could affect your decision?

- 1.42 Refer to 1.41. At your request, your brother provides you with the following information:

Revenues for 2011	\$80 000
Expenses for 2011	(65 000)
Profit for 2011	<u>\$15 000</u>

Required:

How could this information be presented differently to make it more meaningful for you in reaching your loan decision? What could be added to this particular information to make it more meaningful for you?

- 1.43 The office photocopier has just stopped working and is beyond repair. The big question now is what to do with it. Your boss is offering a cash prize for each of the following:
- the longest list of ideas for what to do with the copier
 - the most unusual idea
 - the widest variety of ideas.

Required:

See if you can win all the cash by providing a written list of your ideas.

- 1.44 Your new co-worker just came in and made the following statement: 'Every Friday is casual day around here; people wear casual clothes to work on Fridays. Jan, over there, is wearing jeans and a T-shirt today. It must be Friday. TGIF!!!'

Required:

What's wrong with your co-worker's logic?

Making evaluations

- 1.45 Your friend, Vito Guarino (an incredible cook), plans to open a restaurant when he graduates from university. One evening, while extolling the virtues of linguini to you and some of your other friends, he glances down at your accounting textbook, which is open at Exhibit 1.4. 'What kind of a business is a restaurant?' he asks. 'How would a restaurant fit into this exhibit?' Everyone in the room waits with great anticipation for your answer and the rationale behind your answer. What are you going to say?

- 1.46** You and your cousin, Harvey, have decided to form a partnership and open a landscaping business in town. But before you do, you and Harvey would like to 'iron out' a few details about how to handle various aspects of the partnership and then write a partnership agreement outlining the details. What specific issues would you like to see addressed in the partnership agreement before you begin your partnership with Harvey?
- 1.47** Read a daily newspaper for the next week. What evidence do you find that supports the need for business codes of ethics?
- 1.48** Is a business suit the most appropriate article of clothing to wear to a business meeting?

Required:

Answer the question based on what you believe to be true (answer 'yes', 'no' or 'not sure'). Explain why you answered the way you did. Now give the reasons and evidence that you believe support your answer (authorities, references, facts, personal experience).

- 1.49** Consider, again, the plight of the manager at Unlimited Decadence Corporation, whose boss wants to manufacture and sell the new Empty Decadence chocolate bar, perhaps using it to replace the Decadent Thunderbolt chocolate bar. Suppose the accounting department has projected that profit per chocolate bar will be \$0.10 higher for the Decadent Thunderbolt than for the Empty Decadence chocolate bar. The marketing department predicts that Unlimited Decadence can sell 100 000 Empty Decadence chocolate bars the first year and then more each year for the next ten years if it drops the Decadent Thunderbolt chocolate bar. During that same time period, the marketing department forecasts that sales of the Decadent Thunderbolt will be 80 000 chocolate bars the first year, with sales decreasing slightly after that if the company does not produce the Empty Decadence chocolate bar. However, if the company produces both chocolate bars, predicted sales for Empty Decadence will be reduced to 70 000 chocolate bars the first year, with a slow and steady increase in sales over the next ten years. Predicted sales for the Decadent Thunderbolt will decrease to 65 000 during the first year and decrease slightly each year for the next ten years.

The production department has determined that the new chocolate bar is possible to manufacture and that the factory can be reconfigured to accommodate the new chocolate bar while continuing to produce the old chocolate bar. If Unlimited Decadence drops the Decadent Thunderbolt chocolate bar, it can convert the equipment so that it can be used to produce the Empty Decadence chocolate bar. The human resources department is confident that numerous qualified people are available to work if the company wants to produce both chocolate bars. If the company drops the Decadent Thunderbolt chocolate bar, those people currently working on the Decadent Thunderbolt chocolate bar can be easily retrained to work on the Empty Decadence chocolate bar. The chief financial officer has arranged for financing, if it is needed.

Required:

- a** Based on the above information, what are the advantages and disadvantages of: (i) dropping the Decadent Thunderbolt product line and producing the Empty Decadence chocolate bar, (ii) continuing production of the Decadent Thunderbolt and not producing the Empty Decadence chocolate bar, (iii) producing both the

- Decadent Thunderbolt and the Empty Decadence chocolate bars or (iv) producing neither chocolate bar? How would you decide which alternative is best?
- b What additional information would make your decision easier?
- c What other alternative solutions can you think of?
- 1.50 The changing business environment provides many challenges for today's businessperson but also opportunities.
- Required:*
What opportunities do you see that result from this environment? How would you prepare yourself to take full advantage of these opportunities?
- 1.51 You've just accepted a great job joining a team of consultants writing an advice column, 'Dear Dr Decisive', for the local newspaper. Yesterday, you received your first letter.

Dear Dr Decisive

Yesterday, my boyfriend and I got into a high-spirited 'discussion' about lucky people in business. I say that most successful businesspeople are just plain lucky. They've been in the right place at the right time. He says that these successful people have worked hard preparing themselves for the time when they will be in the right place at the right time. OK, I think we're saying the same thing. He says there is an important difference. Now he won't call me unless I admit I'm wrong (which I'm not) or until you say I'm right.

I'm right, right?

Call me 'Lucky'

Required

- Meet with your Dr Decisive team and write a response to 'Lucky'.

Endnotes

^a <http://specials.ft.com/enron/>.

^b Fortune magazine, 10 Jan. 2001, pp 82–110.

^c Woellert, I., BusinessWeek online, 1 June 2005.

^d International Federation of Accountants, Code of Ethics for Professional Accountants, <http://www.ifac.org/>.

^e Learning and Teaching Academic Standards Project, Business, Management and Economics, Learning and Teaching Academic Standards Statement for ACCOUNTING, December 2010, Australian Learning and Teaching Council, p 10, http://www.altc.edu.au/system/files/altc_standards_ACCOUNTING_090211.pdf.