

# ACCOUNTING IN CONTEXT

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# PREFACE

**THIS TEXTBOOK REPRESENTS** the Australian adaptation of Libby et al.'s *Financial Accounting* (US), which at the time of writing is in its fifth edition. The book has been revised significantly to adapt the content to the Australian context, and to update the book both for recent changes in accounting regulations and to incorporate important topics in managerial accounting.

*Accounting in context* has two primary objectives:

1. to provide those with little or no knowledge of accounting with an introduction to the ways in which business transactions and events are recorded and reported in a manner that can be used in a variety of decision-making contexts
2. to extend the understanding of those with some prior knowledge of accounting and business by providing a contextual understanding of accounting as a crucial tool for organisations.

The book is intended for use by two groups of readers:

1. *Future business managers* who currently hold, or are likely to hold, positions that require an understanding of financial information and an ability to incorporate that information into business decisions.
2. *Future accountants*, whose future responsibilities will include preparing or auditing the information produced, and who will require an in-depth knowledge of the use of accounting information in complex business decision making.

There are a number of ways in which these objectives are addressed in the text. Firstly, the book is set firmly in a business context to enable readers to understand the accounting issues covered in the context in which they typically occur. To assist in this, each chapter is based on a focus company. The focus companies are used as a vehicle for discussing a range of accounting issues. While profit-seeking and publicly listed companies are the main focus, a range of accounting issues as they relate to smaller companies and not-for-profit organisations are also considered. In addition, the text examines the role of accounting in the operation of markets, in particular the role of accounting in the share market, as well as how accounting information is used as an input to the selection and remuneration of senior company executives.

Secondly, and related to the first point, the book includes the agency perspective as a theme throughout. This perspective is used as a basis for understanding the motives that exist for preparers of accounting reports. As a result, readers are better able to understand the role of choice in the preparation of accounting information which, in turn, leads to a better understanding of how the information may be incorporated into decision making.

Finally, the book is principles-based and therefore is not bogged down in detailed discussion of the technical content of accounting standards and rules. This enables an open and free discussion of a range of accounting issues, taking into account the latest developments in accounting research and regulation.

**Brad Potter**  
*University of Melbourne*

**THERE ARE MANY** people I would like to thank for their contribution to this first Australia–New Zealand edition of *Accounting in context*.

Over the years many dedicated instructors have devoted their time and effort to help the US authors improve on each edition. I would like to acknowledge and thank all of my colleagues who helped guide the development decisions for this edition and previous US editions.

Thanks also to the various Australian and New Zealand reviewers of the text whose confidence in this Australian adaptation encouraged me to go ahead with the project. In deciding to adapt this highly successful text to Australian and New Zealand accounting courses, I have relied heavily on the feedback and support of numerous accounting academics and professionals, especially Warwick Baines (Charles Sturt University), Mark Hughes (University of Canberra) and Rebecca Tan (Australian National University).

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The team at McGraw-Hill must also be thanked for their support and encouragement throughout this process. My particular thanks go to Publisher Luisa Cecotti, Development Manager Rosemary Noble and Senior Production Editor Yani Silvana, as well as freelance editor Annie Chandler.

Finally, I would like to thank my wife Nerida and daughters Georgia and Sophie, whose unwavering support enabled me to complete this project.

**Brad Potter**

*University of Melbourne*

# CHAPTER HIGHLIGHTS

## 1 FINANCIAL STATEMENTS AND BUSINESS DECISIONS

**FOCUS COMPANY:** MAXIDRIVE PTY LTD

- The relevance of accounting information for decisions made in a business context
- Using accounting information to understand the value of a company
- The institutional framework in Australian accounting
- Draws on Australian equivalents to the International Financial Reporting Standards (AIFRS) and incorporates recent regulatory changes
- Explores the motives of those preparing financial reports
- Ethical issues and legal liability in accounting and reporting

## 2 INVESTING AND FINANCING DECISIONS AND THE STATEMENT OF FINANCIAL POSITION

**FOCUS COMPANY:** GOODMAN FIELDER LTD

- Explores important assumptions and principles that underpin the preparation of the statement of financial position
- Detailed discussion of the elements of the statement of a properly classified financial position
- Explores accounting policy choices and ethical issues relating to the recognition of assets
- Detailed coverage of transaction analysis and recording for various transactions and events
- Detailed coverage of the implications of Goods and Services Tax (GST) for recording and reporting information

## 3 OPERATING DECISIONS AND THE STATEMENT OF COMPREHENSIVE INCOME

**FOCUS COMPANY:** GOODMAN FIELDER LTD

- Examines important assumptions and principles that underpin the preparation of the statement of comprehensive income.
- Detailed discussion of the elements of the statement of comprehensive income
- Expanded discussion of cash versus accrual accounting
- Understanding and interpreting the information contained in the statement of comprehensive income
- The role of company profits in influencing the share price

## 4 ADJUSTMENTS, FINANCIAL STATEMENTS AND THE QUALITY OF EARNINGS

**FOCUS COMPANY:** GOODMAN FIELDER LTD

- Completes the accounting cycle, providing a detailed discussion of end-of-period adjustments to revenue and expense
- Clear explanation of the rationale for each adjustment
- Explores the role of judgement in the adjustment process and illustrates the impacts of the adjustments on end-of-period performance and position
- Closing and balancing ledger accounts

## 5 COMMUNICATING AND INTERPRETING ACCOUNTING INFORMATION

**FOCUS COMPANY:** BILLABONG INTERNATIONAL LTD

- Examines the range of stakeholders involved in the accounting communication process, including regulators, directors, auditors and financial analysts
- Discusses the diverse sources from which information about a company may be obtained
- Provides an understanding of the common classifications used in the principal financial statements and how those classifications can foster a greater appreciation of the company's financial position and performance
- Demonstrates the role of the notes that accompany financial statements in assisting a general understanding of the information contained in the reports
- Introduces *dupont analysis* as a means of understanding the drivers of company performance and considers the decisions companies can make that impact on those drivers

## 6 REPORTING AND INTERPRETING SALES REVENUE, RECEIVABLES AND CASH

**FOCUS COMPANY:** FUNTASTIC LTD

- Examines a range of business decisions made by companies and the impacts of those decisions on sales revenue, accounts receivable and cash
- Considers a range of issues relating to the measurement and reporting of receivables including classification and valuation including bad debts
- Considers internal controls that may be relevant for sales revenue, accounts receivable and cash
- Introduces the gross profit margin and accounts receivable turnover ratios and illustrates how these ratios may be used to understand company performance

## 7 REPORTING AND INTERPRETING COST OF GOODS SOLD AND INVENTORY

**FOCUS COMPANY:** PACIFIC BRANDS LTD

- Recording and reporting of inventory
- Examines different inventory costing methods and the financial statement effects of the different methods
- Valuation of inventory and the lower of cost or market rule
- Measuring efficiency in inventory management using the inventory turnover ratio
- Different recording approaches for inventory (perpetual versus periodic) and the relative benefits of each
- Internal controls relevant to inventory



## 8 REPORTING AND INTERPRETING PROPERTY, PLANT AND EQUIPMENT, NATURAL RESOURCES AND INTANGIBLES

### FOCUS COMPANY: QANTAS

- Financial and non-financial issues to consider in acquiring long-lived assets
- Identification, recognition and measurement of long-lived assets
- Accounting for repairs, maintenance and additions to long-lived assets
- Accounting issues relating to the use, impairment and disposal of plant and equipment
- Alternative depreciation methods, including the rationale for each, the resulting financial implications and the difference between depreciation and valuation
- Considers unique features of the recording and reporting of natural resources and intangibles

## 9 REPORTING AND INTERPRETING LIABILITIES

### FOCUS COMPANY: METCASH LTD

- Identification, recognition and measurement of liabilities
- Accounting for employee-related costs
- Uses the current ratio and accounts payable turnover to understand how companies manage liabilities
- Apply the present value concept in recording and reporting long-term liabilities

## 10 REPORTING AND INTERPRETING BILLS

### FOCUS COMPANY: ARISTOCRAT LEISURE LTD

- Recording and reporting company bills issued at their par value as well as bills issued at above and/or below par their par value
- Use the debt to equity ratio to understand how a company manages its bills and other liabilities
- Explores the cash flow implications of bills and other liabilities

## 11 REPORTING AND INTERPRETING OWNERS' EQUITY

### FOCUS COMPANY: HARVEY NORMAN LTD

- Recognition and measurement of the components of owners' equity
- Different share-related transactions, including share issues, buy backs, dividends, bonus issues and share splits
- The implications of different share-related transactions for the calculation of earnings per share

## 12 REPORTING AND INTERPRETING INVESTMENTS IN OTHER COMPANIES

### FOCUS COMPANY: HARVEY NORMAN LTD

- Recognition and measurement of the investments in other companies that constitute passive investments and investments where the investor has significant influence and control over the investee
- The role of judgement in accounting for investments in other companies
- Using the return on assets ratio to understand the investing activities of a company

## 13 STATEMENT OF CASH FLOWS

### FOCUS COMPANY: FOSTER'S GROUP LTD

- Preparing, reporting and interpreting cash flows from operations using the direct and indirect methods
- Analysing and interpreting the quality of income ratio
- Preparing reports and interpreting cash flows from investing and financing activities

## 14 ANALYSING FINANCIAL STATEMENTS

### FOCUS COMPANY: HOUSEWARES LTD

- Explores the impact of business strategy on the financial analysis
- Uses financial statement ratios and associated information to understand important dimensions of the performance, position and future prospects for a company
- Discusses a range of operating, strategic and accounting decisions which may impact upon the financial analysis undertaken

## 15 AN INTRODUCTION TO STRATEGIC MANAGEMENT ACCOUNTING

### FOCUS COMPANY: SEVEN NETWORK LTD

- Introduces the role of accounting information for the successful functioning of modern business
- Explores the importance of accounting information for all levels of the business model
- Identifies and discusses some of the major innovations and themes that have shaped the managerial accounting function in recent decades

## 16 COST CLASSIFICATIONS AND CVP ANALYSIS

### FOCUS COMPANY: STRIDE SPORTS MANAGEMENT

- Explores a range of important concepts relating to costs, their behaviour and management
- Applies these concepts in conducting cost volume profit (CVP) analysis
- Extends discussion of CVP to consider multi-product settings and the application of CVP analysis to the not-for-profit sector

## 17 MANUFACTURING ACCOUNTING

### FOCUS COMPANY: AIKMAN ENGINEERING PTY LTD

- The factors to consider in selecting a costing system
- Job and process costing to a small manufacturing company
- Detailed discussion of the accounting for overhead costs
- The application of job costing to service companies

## 18 THE ROLE OF BUDGETS IN PLANNING, CONTROL AND EVALUATION

### FOCUS COMPANY: AUSTRALIAN GOVERNMENT BUDGET

- The various roles of budgeting in a range of organisational settings
- Behavioural implications of budgeting
- The use of flexible budgeting and variance analysis in assisting the decisions made by management

# TEXT AT A GLANCE

**ACCOUNTING IN CONTEXT** offers a range of pedagogical tools that complement the way teachers like to teach and students like to learn. Some offer information and tips that help teachers present complex subjects; others highlight issues relevant to what students hear and see in their daily lives.

## LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain the objective of preparing a trial balance. *p. 191*
2. Analyse and prepare the adjustments necessary at the end of the period to update statement of financial position and statement of comprehensive income accounts. *p. 193*
3. Present a statement of comprehensive income with earnings per share, statement of changes in shareholders' equity, statement of financial position. *p. 203*

## LEARNING OBJECTIVES

Each chapter starts with a list of the chapter's learning objectives; these are restated in the margin where they are addressed. The learning objectives flag what student should know when they have worked through the chapter. Students can make them the foundation for exam revision by testing themselves.

### DEMONSTRATION CASE

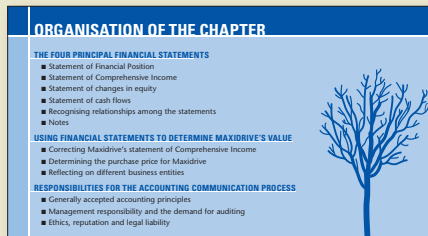
We take our final look at the accounting activities of Terrific Lawn Maintenance Co. by illustrating the activities at the end of the accounting cycle: the adjustment process, financial statement preparation and the closing process—including both the closing journal entries and the closing of the ledger accounts. No adjustments had been made to the accounts to reflect all revenues earned and expenses incurred in April. The trial balance for Terrific Lawn on 30 April 2008, based on the unadjusted balances in Chapter 3, is as follows:

## DEMONSTRATION CASES

Occurring at the end of most chapters, these cases provide an overview of the primary issues discussed in the chapter. Each demonstration case is followed by a recommended solution.

## ANNUAL REPORTS

The annual reports for JB HiFi Ltd and Super Cheap Auto Ltd are reproduced in full in the appendices. The data in these reports are used extensively in the end-of-chapter problems and exercises.



## ORGANISATION OF THE CHAPTER

The clear statement of the chapter's organisation provides a powerful visual representation of the content of the chapter, easily enabling instructors and students to find what they are looking for.

### Recording expenses in the appropriate period

When cash is paid prior to incurring an expense, the company records a journal entry to debit the appropriate asset accounts (including the GST asset where applicable) and credit Cash (A) on the timeline to the left). Common examples of **deferred expenses** include Supplies; Prepaid Expenses such as rent, advertising and insurance; Buildings, Equipment and Intangible Assets such as **patents** and **copyrights**. When the assets are used during the period to generate revenues, an adjusting entry is necessary to debit an expense account (E) and credit an

asset account (A) for the amount of expense incurred. Examples of deferred expenses:

- Supplies
- Prepaid expenses (e.g. rent, advertising, insurance)
- Buildings and equipment

Adjusting entry:  
Dr ↑ Expense and Cr ↓ Asset

**Deferred expenses** are previously acquired assets that may need to be adjusted at the end of the accounting period to reflect the amount of expense incurred.

Examples of deferred expenses:

- Supplies
- Prepaid expenses (e.g. rent, advertising, insurance)
- Buildings and equipment

Adjusting entry:  
Dr ↑ Expense and Cr ↓ Asset

## KEY TERMS

Key terms are not only bolded in blue in the text the first time they are used, but are also defined in the margin, as well as in the glossary, and listed in the end-of-chapter material with the page numbers of their definitions.

## IN-CHAPTER FEATURES

### QANTAS LOGO ?? TO COME??

*Managing profits through the control of productive capacity*

FOCUS COMPANY:

**QANTAS**

<[www.qantas.com.au](http://www.qantas.com.au)>

As of 30 June 2007 the Qantas Group ('Qantas') operated a fleet of 213 aircraft, providing services to 143 destinations in 36 countries—57 in Australia, 86 beyond Australian shores. Qantas is a capital-intensive company with more than \$12.3 billion in property, plant and equipment reported on its statement of financial position. For the financial year ending 30 June 2007 Qantas spent \$1.2 billion on

**FOCUS COMPANY:** Each chapter opens with detailed financial information about the relevant focus company. The selected companies, chosen to contextualise the topics in a real-world setting, range from multinational to small enterprises, manufacturing to service industries.

### A QUESTION OF ETHICS

*Taking a different strategy*



Singapore Airlines, SIA, formed in 1972, has shown continued profitability as one of the world's largest operators of the most technologically advanced 'jumbo jet', the Boeing 747-400. Unlike other airlines whose average fleet age is more than 12 years, Singapore Airlines uses its aircraft for an average of just under six years. This strategy has a dual effect. First, depreciation expense is significantly higher due to the aircraft's shorter estimated useful life and thus reduces net profit. Singapore Airlines sells its used aircraft, however—an activity

**A QUESTION OF ETHICS:** Accounting ethics is integrated throughout the text (and end-of-chapter assignments) to convey to students the importance of acting responsibly in business practice.

**FINANCIAL ANALYSIS** Management uses of financial statements

In our discussion of financial analysis thus far, we have focused on the perspectives of investors and lenders—i.e. those external to the company. Throughout later chapters we will see that once transaction data is recorded in the company's accounting information system, it may be rearranged and formatted for inclusion in the business's financial reports, which are used by a range of external users. In addition, other parties may need to review the data to assist in their decision making. For example, managers within the company also make direct use of financial statements to assess the company's ability to invest in additional productive capacity, such as machinery or human capital. When making particular economic decisions, managers generally will need to ascertain

**FINANCIAL ANALYSIS:** This feature appears throughout the text, and relates directly to the decisions faced by managers and financial statement users at the focus and contrasting companies. The Financial analysis feature provides current, interesting information that makes the content relevant and interesting to students.

**KEY RATIO ANALYSIS** Fixed asset turnover

**ANALYTICAL QUESTION:**  
How effectively is management utilizing fixed assets to generate revenues?

**RATIO AND COMPARISONS:**

Fixed asset turnover =  $\frac{\text{Net sales for operating revenues}}{\text{Average total fixed assets}}$

The 2007 ratio for Qantas is:

$\$15\,105.7 \text{ operating revenues} \div (\$13\,917.7 + \$14\,234.9) \div 2 = 1.08 \text{ times}$

Companies over time		Companies with competitors	
Qantas		Virgin Airline	Singapore Airlines
2007	2006	2007	2007
1.08	1.06	1.07	1.07

**INTERPRETATION**  
**In general** — The fixed asset turnover ratio measures the sales dollars generated by each dollar of fixed asset used. A high rate normally suggests effective management. An increasing rate over time signals more efficient fixed asset use. Lenders and security analysts use this.

**KEY RATIO ANALYSIS:** Each Key ratio analysis box presents ratio analysis for the chapter focus company plus comparative companies to help students evaluate financial performance.

**DEPRECIATION METHODS GLOBALLY**

The various depreciation methods discussed in this chapter are used widely by companies in most countries. Some methods used in countries around the globe are not quite as common. For example, some German companies may depreciate an asset's cost based on the number of hours it is used, and British companies may tend to use the unitary method, which results in lower depreciation during the early years of an asset's life (contrasted with accelerated depreciation, which results in higher depreciation during the early years).

Many countries, including Australia, Brazil, England, Hong Kong, Mexico and Singapore, also permit the revaluation of property, plant and equipment to their fair value as of the statement of financial position date. The primary argument in favour of revaluation is that the historical cost of an asset purchased 15 or 20 years ago is not meaningful because of the impact of inflation. For example, most people would not compare the original price of a 1979 Ford to the original price of a 2009 Ford because the purchasing power of the dollar changed dramatically between those years. Where such revaluation is allowed, accounting regulations generally require the amount to be recorded as an increase to the Asset Revaluation Reserve and prohibit the recognition of revaluation increments in periodic income. Revaluation to fair value is prohibited in the US (under GAAP) and in Canada, Germany and Japan.

**FOCUS ON CASH FLOW** Productive assets and depreciation

**LEARNING OBJECTIVE 1**  
Explain the impact on cash flows of acquiring, using and disposing of long-lived assets.

**EFFECT ON STATEMENT OF CASH FLOWS**  
The buying and selling of long-lived assets impacts on the company's statement of cash flows in two primary ways. When such assets are purchased, they result in an investing cash outflow, while the cash proceeds from the sale of these assets are recorded as a cash inflow from investing activities. It is important to note that it is the total cash proceeds that impact upon the statement of cash flows, while the gain or loss on sale is what is recorded in the statement of comprehensive income for the period. When depreciation is recorded, no cash payment is made (i.e. there is no credit to Cash) and therefore no statement of cash flows effect.

**In general** — Acquiring, selling and depreciating long-term assets are reflected on a company's statement of cash flows as indicated in the following table:

	Effect on cash flows
Operating activities (direct method)	No impact
Investing activities	
Purchase of long-term assets	-
Proceeds from the sale of long-term assets	+

**FOCUS ON CASH FLOWS:** These sections generally provide a discussion and analysis of changes in the cash flow, and the decisions that caused the changes in cash flow, of the focus company in question. These discussions encourage students to think more critically about the impact managerial decisions have on a company's cash flow.

**SELF-STUDY QUIZ**

Now let us assume the same facts as above except that the asset was sold for \$2 000 000 cash. Prepare the two entries on the date of the sale.

- Update depreciation expense for year 17.
- Record the sale.

After you have completed your answers, check them with the solutions at the end of the chapter:

**Assets = Liabilities + Shareholders' Equity**

**SELF-STUDY QUIZZES:** This feature stops students at strategic points throughout each chapter to make sure they understand key points. The quizzes often require students to prepare or use financial statement disclosures based on actual companies to reinforce the usefulness of what they are learning.

**INTERNATIONAL PERSPECTIVE:** This feature exposes students to a variety of reporting practices used throughout the world so they can understand and appreciate the implications of different accounting practices. International accounting sections are incorporated throughout the text and in the homework material.

## END-OF-CHAPTER FEATURES

At the end of each chapter there is a comprehensive range of assessment tools designed for self-study by students, and assignment topics for instructors. These features include:

- chapter summaries
- solutions to the self-study quizzes
- multiple-choice questions
- questions
- mini-exercises
- exercises
- problems
- alternate problems
- cases and projects related to the annual reports in the appendices.

# E-STUDENT



Online  
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with POWERWEB

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This is the **asset** sect  
balance

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ASSETS	
Current assets	
Cash	
Accounts receivable	
Supplies	
Prepaid expenses	
Other current assets	
Total current assets	
Long-term investments	
Property, and equipment (net of accumulated depreciation of \$1	
Long-term notes receivable	
Intangibles	
Other assets	
Total assets	

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PPTs via Accounting in Context by Potter & Libby

**ACCOUNTING IN CONTEXT**  
POTTER | LIBBY | LIBBY | SHORT

Information Center

Financial Accounting  
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2-49

ction of Papa John's  
e sheet.

ational, Inc. and Subsidiaries  
dated Balance Sheet  
(ars in thousands)

	January 31, 2004	December 28, 2003
\$	9,000	\$ 7,000
	20,000	20,000
	17,000	17,000
	11,000	11,000
	7,000	7,000
	64,000	62,000
	9,000	8,000
	214,000	204,000
	14,000	11,000
	49,000	49,000
	13,000	13,000
	<u>\$ 363,000</u>	<u>\$ 347,000</u>

of  
\$149,000)

1-49

## SOLUTIONS MANUAL

A comprehensive solutions manual is available for instructors.

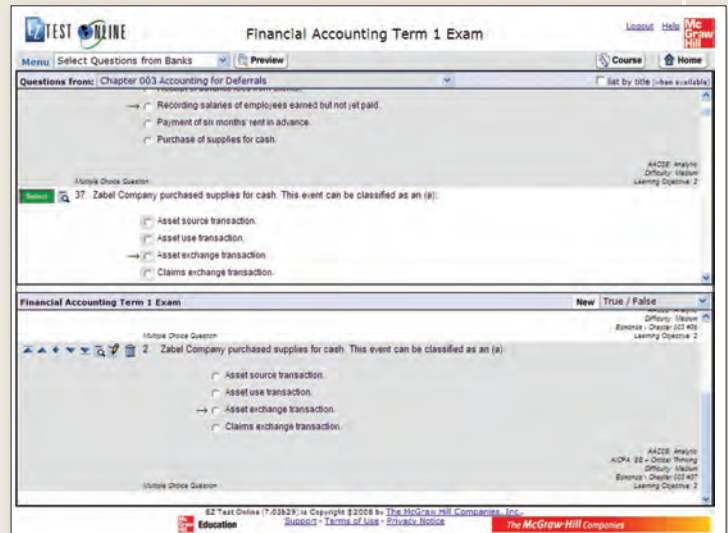
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