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Where are we headed?
After completing this chapter, you should be able to:
- explain the role of accounting
- identify the users of accounting information and the financial information they may require
- distinguish between financial data and financial information
- identify and explain the stages in the accounting process
- define and apply the accounting principles and qualitative characteristics
- explain the relationships between the accounting principles and qualitative characteristics
- identify and define the elements of financial statements.

CHAPTER 1
THE ROLE OF ACCOUNTING

KEY TERMS
After completing this chapter, you should be familiar with the following terms:
- financial data
- financial information
- transaction
- source documents
- recording
- reporting
- advice
- agreed value
- materiality
- accounting principles
  - entity
  - Going Concern
  - Reporting Period
  - Historical Cost
  - Conservatism
  - Consistency
  - Monetary Unit
- qualitative characteristics
  - Relevance
  - Reliability
  - Comparability
  - Understandability
- elements of financial statements
  - assets
  - liabilities
  - owner’s equity
  - revenue
  - expense
1.1 THE PURPOSE OF ACCOUNTING

Unfortunately for business owners, having a great business idea is not enough to guarantee success. You don’t have to look very far to find stories of business owners who started out with what they thought was a fantastic product or service, but ended up going bust. Aside from the quality of what business owners are selling, there are a variety of other factors that will influence their chance of success, including:

- consumer tastes and demand
- the level of competition
- the quality of their staff/employees
- the economic climate
- the management skills of the owners.

This last point is particularly important because in most small businesses owners have a hands-on managerial role, and their management skills can have a direct and significant effect on what happens to that business. Whether they are determining selling prices, deciding on advertising campaigns, employing staff, or undertaking more mundane tasks, such as paying bills, the owner must make important decisions on a daily basis.

Certainly, small business owners must have detailed knowledge of whatever it is they are trying to sell, but they must also have detailed information on a whole range of other issues that may affect their chances of success. This is where accounting comes into the picture; it is essentially an information service.

Accounting is the collection and recording of financial data, and the reporting, analysis and interpretation of financial information.

The purpose of accounting is to provide business owners with financial information that will assist them in making decisions about the activities of their firm. This does not mean that accounting will ensure owners make the right decisions, but it should help them to make more informed decisions, which will hopefully improve the performance of the firm and its chances of success.
CHAPTER 1    THE ROLE OF ACCOUNTING

1.2 USERS OF ACCOUNTING INFORMATION

This course concentrates specifically on accounting for sole traders; that is, trading businesses that are owned by only one person, who is usually responsible for running the firm. For this reason, we will concentrate on the information that the owner will want to see. However, it is important to note that a number of different parties may be interested in the firm's financial information. These parties are known as the ‘users’ of the accounting information, and may include:

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

Considering the variety of users of accounting information, and the different information each may require, what information should the accounting system provide? This seemingly difficult question has a surprisingly simply answer: the accounting system should provide whatever information the user decides is necessary. This means that it is the user – not the accountant or the accounting system – who decides what is necessary.

**Financial data versus financial information**

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

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

If we work backwards, then what the owner is looking for is the information the accounting system can provide. Data must be collected, processed into a useable form, and then communicated so that the business owner has meaningful information on which to base a decision. The accountant should then provide some guidance as to appropriate courses of action. These four ‘phases’ or ‘stages’ are the basis of what is known as the accounting process.

**Figure 1.1 The accounting process**

Stage 1: collecting source documents

Collecting source documents is sometimes known as the ‘input stage’, where the business collects the source documents relating to its transactions. A transaction is simply an exchange of goods or services with another party.

Source documents are the paper or electronic documents that provide both the evidence that a transaction has occurred and the details of the transaction itself. Source documents provide the data on which the accounting information will be based. Common source documents include:

- receipts, which provide evidence of cash received by the business
- cheque butts, which provide evidence of cash paid by the business
- invoices, which provide evidence of credit sales and purchases
- memos, which provide evidence of transactions within the firm itself.

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

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

Stage 2: recording

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

Common accounting records include:

- journals, which record daily transactions of a common type (such as all cash paid or all stock purchased on credit)
- ledgers, which record the effect of each transaction on the items in the firm’s accounting reports
- stock cards, which record all the movements of stock in and out of the business.

**REVIEW QUESTIONS 1.2**

1. List six likely users of accounting information.
2. Explain why banks and other financial institutions will be interested in the financial information of a small business.
3. Explain the difference between ‘financial data’ and ‘financial information’.
These accounting records, and how they are used, will be discussed in detail throughout this text.

**Stage 3: reporting**

The ‘output’ stage of the accounting process involves taking the information generated by the accounting records (in stage 2) and reporting that financial information to the owner of the business in an understandable form. Reporting involves the preparation of financial statements that communicate financial information to the owner, so that decisions can be made.

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

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

**Stage 4: advice**

Armed with the information presented in the reports, the owner should be in a much better position to make informed decisions. However, the best course of action is sometimes unclear. Therefore, the accountant should be able to offer advice by making some suggestions about an appropriate course of action or, at the very least, presenting owners with a range of options from which they can then choose.

The provision of advice is the accountant’s key function, but this advice rests on the information generated by the first three stages of the accounting process.

Essentially, the accounting process involves collecting data from source documents; sorting it, classifying it and writing it down; communicating the financial information to the owner; and providing advice about that information. We will refer to this accounting process throughout the text, so that you have a clear idea of how each topic fits into the overall process.

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**REVIEW QUESTIONS 1.3**

1. **List** the four stages in the accounting process.
2. **Explain** the role of source documents in the accounting process.
3. **State** the type of transaction evidenced by the following source documents:
   - receipt
   - cheque butt
   - invoice
   - memo.
4. **Explain** the difference between the ‘recording’ and ‘reporting’ stages of the accounting process.
5. **State** the purpose of the following accounting reports:
   - Cash Flow Statement
   - Income Statement
   - Balance Sheet.
1.4 ACCOUNTING PRINCIPLES

By and large, accountants approach their craft from a common perspective. For instance, most would agree that a motor vehicle owned by the firm should be regarded as an asset. However, from time to time certain issues arise where proper accounting procedure is unclear, and a number of alternative approaches are possible. For instance, if a business purchased a building in 1991 for $225 000, and spent $140 000 on renovations in 2004, at what value should it be recorded and reported today? What if the building would be worth $850 000 if sold today? What if its plumbing system requires replacement? In short, how much is the building worth?

These are but a few of the questions that an accountant must answer, and in many cases, each of these questions could have more than one answer.

To provide for some degree of certainty, the accounting profession has agreed to a number of accounting principles that govern the way accounting information is generated. In this course, we will investigate the following accounting principles:

- **Entity**
- **Going Concern**
- **Reporting Period**
- **Historical Cost**
- **Conservatism**
- **Consistency**
- **Monetary Unit**

**Entity**

The Entity principle states that from an accounting perspective, the business is assumed to be separate from the owner and other businesses, and its records should be kept on this basis. This may seem a slightly bizarre idea, especially when we consider that the owner of a sole proprietorship is frequently the person behind the counter, or the one actually performing the service. However, if we are to assess the performance of the business itself, we must include only information relevant to that business. The owner may have a beach house or a four-wheel drive, but if this item is not being used by the business, it must not be included as a business asset.

**Transactions between the business and the owner**

In practical terms, the Entity principle means that the business must have a separate bank account, and that it should only be used for business purposes. If the owner uses the business’s funds for personal purposes, this must be recorded in the business’s records as drawings.

In the same way, if the owner contributes personal assets to the business, then this should be recorded as a capital contribution from one entity (that is, the owner) to another entity (that is, the business).

In the case of a contribution of non-cash assets, such as a vehicle, the Entity principle will have a further effect in terms of the way the asset is valued. Consider an asset, such as a vehicle, purchased by the owner but then contributed to the business. This asset cannot be valued at the original price paid by the owner, as it is the cost to the business, as a separate entity, that is important.

However, although the business and the owner are assumed to be separate accounting entities, there would be no source document to verify the ‘sale’ by the owner to the business as they are, in fact, one and the same. In this case, the asset...
If a business owner contributes a personal asset, such as a vehicle, to the business, this should be recorded as a capital contribution from one Entity (the owner) to another Entity (the business).

**Going Concern**

The *Going Concern* principle assumes that the life of the business is continuous, and its records are kept on that basis. This principle is important because it allows us to record transactions that have an effect on the future. For instance, where a sale is made on credit terms, the cash will not have been received from the customer. By assuming that the business will continue trading indefinitely, the *Going Concern* principle allows us to record debtors (amounts owed to the business by credit customers) as an asset because at some stage in the future the business is likely to receive cash. This applies to amounts the business owes to its creditors for its credit purchases, or to amounts the business has paid in advance for benefits it is yet to receive.

The effect of the *Going Concern* principle is also significant in distinguishing between expenses (whose benefit is consumed entirely) and assets (whose benefit extends into the future). Only by assuming that the life of the business is ongoing can we recognise the benefit that will be derived some time in the future from the assets under the firm’s control. (See ‘1.6 The elements of financial statements’ for a discussion of the difference between assets and expenses.)

**Reporting Period**

The *Reporting Period* principle states that the life of the business must be divided into periods of time to allow reports to be prepared. This principle is inextricably linked to the idea that the business is a *Going Concern*. Because the life of the business is assumed to be continuous, it is necessary to divide that life into arbitrary periods so that profit can be determined. We cannot wait until the end of the firm’s life to calculate profit (because we are assuming that the end will never come) so we calculate profit for the month, or year. A *Reporting Period* can be as short as the owner requires, but in most cases, to meet taxation requirements, is no longer than a year.

would be recorded in the books of the business at an **agreed value** (determined at the time the asset is contributed to the business). This agreed value would then become the effective Historical Cost as far as the business is concerned.
One possible consequence of dividing the life of the business is that at the end of a Reporting Period the business may still be waiting for some cash from debtors, or may not yet have paid for some expenses. These amounts are still included in the calculation of profit, as the revenue was *earned* (when the goods were sold) and the expense *incurred* (when the item was consumed) in the current reporting period. This method of calculating profit as revenues *earned* less expenses *incurred* in each Reporting Period is known as **accrual accounting**.

**Historical Cost**

The **Historical Cost** principle states that a transaction should be recorded at its original cost or value, as this value is verifiable by reference to the source document. This principle applies particularly to assets, which must be recorded at their original purchase price. Any other valuation, such as resale value or replacement value, is subject to a certain amount of guesswork, and therefore Historical Cost is preferred. For instance, if land is bought for $300 000, and is later estimated to be worth $320 000, it should remain in the accounting records as $300 000 as the other price is only an estimate, and not verifiable. There are certain situations in which it is acceptable to use a valuation other than Historical Cost, but these situations will be covered in later chapters.

**Conservatism**

The **Conservatism** principle states that losses should be recorded when probable but gains should only be recorded when certain, so that liabilities and expenses are not understated and assets and revenues are not overstated. This principle advocates a *worst-case scenario* approach to accounting. Where different valuations are possible, or it is impossible to avoid the use of an estimate, accountants should use whichever data gives the most cautious or ‘conservative’ assessment. This does not mean the records should deliberately represent a situation as worse than it actually is, but it does mean they should not represent the situation as better than it might turn out to be. From an accounting point of view it is better to be cautious and conservative than overly optimistic (and then get a rude shock when reality does not match expectations).

**Consistency**

The **Consistency** principles states that accounting methods should be applied in a consistent manner from one period to the next, so that reports can be compared between periods. Without consistent accounting methods, it is difficult to tell whether changes in accounting reports are the result of changes in business performance, or simply changes in accounting procedures. This makes it difficult to compare reports from one period to the next. The amounts in the reports do not need to be the same, but the way they are calculated does.

**Monetary Unit**

The **Monetary Unit** principle states that all items must be recorded and reported in a common unit of measurement; that is, Australian dollars. This is one of the more obvious principles. It would make little sense to record the purchase of a motor vehicle as ‘1 Holden Commodore’ without attaching a valuation in dollars. To do so would make it impossible to aggregate total assets or make comparisons between periods or businesses. Similarly, recording loans in Australian dollars and stock in Japanese yen would make the information impossible to use.
REVIEW QUESTIONS 1.4

1 Define the following accounting principles:
   - entity
   - Going Concern
   - Reporting Period
   - Historical Cost
   - Conservatism
   - Consistency
   - Monetary Unit.

2 Explain one practical consequence of adopting the entity principle.

3 State the length of a Reporting Period. (Beware: this is a trick question!)

4 Explain why the implementation of the Going Concern principle requires the adoption of the Reporting Period principle.

5 State how profit is calculated under accrual accounting.

1.5 QUALITATIVE CHARACTERISTICS

In addition to the accounting principles, which guide the recording process, the profession is guided by what is known as The International Framework for the Preparation and Presentation of Financial Reports. The Framework, as it has become known, sets out the broad concepts that underpin the preparation of financial reports. These concepts are known as qualitative characteristics. The Framework also defines the items that will be reported in each report.

The Framework also provides the basis for the development of Accounting Standards, which are rules governing specific accounting procedures that all accountants are compelled to follow. These standards underpin many of the techniques used in this text, but students are not required to know the relevant Accounting Standard.

If we follow and implement the accounting principles when we are recording, then our accounting reports should possess the qualitative characteristics outlined in the Framework. The qualitative characteristics are basically the qualities we would like our accounting information to possess. The four qualitative characteristics of accounting reports are:

- Relevance
- Reliability
- Comparability
- Understandability.
Relevance

Relevance states that reports should include all information that is useful for decision-making, and exclude information that is not. This information should be up-to-date, and appropriate to the decision at hand. The quality of Relevance guides us in what to include in our reports, and will be present if we follow the Entity and Reporting Period principles. For example, when preparing a Balance Sheet for a business, it is not relevant to include the personal assets of the owner, as these are not being used by the business to earn revenue, and thus are not useful for making decisions about future business activities. Similarly, the Income Statement should include only revenues and expenses from the current Reporting Period – last year's wages, or next year's sales figures will not help us to assess this year's profit. The key is whether the information is useful for decision-making.

Although Relevance is determined largely by whether the nature of the item makes it useful for decision-making, the size or materiality of the item can also be important. Items that are too small or insignificant to affect decision-making may be considered to be immaterial, meaning they can be reported in the value of a larger item, or in some cases omitted from the reports. For instance, Relevance allows us to omit from the Balance Sheet $1.95 spent on stationery (as it is such a small amount) and instead report this as an expense. Its inclusion (or exclusion, for that matter) in the Balance Sheet will not affect decision-making in any material way.

Reliability

Reliability states that reports should contain information that is free from bias and error, and thus can be relied upon for its accuracy. The quality of Reliability means that in relation to the amounts we show in reports, we should avoid the use of estimates. Reliability will be assisted via the Historical Cost principle, because the best way to ensure that information is free from bias and error is to make sure it is verifiable by reference to a source document. Reliable information has proof to support its accuracy. For example, it should be possible to check the level of credit sales reported in the Income Statement against the invoices that documented the sales. This ensures there is no room for subjectivity or guesses.

Comparability

Comparability states that reports should be comparable over time, and between different companies, through the use of consistent accounting procedures. One of the most basic uses of accounting reports is to compare performances of businesses and between periods. However, this will only be possible if consistent accounting methods have been used. Where accounting procedures are changed, this should be stated clearly (disclosed) in the reports, so that the users can make more informed assessments of what the reports are telling them.

Understandability

Understandability states that reports should be presented in a manner that is simple to understand.

It is important to remember that the most basic function of accounting reports is to communicate information to the user; that is, sole traders and/or owners. Most small business owners are not accountants, so it is not sensible to present reports in a form that owners cannot understand. The characteristic of Understandability means it is easy for the user to comprehend the meaning of reports. For this reason, it may be more effective to present information in graphs, tables or charts, or simply in language that is free from accounting jargon.
In summary, the accounting process is guided by:

- accounting principles, which govern the way accounting information is recorded
- qualitative characteristics, which inform the way accounting reports are prepared.

### REVIEW QUESTIONS 1.5

1. **Define** the following qualitative characteristics:
   - Relevance
   - Reliability
   - Comparability
   - Understandability.

2. **Explain** how the Entity and Reporting Period principles ensure Relevance in the accounting reports.

3. Referring to one qualitative characteristic, **explain** why accountants must follow the Historical Cost principle.

4. **Explain** how the recording system can ensure Comparability of accounting reports.

5. **Suggest** two ways of improving the Understandability of accounting reports.

### 1.6 THE ELEMENTS OF FINANCIAL STATEMENTS

We have discussed at length the qualities that accounting reports should possess, but what items should they include? The Framework defines the elements of the accounting reports as:

- **assets**
- **liabilities**
- **owner’s equity**
- **revenues**
- **expenses**.

**Assets**

**Assets** are resources controlled by an entity, as a result of past events, from which future economic benefits are expected to flow to the entity. For an item to be recognised as an asset, it must meet each part of the definition. An item that fails to meet any of these requirements cannot be considered to be an asset.

Let’s break this definition down into its main components.

**Resources controlled by the entity**

Resources are simply items that are capable of generating an economic gain for a business, such as bank (the cash held there, not the building), debtors, stock, vehicles and premises.

However, only those items that are under the firm’s control can be defined as assets. This means that the firm must be in a position to determine how and when the item is used. For instance, it is up to the business to determine how and when the cash in the bank account will be spent, when the debtors are expected to pay and how the vehicles will be used.

By contrast, the owner’s home cannot be classified as a business asset because it is not under business control. Don’t forget the Entity principle here: the owner’s home is under the control of the owner, who is considered to be a separate accounting entity from the business.
Note that although a business will own many of its assets, ownership itself is not a necessary condition for an item to be classified as a business asset. Control is much broader than ownership, so the firm’s assets will obviously include, but not be restricted to, what it owns.

**Future economic benefits**

In addition to falling under business control, assets must be capable of generating a future economic benefit. That is, they must represent some sort of benefit that is yet to be received. This reflects the Going Concern principle. For example, cash in the bank can be spent and stock can be sold at some point in the future; the amount owed to the business by its debtors will be received as cash some time in the next month or so; and items such as premises and vehicles will usually be used for business activities for a number of years into the future.

On the other hand, cash paid for this month’s wages is not an asset, as there is no future benefit. In order to gain a further benefit from employees, a further payment must be made. Items such as this cannot be classified as assets because their benefit does not extend beyond what has already been received.

**Liabilities**

Liabilities are present obligations of the entity as a result of past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. This may seem like a lot of jargon, but broken into its components it is easier to understand.

**Present obligations**

If the business has a legal responsibility (or obligation) to settle a debt, then this debt is likely to be a liability. In the case of a bank overdraft or mortgage, the contract with the lender means the business is obliged to repay the amount owing.

Contrast these items with the amount that the business expects to pay next year for advertising. This cannot be reported as a liability, as at present there is no obligation to pay. The obligation will only occur once the firm has signed the contract, or the advertising itself has been provided.

**Expected to result in an outflow of economic benefits**

The fact that a liability is expected to result in an outflow or sacrifice of economic benefits means that the outflow/sacrifice has not yet occurred. In this way, a liability could be seen as requiring a future economic sacrifice.

In most cases, the economic benefit to be sacrificed will be cash, and the expected outflow will occur when the business pays its debts. However, this is not always the case; there may be an alternative economic benefit that must be sacrificed. For example, a firm may have received cash in advance for a job yet to be completed; it is not a payment that is required to extinguish this liability, but the completion of the work.

**Owner’s equity**

Owner’s equity is the residual interest in the assets of the entity after the deduction of its liabilities. In effect, owner’s equity is what is left over for the owner once a firm has met all its liabilities. Given that the owner and the firm are considered to be separate entities, it can also be described as the amount the business ‘owes the owner’.
Revenue

Revenues are inflows of economic benefits (or savings in outflows) in the form of increases in assets (or decreases in liabilities) that increase owner’s equity, except for capital contributions by the owner. Capital contributions are excluded because they occur not due to the activities of the business, but rather the actions of the owner.

Revenue then represents the increases in owner’s equity that occur through business activities, and in most cases will represent what the business has gained from the goods it has sold or the work it has done. But there are other forms of revenue, and although revenue may take the form of cash, this is not a requirement: credit sales would be revenue in the form of an increase in an asset other than cash (namely, debtors), whereas discount revenue would take the form of a decrease in a liability (creditors). The key is that a revenue must increase owner’s equity, but not as a consequence of the owner making a contribution.

Expenses

Expenses are outflows or consumptions of economic benefits in the form of decreases in assets (or increases in liabilities) that reduce owner’s equity, except for drawings by the owner. Drawings is excluded because it doesn’t contribute to the firm’s ability to carry out its trading activities, and so does not affect its ability to earn revenue or profit.

Expenses then represent the decreases in owner’s equity that occur through business activities or, put simply, what a business has consumed (or used up) to earn its revenue. Even though many expenses are paid in cash, this is not a requirement: stock loss due to theft would be an expense in the form of a decrease in assets (stock), whereas wages could take the form of an increase in liabilities if it were yet to be paid. The key here is that an expense must decrease owner’s equity, but not as a consequence of the owner making a withdrawal from the business.

REVIEW QUESTIONS 1.6

1 Define the following items:
   - asset
   - liability
   - owner’s equity
   - revenue
   - expense.

2 State one reason why wages is not considered to be an asset.

3 State one reason why the advertising for next year is not considered to be a liability.

4 Explain why a capital contribution is not considered to be revenue.

5 Explain why drawings is not considered to be an expense.
WHERE HAVE WE BEEN?

- The purpose of accounting is to provide financial information to assist decision-making.
- The accounting process involves collecting source documents, recording financial data and then reporting financial information, and subsequently advising the owner on an appropriate course of action.
- Accounting principles, the generally accepted rules governing the way accounting information is generated, are:
  - entity
  - Going Concern
  - Reporting Period
  - Historical Cost
  - Conservatism
  - Consistency
  - Monetary Unit.
- Qualitative characteristics, the qualities we would like our financial reports to possess, are:
  - Relevance
  - Reliability
  - Comparability
  - Understandability.
- The three general-purpose financial reports are the Cash Flow Statement, the Income Statement and the Balance Sheet.
- The elements of the financial reports are assets, liabilities, owner’s equity, revenue and expenses.

EXERCISE 1.1

ACCOUNTING PRINCIPLES

In each of the following situations, state and explain the accounting principle that has been breached.

a. Rhonda recorded the payment of her daughter’s orthodontist’s fees as a business expense.

b. The proprietor of Richmond Spare Parts decided to combine the recording of repair expenses with vehicle expenses after recording them separately for several years.

c. Due to uncertainties with the exchange rate, Dig Freely decided to record foreign earnings in yuan (the Chinese currency).

d. During January 2015, Jean Simons received cash for goods sold in December 2014. Jean decided to record the cash as revenue for 2015.

e. Mills & Son have just revalued their non-current assets upwards by 4% to reflect the rate of inflation.

f. Paul Rullett is the proprietor of PR Traders. He has decided to list all the liabilities of the firm as current to give him a better picture of what he owes, despite a mortgage that is due in 10 years.

g. Karen Roberts only prepares financial reports every two years.
EXERCISE 1.2
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

During December 2015, Bon Wilhelm paid for a family holiday using a business cheque. This transaction was treated as a business expense, with Bon arguing, ‘It’s my business; it’s my money.’

Required
a Referring to one accounting principle, explain why this transaction should have been recorded as drawings.

b Explain how Wilhelm’s decision will undermine the Relevance of the financial reports.

EXERCISE 1.3
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

In October 2015, Mark Larkin, the owner of Larkin Lighting, decided that the firm’s stock should be valued at its selling price rather than its cost price because, according to Mark, ‘That’s what it is actually worth.’

Required
a Referring to one accounting principle, explain why the stock must be valued at its cost price.

b Explain how valuing stock at its selling price will undermine the Reliability of the reports.

EXERCISE 1.4
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

Erica Carr’s business has been sued for false advertising, and her solicitor has indicated that she is likely to lose the forthcoming court case and be liable to pay damages. Erica has decided to not disclose the damages in the Income Statement.

Required
a Referring to one accounting principle, explain why Erica should disclose the damages in the Income Statement.

b State the qualitative characteristic that supports your answer to part ‘a’. Justify your answer.

EXERCISE 1.5
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

In an attempt to satisfy the Consistency principle, Coolick Refrigerators always reports the same figure for depreciation of equipment.

Required
a Define ‘consistency’ as an accounting principle.

b Referring to one qualitative characteristic, explain why the accounting records should be maintained by following the Consistency principle.
EXERCISE 1.6
ACCOUNTING PRINCIPLES, QUALITATIVE CHARACTERISTICS AND ELEMENTS OF THE REPORTS

In October 2014, Rad Magazines successfully completed a marketing campaign where readers pay in advance for magazines to be delivered in 2015. The owner wants to record all the cash received as revenue for 2014.

Required
a Referring to one accounting principle, explain why the cash received should not be recorded as revenue for 2014.
b State the qualitative characteristic that will be undermined if the cash received is reported as revenue for 2014. Justify your answer.
c Referring to the definitions of the elements of the reports, explain why the cash received is not yet revenue.

EXERCISE 1.7
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

The accounting department of Plastic Cups Emporium recently issued a report to a meeting of the workers of the firm, complete with various financial statements and financial ratios. None of the workers at the meeting had any knowledge of accounting.

Required
a Referring to one qualitative characteristic, explain why the accounting reports will not fulfil their intended function.
b State one technique the accounting department could employ to improve the appropriateness of its financial reports.

EXERCISE 1.8
ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

The owner of Frosty Fridges believes its market value is shown in the Balance Sheet as the difference between total assets and total liabilities.

Required
a Referring to one accounting principle, explain why the market value of Frosty Fridges will not be shown as the difference between total assets and total liabilities.

EXERCISE 1.9
ACCOUNTING PRINCIPLES, QUALITATIVE CHARACTERISTICS AND ELEMENTS OF THE REPORTS

On 1 April 2012, Max contributed second-hand shelving to his business with an agreed value of $12 500. Max originally paid $15 000 for the shelving. On 30 June 2015, the resale value of the shelving was $8 500.
Required

a Referring to the definitions of the elements of the reports, explain how the shelving should be classified in the Balance Sheet of Max’s business.

b Referring to one accounting principle, explain how the shelving should have been valued in the Balance Sheet of Max’s Mart as at 1 April 2012.

c Referring to one qualitative characteristic, explain why the shelving should not be valued at its resale value in the Balance Sheet as at 30 June 2015.

EXERCISE 1.10
ELEMENTS OF THE REPORTS

For each of the following items, state whether it should be reported in the Income Statement or the Balance Sheet, using the definitions of the elements of the reports to explain how it should be classified:

a debtors
b loan – principal
c interest on loan
d stock loss
e cash sales
f wages incurred
g wages owing
h discount revenue.

EXERCISE 1.11
ELEMENTS OF THE REPORTS

Hard Utes specialises in the sale of utility vehicles. On 31 August 2014, the firm purchased a new vehicle worth $35 000 on credit from Holden.

Required

a Explain the difference between an asset and an expense.
b Explain one circumstance in which the cost of the vehicle would be reported as a current asset.
c Explain one circumstance in which the cost of the vehicle would be reported as a non-current asset.
d Explain one circumstance in which the cost of the vehicle would be reported as an expense.

EXERCISE 1.12
GOODWILL

Over the last couple of years, Elaine has built up a loyal clientele for her fashion boutique, Fine Fashions. These customers buy from Elaine on a regular basis because they trust her judgement and expertise.

Required

a Discuss whether Elaine should recognise this ‘goodwill’ as an asset.