

UNIT

1

ESTABLISHING AND OPERATING A SERVICE BUSINESS

In Unit 1 of the VCE Accounting course, we will cover the following chapters:

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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
- **distinguish** between financial data and financial information
- **explain** the accounting process
- **state** the various forms of source documents
- **identify** and **explain** the seven Accounting Principles
- **identify** and **explain** the four Qualitative Characteristics.

CHAPTER 1

THE NATURE AND ROLE OF ACCOUNTING IN SMALL BUSINESS

KEY TERMS

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

- accounting
- financial data
- financial information
- transaction
- source documents
- recording
- reporting
- advice
- Accounting Principles
 - Entity principle
 - Going Concern principle
- Reporting Period principle
- Historical Cost principle
- Consistency principle
- Conservatism principle
- Monetary Unit principle
- Qualitative Characteristics
 - *Relevance*
 - *Reliability*
 - *Comparability*
 - *Understandability.*

1.1 THE NEED FOR ACCOUNTING

The next time you visit a shopping centre, take a look at the types of businesses operating there. Chances are, you'll see a variety of shops: some with names you know, and some that are unfamiliar; some selling clothes, food, or household goods; some providing services such as building or hairdressing services. Behind each of these businesses is a small business owner who has detailed knowledge of the product or service they are selling. But unfortunately, this product knowledge on its own is not enough to guarantee the success of their business. Business is not just about making and selling; it is about *managing* – managing people, managing stock, managing customers and suppliers – and, last but not least, managing cash. And if a business owner is to manage their business *effectively*, then they will need accurate information that can be relied upon to assist them in the decisions they make.



Accounting

the collection, recording and reporting of financial information to assist business owners in decision-making

This is why **accounting** is important; it is essentially an information service. It is a process that turns the day-to-day operations of a small business (such as sales over the counter or payment of bills) into a form that the owner can study to determine which areas of their business need improvement.

The purpose of accounting then 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 decision, but it should help them to make a *more informed* decision, one which will hopefully improve the performance of the firm and its chance of success.

Users of accounting information

Accounting in this course concentrates on small businesses where the person managing the business is also the owner of that business. Thus, any accounting information will be generated primarily for the benefit of the owner/manager. However, it is important to note that there will be a number of different parties who may also be interested in the firm's financial information. These parties are known as the 'users' of the accounting information, and may include:

- *debtors 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*, which will certainly want to know about the firm's current levels of debt and their ability to repay before providing them with any additional finance
- *employees*, who may wish to know about the firm's long-term viability, and their own 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, and its assets and liabilities to determine the firm's worth
- *The Australian Tax Office (ATO)*, which will require financial information for taxation purposes.

There is a wide variety of users of accounting information, and each of them may require different information. The accounting system must ensure that it can generate the information necessary to satisfy the users' needs. This means that it is the intended user, not the accounting system, who decides what information needs to be prepared.

Financial data versus financial information

Accounting is about providing information; however, that information has to come from a source and actually begins its life as raw facts (source documents) before being transformed into a form that is useful for decision-making (financial reports). Therefore we need to distinguish 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 source documents such as receipts, cheque butts, invoices, memorandums (memos) and bank statements. This data then becomes **financial information** once it has been sorted and processed into a more useable and understandable form. For instance, a pile of source documents (data) may provide specific details of the firm's transactions over the past week or so, but a pile of documents conveys no useful information. The data has not been sorted, or classified into groups, or summarised in any way. Once this information is sorted, classified and summarised, it becomes financial information that can be used as the basis for business decisions. This is the role of the accounting system.

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

Financial information
financial data which has
been sorted, classified
and summarised into
a more usable and
understandable form

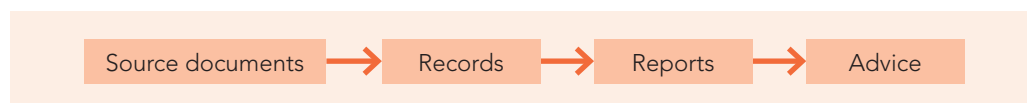
REVIEW QUESTIONS 1.1

- 1 **Define** the term 'accounting'.
- 2 **Explain** the purpose of accounting.
- 3 **Identify** the other users of accounting information and **describe** their interest in the accounting reports of a small business.
- 4 **Explain** the relationship between financial data and financial information.

1.2 THE ACCOUNTING PROCESS

The process of turning financial data into financial information is facilitated by what is known as the *accounting process*.

Figure 1.1 The accounting process



Stage 1 Collecting source documents

Also known as the *input stage*, this is where the business collects the source documents relating to its **transactions**.

Source documents are the pieces of paper that provide both the evidence that a transaction has occurred, and the details of the transaction itself. Thus, 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 transactions
- *memos*, which provide evidence of transactions within the firm itself
- *bank statements*, which not only verify the cash transactions of the business but also provide evidence of transactions that the business may have been unaware of, such as the receipt of interest or the charging of a service fee.

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

Stage 2 Recording

Once the source documents have been collected, the information they contain must be written down or 'recorded'. This is also known as the *processing stage*. **Recording** involves sorting, classifying and summarising the information contained in the source documents so that it is more usable.

Common accounting records include:

- *journals*, which record daily transactions of a common type (such as all cash paid, all cash received, or all stock purchased on credit)
- *stock cards*, which record all the movements of stock in and out of the business.

Stage 3 Reporting

The *output stage* of the accounting process involves taking the information that has been generated by the accounting records (the journals) and 'reporting' that financial information to the owner of the business in a form that he or she can understand.

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 *Statement of Receipts and Payments* to report on the cash the firm has received and paid, and the change in its bank balance over a period
- an *Income Statement* to report on the firm's revenues and expenses over a period
- a *Balance Sheet* to report on the firm's assets and liabilities at a particular point in time.

Transaction

an agreement between two parties to exchange goods or services for payment

Source documents

the pieces of paper that provide both the evidence that a transaction has occurred, and the details of the transaction itself

Recording

sorting, classifying and summarising the information contained in the source documents so that it is more usable

Reporting

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

Essentially, the accounting process is about collecting data from source documents; sorting it, classifying it and recording it in journals; and then communicating the information to the owner via financial reports.

Stage 4 Advice

Armed with the information presented in the reports, an accountant should be able to make some suggestions on an appropriate course of action. This is where the real skill of an accountant comes into play. Without proper **advice**, the information in the reports is as good as useless, but if the reports are explained carefully and the accountant provides the owner with a range of options, a more informed decision – and a better outcome for the business – should occur.

Advice

the provision to the owner of a range of options appropriate to their aims/objectives, and recommendations as to their suitability

REVIEW QUESTIONS 1.2

- 1 **Explain** the four stages of the accounting process.
- 2 **State** and **describe** two types of accounting records.
- 3 **State** and **describe** three types of accounting reports.

1.3 ACCOUNTING PRINCIPLES

As they generate financial information, accountants must follow a number of guidelines and in some cases strict rules governing the way accounting is done. Some of these guidelines are generally agreed to by all accountants as they have been followed for a long period of time. Others are enforced by law, and they have to be followed or legal sanctions may follow. Together, these guidelines dictate the way records and reports are prepared.

The main guidelines of importance to this course are:

- 1 *Accounting Principles*, which govern the way accounting information is recorded
- 2 *Qualitative Characteristics*, which inform the way accounting reports are prepared.

Accounting Principles are the ‘generally accepted rules’ that govern the way accounting information is recorded. In our course, the seven principles that govern the way accounting information is recorded are the:

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

Entity principle

The **Entity principle** states that from an accounting perspective, the business is separate from the owner and other entities, and its records should be kept on this basis.

Since we are focussing on small businesses this concept may appear strange, as it is the person behind the counter, or the one actually performing the service who owns the business. Surely any money the business earns belongs to the owner and any assets or debts the owner has would be part of the business since they would be one and the same? In the eyes of the law this is true, but in terms of accounting we assume that the business and the owner are separate entities/beings. If we are to assess the

Accounting Principles are the generally accepted rules which govern the way accounting information is recorded

STUDY TIP

Accounting Principles and Qualitative Characteristics are linked, but different: be careful to provide exactly what is asked for in each question.

Entity principle

the business is separate from the owner and other entities, and its records should be kept on this basis

performance of the business itself, we must only include information that is relevant to that business. The owner may have a home and a large loan (mortgage), but if neither of these items is being used by the business, it must not be included as a business asset or liability. If the owner brings these items into the business for business use, then we should treat that as a transaction between the owner and the firm as if they are separate accounting entities.

Going Concern principle

Going Concern principle

the life of the business is assumed to be continuous, and its records are kept on that basis

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 affect the future of the business. It allows the business to recognise transactions that occur over more than one period such as credit transactions. For instance, if we sell goods on credit we will not receive the cash for those goods until a later date. However, if we assume that our business will continue, then at some stage in the future we are likely to receive the cash from credit sales, and this allows us to record Debtors (amounts owed to us by credit customers) as an asset at the time of the sale. The same applies to amounts we owe to our creditors for our credit purchases. It also helps us to determine if an item should be treated as an asset or an expense. An expense will be consumed within one reporting period; however, an asset will provide benefit to future reporting periods. An example would be Rent Expense (expense) compared to Prepaid Rent Expense (asset).

Further, based on this assumption we can recognise long-term assets and liabilities and distinguish them from the short-term ones. This will allow the owner/manager to see the financial position of the business much more clearly and ensure that there are sufficient short and long-term assets to meet the short and long-term liabilities.

Reporting Period principle

Reporting Period principle

the life of the business must be divided into 'periods' of time to allow reports to be prepared, and the accounting records should reflect the reporting period in which a transaction occurs

The **Reporting Period principle** states that the life of the business must be divided into periods of time to allow reports to be prepared, and the accounting records should reflect the period in which a transaction occurs.

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 reports can be prepared. We cannot wait until the end of the business's life to calculate profit, because we are assuming that will never come, so we calculate profit for the month, or year. A reporting period can be as short as the owner requires, but cannot be longer than a year to meet taxation requirements. (Many businesses will complete a Business Activity Statement – a BAS – once per quarter, meaning their reporting period is three months.)

Historical Cost principle

Historical Cost principle

transactions should be recorded at their original purchase price, as this value is verifiable by source document evidence

The **Historical Cost principle** states that transactions should be recorded at their original purchase price, as this value is verifiable by source document evidence.

This principle applies particularly to assets, which must be recorded at their original purchase price, as this price is able to be proven, usually by reference to the source document which verifies the transaction. Any other valuation, such as resale value or replacement value, is purely an estimate and could be biased by the owner/manager's opinion.

Consistency principle

The **Consistency principle** states that accounting methods used by the business should be kept the same from one period to the next.

In certain situations the accountant may have the option of choosing different methods of accounting for items like stock, depreciation and non-current assets. If the reports are prepared using consistent accounting methods, the owner can be confident that changes in those reports reflect changes in business performance, not simply changes in accounting methods.

This is not to suggest that once a business has decided on a method it is stuck with it forever! A business owner is able to change accounting methods but must disclose this fact to the users of the reports so that they are not misled in any way.

Consistency principle
the business should use the same accounting methods to allow for the comparison of reports from one period to the next

Conservatism principle

The **Conservatism principle** states that losses should be recorded when probable, but gains only when certain (actually earned) 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. Because the accounting system may contain estimates, accountants should view records and reports conservatively/cautiously. It is far better to predict the worst and be pleasantly surprised than to expect the best and then get a rude shock when reality doesn't match expectations.

Conservatism principle
losses should be recorded when probable, but gains only when certain so that liabilities and expenses are not understated and assets and revenues are not overstated

Monetary Unit principle

The **Monetary Unit principle** states that all items must be recorded and reported in monetary terms; that is, in the currency of the country of location where reports are being prepared and ultimately used.

This is one of the more obvious principles. It would make little sense to record the purchase of office equipment as 'one photocopier' without attaching a valuation in dollars: comparisons between periods and between businesses would be almost impossible. Some businesses have overseas operations and it would be pointless trying to report to Australian owners the performance of the overall business in a mixture of currencies; for example, recording loans in Australian dollars and stock in Japanese yen would make the information impossible to use.

Monetary Unit principle
all items must be recorded and reported in the currency of the country of location where the reports are being prepared

REVIEW QUESTIONS 1.3

- 1 **Explain** the role of the Accounting Principles.
- 2 **Define** the seven Accounting Principles.
- 3 **Explain** why a business is assumed to have a life separate to its owner.
- 4 **Define** the length of a reporting period. (Beware: this is a trick question!)

1.4 QUALITATIVE CHARACTERISTICS

While the principles govern the way accounting information is recorded, reports are prepared under the guidance of what is known as the *International Framework*. This framework identifies what the reports should include, and also the qualities the reports should possess. If we follow and implement the Accounting Principles when we are recording, then our accounting reports should possess certain **Qualitative Characteristics**.

Qualitative Characteristics
the qualities of the information in accounting reports

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

reports should include all information which is useful for decision-making

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, relate solely to the business and be appropriate to the decision at hand.

This characteristic is really telling us 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 the 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 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 assess this year's profit.

Therefore financial reports should disclose all significant information that may affect the decision-making, and omit details that will not affect decision-making. *Relevance* also relates to what to include in the reports in terms of what is *material*. Information is regarded as material if its exclusion or inaccuracy could affect user's decision-making. This refers to the level of detail in which that information is shown. For example, the asset 'Debtors' must be included in a Balance Sheet, but it would not be material to list every single debtor and the amount each owes, as this information will not affect decision-making. In fact, all it will do is make the report more difficult to read. (A successful small business might have a hundred debtors – to list them all individually in the Balance Sheet would make the report an extra five pages long!) A similar application allows us to omit cents from our reports as such a minor detail is not significant in terms of decision-making.

Reliability

reports should contain information verified by source document evidence so that it is free from bias

Reliability

Reliability states that reports should contain information that is free from bias, and thus can be relied upon for its accuracy.

This characteristic is telling us that in relation to the amounts we show in our 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 is to make sure it is verifiable by reference to a source document. Reliable information has proof to support its accuracy and should extend to all transactions that the business will record and report; any item in any of the financial reports should be able to be traced back to its origin; that is, its source document. This way there is no room for subjectivity or guesses.

Comparability

reports should be able to be compared over time through the use of consistent accounting procedures

Comparability

Comparability states that reports should be comparable over time, and between different companies, through the use of consistent accounting procedures.

STUDY TIP

'Principles' apply mainly to records, and 'qualities' apply to reports. Any of the 'ability' ones are qualities rather than principles.

One of the most basic uses of accounting reports is to compare performance between businesses and between periods. However, this will only be possible if consistent accounting methods have been used. Otherwise, it is difficult to tell whether changes in accounting reports are the result of changes in business performance, or simply changes in accounting procedures. Where accounting procedures are changed, this should be stated clearly in the reports (or 'disclosed'), 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 makes it easy for the user to understand their meaning.

It is important to remember that the most basic function of accounting reports is to communicate information to the user. Most small business owners are not accountants, and it is therefore pointless to present reports in a form that they cannot understand. 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.

STUDY TIP

All items – even something as small as a fifty-cent stamp – must be recorded, but they might not have to be disclosed separately in the accounting reports.

Understandability

reports should be presented in a manner that makes it easy for the user to comprehend their meaning

REVIEW QUESTIONS 1.4

- 1 **Define** the four Qualitative Characteristics.
- 2 **Explain** how the application of the Entity and Reporting Period principles ensures relevance in the accounting reports.
- 3 **Explain** how the application of the Historical Cost principle ensures reliability in the accounting reports.

WHERE HAVE WE BEEN?

- The purpose of accounting is to provide financial information to assist decision-making.
- The users of accounting information include the owner, debtors, creditors, banks and other lenders, prospective owners and the government through the Australian Taxation Office (ATO).
- The accounting process involves collecting source documents, recording the transactions, and then reporting financial information before advice is provided.
- Accounting Principles are the generally accepted rules governing the way accounting information is recorded, and include: Entity, Going Concern, Reporting Period, Historical Cost, Consistency, Conservatism and Monetary Unit.
- Qualitative Characteristics are the qualities we would like our accounting reports to possess, and include: *Relevance, Reliability, Comparability* and *Understandability*.

EXERCISES

EXERCISE 1.1



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THE ACCOUNTING PROCESS

Reorder the following stages of the accounting process:

- a recording transactions in journals and stock cards
- b collecting source documents like receipts and cheque butts
- c providing advice to the owner of the business
- d preparing financial reports.

EXERCISE 1.2



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THE ACCOUNTING PROCESS

Identify which stage of the accounting process is performed by each of the following actions:

- a preparing an Income Statement
- b filing sales invoices
- c entering transactions in a cash journal
- d presenting the owner with alternative sources of finance.

EXERCISE 1.3



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ACCOUNTING PRINCIPLES

Michael's business is his band – Inside Out – which provides music for functions. In each of the following situations, **identify** and **explain** which Accounting Principle has been breached.

- a Michael bought his mum a new computer for her home using cash from the business cheque account.
- b Michael thinks that the band (the business) might disband in a year or so and therefore has decided to wait until then to calculate profit.
- c Musical instruments that were bought six years ago are valued in the firm's Balance Sheet at what the business is likely to receive if they were sold today.
- d After the band toured Japan, Michael decided to record the earnings in Japanese yen.
- e Michael changes accounting methods every year in order to make the profit appear as big as possible.
- f Michael has decided to list all the liabilities of the firm as current, despite a loan that is due in three years.

EXERCISE 1.4



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QUALITATIVE CHARACTERISTICS

Pat Silcox owns a plumbing business. For each of the following examples **identify** and **explain** the Qualitative Characteristic that has been breached.

- a All 35 individual debtors are listed in the Balance Sheet.
- b In 2015 the reports were prepared using the modified cash method, but in 2016 the accrual method was used.
- c Pat reported the amount for electricity based on what he thought he had paid.
- d Some business expenses were paid out of Pat's personal cheque book, and so do not appear in the reports.

- e Some plumbing equipment has been reported in the Balance Sheet at its current market value.
- f In calculating profit, Pat included an amount that was received for a job that will not be completed until next month.

EXERCISE 1.5



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ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

Betty believes that once transactions for the business have been recorded there is no need to keep the source documents as they take up too much storage space.

Required

- a Referring to one Accounting Principle, **explain** why Betty must keep all the firm's source documents.
- b **Identify** and **define** the Qualitative Characteristic that will be breached if Betty fails to keep the source documents.

EXERCISE 1.6



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ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

During July 2016, the owner of Perfect Painting discovered a receipt for a sale that occurred two years ago and included the transaction in the reports for July 2016.

Required

- a Referring to one Qualitative Characteristic, **explain** why the owner must not include this transaction in the reports for July 2016.
- b Referring to one Accounting Principle, **explain** when the transaction should have been reported.

EXERCISE 1.7



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ACCOUNTING PRINCIPLES AND QUALITATIVE CHARACTERISTICS

Beria Munir has withdrawn \$500 cash to pay the deposit on a family holiday. Since she is the owner of the business, she sees no need to record the transaction.

Required

- a Referring to one Accounting Principle, **explain** the problem with Beria's approach.
- b **Identify** and **explain** the Qualitative Characteristic that will be undermined if this transaction is not reported.