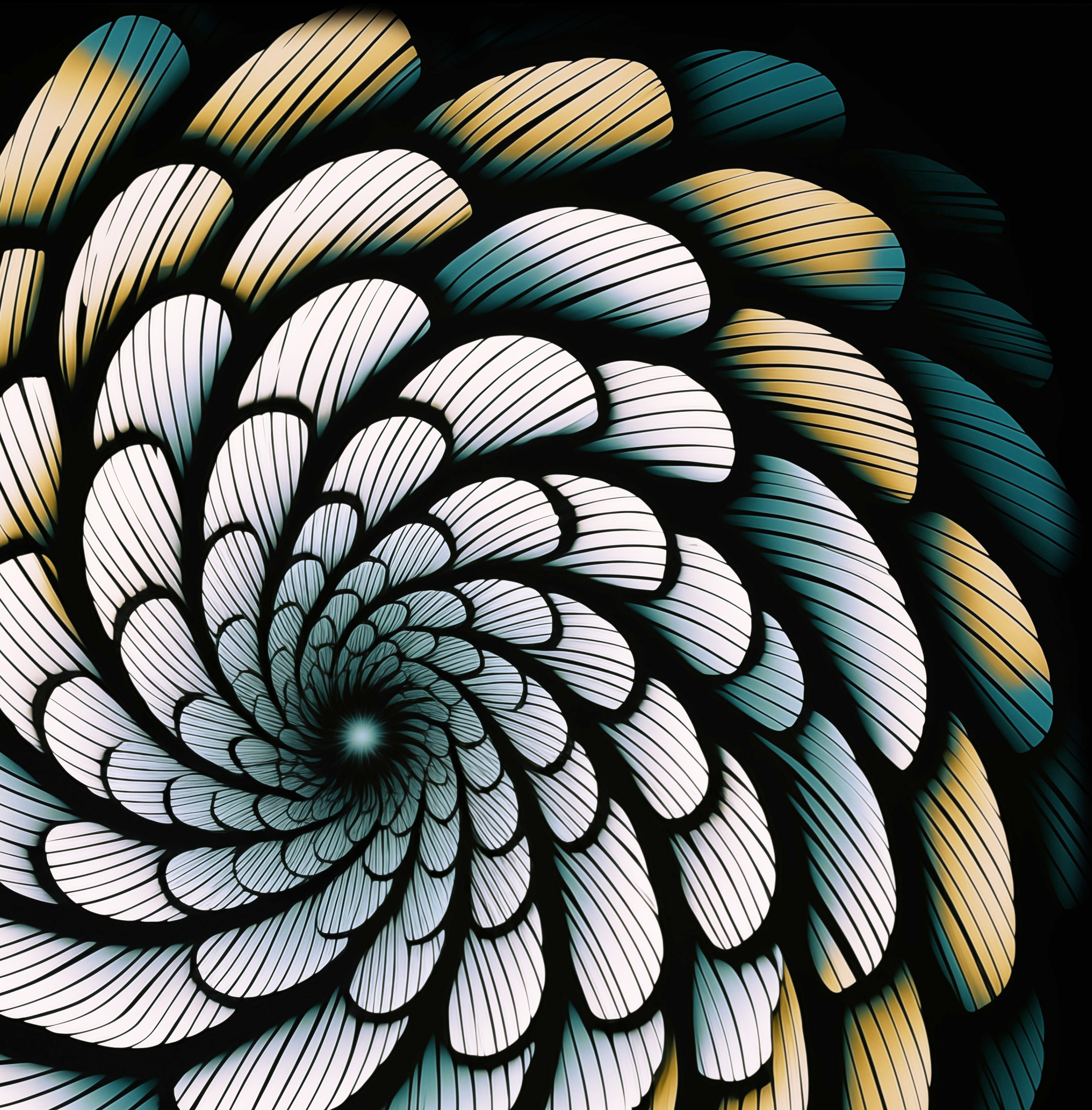
CARLON | McALPINE | LEE | MITRIONE | BAYNE | KIRK | WONG

ACCOUNTING

REPORTING, ANALYSIS AND DECISION MAKING

EIGHTH EDITION



WILEY

Accounting

Reporting, analysis and decision making

EIGHTH EDITION

Shirley Carlon

Rosina McAlpine

Chrisann Lee

Lorena Mitrione

Lyndie Bayne

Ngaire Kirk

Lily Wong

WILEY

Eighth edition published 2026 by
John Wiley & Sons Australia, Ltd
Level 4, 287 Lonsdale Street, Melbourne Vic 3000

Typeset in 10/12pt Times LT Std

ISBN 9781394333974 (print); ISBN 9781394333998 (e-text)

NATIONAL LIBRARY OF AUSTRALIA

A catalogue record for this book is available from the National Library of Australia

Wiley acknowledges the Traditional Custodians of the land on which we operate, live and gather as employees, and recognise their continuing connection to land, water and community. We pay respect to Elders past, present and emerging.

Creators/contributors
Shirley Carlon (Author), Rosina McAlpine (Author), Chrisann Lee (Author), Lorena Mitrione (Author), Lyndie Bayne (Author), Ngaire Kirk (Author), Lily Wong (Author)

Wiley
Mark Levings (Publishing Manager, Tertiary and Professional), Jess Carr (Manager, Higher Education Content Management), Rebecca Campbell (Senior Production Editor), Laura Brinums (Publishing Coordinator), Georgie O'Brien (Publishing Coordinator), Renee Bryon (Copyright & Image Research Supervisor), Delia Sala (Cover Design), Jess Ní Chuinn (Copyeditor)

Cover: © Adam / Adobe Stock Photo

Typeset in India by diacriTech

BRIEF CONTENTS

CONTENTS

PREFACE

In recent years accounting education has seen numerous changes to the way accounting is taught. These changes reflect the demands of an ever-changing business world, opportunities created by new technology and an increased understanding of how you (students) learn. The foundation of this text is based on a number of unique principles and innovations in accounting education.

‘Less is more.’

The objective of this text is to provide you with an understanding of those concepts that are fundamental to the preparation and use of accounting information. Most will forget procedural details within a short period of time. On the other hand, concepts, if well taught, should be remembered for a lifetime. Concepts are especially important in a world where the details are constantly changing.

‘Don’t just sit there — do something.’

You learn best when you are actively engaged. The overriding pedagogical objective of this text is to provide you with continual opportunities for active learning. One of the best tools for active learning is strategically placed questions. Our discussions are framed by questions, often beginning with rhetorical questions and ending with review questions, and our analytical devices, called ‘Decision-making toolkits’, use key questions to demonstrate the purpose of each.

‘I’ll believe it when I see it.’

You will be more willing to commit time and energy to a topic when you believe that it is relevant to your future career. There is no better way to demonstrate relevance than to ground discussion in the real-world. Consistent with this, we adopted a macro-approach — starting in chapter 1, you are shown how to use financial statements of companies, demonstrating the relevance of accounting. As you become acquainted with the financial successes and fluctuations of these companies, many will begin to follow business news more closely, making their learning a dynamic, ongoing process. We also discuss small to medium-sized companies to highlight the challenges they face as they try to grow.

‘You’ll need to make a decision.’

In a business environment there are many and varied decisions to be made. Illustrative examples of the types of decisions internal management and external financial statement users make are discussed throughout the text. Decision making involves identifying and sourcing the relevant information, analysing data and critically evaluating alternatives, and this takes practice.

In addition, to develop your analysis and decision-making skills we have integrated important analytical tools throughout the text. After each new decision-making tool is presented, we summarise the key features of that tool in a decision-making toolkit. At the end of each chapter, we provide a comprehensive demonstration of an analysis of a real or hypothetical company using the decision tools presented in the chapter. The presentation of these tools throughout the text is logically sequenced to take full advantage of the tools presented in earlier chapters.

‘It’s a small world.’

Business operates in a global environment. Rapid and ever-changing improvements in information technology, logistics and transport continue to strive toward a single global economy. The internet has made it possible for even small businesses to sell their products virtually anywhere in the world. Few business decisions can be made without consideration of international factors. To heighten your awareness of the issues that concern business most we have included a range of case studies that explore international, environmental, financial analysis and ethical issues.

‘Apply what you learn.’

In developing this text, we have been mindful of the Accounting Threshold Learning Outcomes and, accordingly, we have integrated case studies into the resources available for instructors. The case studies feature a series of capstone cases aligned to the first 12 chapters of the text, and have been designed to challenge you to apply analytical skills, exercise judgement and communicate a financial decision.

ABOUT THE AUTHORS

Shirley Carlon

Shirley Carlon MCom (Hons), CA, has over 25 years' experience in academia. Her teaching interests include financial and managerial accounting, auditing and tax. Shirley has considerable experience in the delivery of both external and internal programs, including web-based courses. Shirley has received a national teaching citation award for outstanding contributions to student learning for innovations in curriculum development and the creation of peer support mechanisms for off-campus students. She has taught extensively in China and has been a guest speaker on accounting issues at government functions. Shirley's research interests are in financial reporting where she has published several articles on peer mentoring, risk reporting, intangible assets, accounting policy choice and tax in Australian and international journals. She is a chartered accountant with experience in both large and medium-sized audit firms.

Rosina McAlpine

Dr Rosina McAlpine BCom, MCom (Hons), MHEd, PhD, is an author, social entrepreneur and CEO of Win Win Parenting. Dr Rosina is a former associate professor at the University of Sydney Business School and holds a Masters of Higher Education and an education-focused PhD. She is an internationally recognised, award-winning researcher and educator, having received five outstanding teaching awards at the faculty, university and national levels as well as five international best paper awards. Since becoming a parent, Dr Rosina has been developing programs to help working parents overcome the many challenges of modern-day parenting using the latest research in child development. Dr Rosina's research interests include navigating work and family, gender equality and parenting education. Dr Rosina appears regularly in the media and her innovative evidence-based parenting programs are delivered across a variety of corporations, universities and government organisations locally and internationally to support working parents to manage the work–family interface. Dr Rosina is the contributing editor of the book entitled *Inspired children: how the leading minds of today raise their children*.

Chrisann Lee

Dr Chrisann Lee has a PhD (QUT), a Master of Commerce (CSU) and a Graduate Diploma in Management (AGSM). She has lectured in introductory accounting, management accounting, superannuation and personal financial planning. Chrisann is passionate about teaching and has received numerous teaching excellence awards during the two decades of working in the higher education sector. For the last three years, she has followed her passion for wellness as a yoga instructor, teaching yoga classes and hosting international wellness retreats. Besides running her wellness business, Chrisann continues to use her financial knowledge to manage various portfolios including property and investment funds.

Lorena Mitrione

Dr Lorena Mitrione PhD, BCom, MBus, PGrad DipEc & Comm, is a lecturer in accounting at the Monash Business School. She has taught and co-ordinated financial accounting units in all year levels, both undergraduate and postgraduate. Passionate about accounting education, prior to joining Monash in 2009, Lorena worked at CPA Australia. From 2001 she was the CPA Program Manager, responsible for the development and maintenance of CPA Program materials and examinations. In this role Lorena developed a sound sense of the requirements for accounting learning materials while maintaining an up-to-date knowledge of accounting standards, accounting research, technical accounting matters and business practices. Her PhD, titled 'Motivation and self-regulated learning strategies accounting students adopt in a blended learning environment', was completed in 2021.

Lyndie Bayne

Dr Lyndie Bayne is a fully qualified chartered accountant (FCA) with over 20 years of experience as a sustainability researcher and accounting (financial and management accounting) lecturer, after being in audit at KPMG. She has been awarded competitive industry grants for research on climate disclosures and non-financial KPIs, such as the IAAER-KPMG Grant Program Round 8 (2023–2025) and the Institute of Chartered Accountants of Scotland (2018–2019). Her research has been published in high-quality academic journals (e.g. *Accounting, Auditing and Accountability Journal*) and industry reports and has been presented at industry and academic conferences. In 2025, Lyndie was elected to the Regional Council of CA ANZ. She is the Chair of the CA ANZ Sustainability Working Group WA. Lyndie promotes a practical, strategic and collaborative approach to incorporating sustainability principles and practices into organisational behaviour.

Ngaire Kirk

Ngaire Kirk BBS, BBS (Honours), MBS, CA, had a background in sheep and cattle farming and in the public and private health sectors. Her teaching responsibilities at Massey included coordinating and teaching introductory and intermediate financial accounting papers and teaching advanced auditing. Her research interests focused mainly on financial accounting, financial reporting and accounting education, in particular the use of electronic and online resources to enhance both internal and distance learning. Ngaire retired from Massey University at the end of April 2017, but prior to her retirement she was a member of two key Massey Business College committees whose role is to enhance assurance of learning, and teaching and learning development across the college. Despite retiring, Ngaire accepted a request from Victoria University of Wellington to coordinate their large first-year accounting class for nonaccountants (ACCY130) in trimester 2, 2017 and continued as a teaching fellow, teaching ACCY115, ACCY130 and the second-year financial accounting paper ACCY231 in 2018, and also ACCY130 and ACCY115 and ACCY231. Ngaire fully retired from Victoria University at the end of trimester 1, 2020 after teaching ACCY130 and ACCY231 for half that semester. Ngaire passed away peacefully in 2023.

Lily Wong

Lily Wong BBus, MBus, PhD, CPA is an honorary professor in the Victoria University Business School, Australia. Lily is a recipient of international best paper awards, as well as university and national teaching excellence awards for her contribution to student learning in accounting education. Lily's key research interests relate to improving the learning experience and academic outcomes for first-year accounting students. Current areas of interest include blended learning, development of online teaching resources and examining the impact of technology-enhanced teaching options on student learning outcomes.

KEY FEATURES

Print text

This text is designed for students studying accounting for the first time. Real and hypothetical company financial information to support your understanding of accounting as an information system is presented in a clear, easy-to-follow way.

- Financial data from various companies are used to highlight comparative financial results and measure financial performance.
- There is a clear, well-developed balance between the perspectives of the users and the preparers of financial statements.
- In several chapters, 'Review it' questions relate chapter topics to real-world scenarios.
- In the 'Building business skills' section at the end of each chapter, financial reporting problems use financial statements to align the chapter material to the real world.
- Analysis and decision making incorporated throughout the chapters reinforce applications to decision making and use of accounting information by management.

Pedagogical framework

We have used many constructive pedagogical tools to help you learn accounting concepts and apply them to decision making in the business world.

Understanding the context

- **Learning objectives**, listed at the beginning of each chapter, form a framework throughout the text, with each objective repeated in the main body of the chapter and again in the **Summary**. Also, end-of-chapter assignment materials are linked to the learning objectives.
- A **chapter preview** provides an overview of the major topics of the chapter. First, an introductory paragraph explains how the story relates to the topics to be discussed, and then a graphic outline of the chapter provides a 'road map', useful for seeing the big picture as well as the connections between subtopics.

Learning the material

- This text emphasises the accounting experiences of real entities throughout, from chapter preview to the chapter's last item of homework material. Details on these many features follow. In addition, every financial accounting chapter uses **financial statements** from companies.
- **Illustrations** support and reinforce the concepts of the text. Infographics help you visualise and apply accounting concepts to the real-world. The infographics often portray important concepts in entertaining and memorable ways.
- **Learning reflection and consolidation** sections occur at the end of each key topic and consist of two parts. *Review it* serves as a learning check within the chapter by asking you to stop and answer knowledge and comprehension questions about the material just covered. These exercises help cement your understanding of how topics covered in the chapter are reported in financial statements. Answers to questions using financial statements appear at the end of the chapter. *Do it* is a brief demonstration problem that gives immediate practice using the material just covered. Solutions are provided in the text to help you understand the reasoning involved in reaching an answer.
- **Accounting equation analyses** are included in each chapter underneath key journal entries. This feature reinforces your understanding of the impact of an accounting transaction on the financial statements.
- **Helpful hints** in italicised text throughout the chapters expand on or help clarify concepts under discussion in the surrounding text. Sometimes the hints also provide alternative terminology — synonymous terms that students may come across in subsequent accounting courses and in business — or international notes — exposing international issues in accounting, reporting and decision making.
- Each chapter presents decision tools that are useful for analysing the financial statement components discussed in that chapter. At the end of the text discussion relating to the decision tool, a **Decision-making toolkit** summarises the key features of that decision tool and reinforces its purpose. For example, chapter 7 presents the receivables turnover and average collection period as tools for use in analysing receivables. At the end of that discussion the toolkit shown below appears.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Are collections being made in a timely fashion?	Net credit sales and average receivables balance	$\text{Receivables turnover} = \frac{\text{Net credit sales}}{\text{Average net receivables}}$ $\text{Average collection period} = \frac{\text{365 days}}{\text{Receivables turnover}}$	Receivables turnover and average collection period should be consistent with the entity's credit policy. Any significant deviation which results in a slower receivables turnover or a longer collection period may suggest a decline in the financial integrity of credit customers.

- The **Decision-making toolkit — a summary**, which follows the final **Learning reflection and consolidation** section in the chapter, presents the decision tools used throughout the chapter in one place.
- Next, a **Using the decision-making toolkit** exercise asks you to use the decision tools presented in that chapter. You will need to evaluate the financial situation of a company, often using ratio analysis to do so.

Putting it together

- At the end of each chapter, between the body of the text and the homework materials, are several useful features for review and reference: the **Summary** lists the main points of the chapter under each learning objective and the **Key terms** section provides a concise list of all important terms in the text and gives their definitions.
- Next, a **Demonstration problem** gives you another opportunity to refer to a detailed solution to a representative problem before you do homework assignments. Problem-solving strategies help establish logic for approaching similar problems and assist you in understanding the solution.

Developing skills through practice

Throughout the homework material, certain questions, exercises and problems make use of the decision tools presented in the chapter.

- **Self-study questions** comprise a practice test to enable you to check your understanding of important concepts. These questions are keyed to the learning objectives, so you can go back and review sections of the chapter for which you find you need further work.
- **Questions** provide a full review of chapter content and help you prepare for class discussions and testing situations.
- **Brief exercises** build your confidence and test your basic skills. Each brief exercise focuses on one of the learning objectives.
- Each of the **Exercises** focuses on one or more of the learning objectives. These tend to take a little longer to complete, and they present more of a challenge than the brief exercises. The exercises help to make a manageable transition to more challenging problems.
- **Problem sets** stress the applications of the concepts presented in the chapter. Problems are keyed to the learning objectives. Certain problems help build business writing skills.
- Each brief exercise, exercise and problem has a description of the concept covered and is keyed to the learning objectives.

Building business skills

This is a unique section at the end of each chapter that offers a wealth of resources to help you pull together the learning for the chapter. This section offers problems and projects for those who want to broaden the learning experience by bringing in more real-world decision-making and critical-thinking activities.

- **Financial reporting and analysis** problems use financial statements of companies or other sources, such as journals, for further practice in understanding and interpreting financial reporting. A selection of some of the following types of problems is used in each chapter. A *Financial reporting problem* directs you to study various aspects of the financial statements. A *Comparative analysis problem* offers the opportunity to compare and contrast the financial reporting of two companies. Since the ability to

read and understand business publications is an asset in one's career, *Research cases* direct you to articles published in popular business periodicals for further study and analysis of key topics. The *Interpreting financial statements* problems ask you to read parts of financial statements of actual companies and use the decision tools presented in the chapter to interpret this information. A *Global focus* or *Real-world* problem asks you to apply concepts presented in the chapter to specific situations faced by actual international companies. *Financial analysis on the web* exercises guide you to web sites from which you can obtain and analyse financial information related to the chapter topic.
- **Critical thinking** problems offer additional opportunities and activities. A selection of the following types of problems is used in each chapter. The *Group decision cases* help promote group collaboration and build decision-making skills by analysing accounting information in a less structured situation. These cases require teams of you to analyse a manager's decision or to make a decision from among alternative courses of action. They also give practice in building business communication skills. *Communication activities* provide practice in written communication — a skill much in demand among employers. *Ethics cases* describe typical ethical dilemmas and ask you to analyse the situation, identify the ethical issues involved, and decide on an appropriate course of action.

Interactive eBook

Students who purchase a new print copy of *Accounting: Reporting, analysis and decision making*, 8th edition will have access to the interactive eBook version (a code is provided on the inside of the front cover). The eBook integrates the following media and interactive elements into the narrative content of each chapter.

- **Practitioner videos** provide insights into the application of financial accounting concepts.
- **Animations of worked examples** talk you through the steps in solving financial accounting problems.
- **Interactive questions** provide you with the scaffolding to attempt and solve problems.

CHAPTER 1

An introduction to accounting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

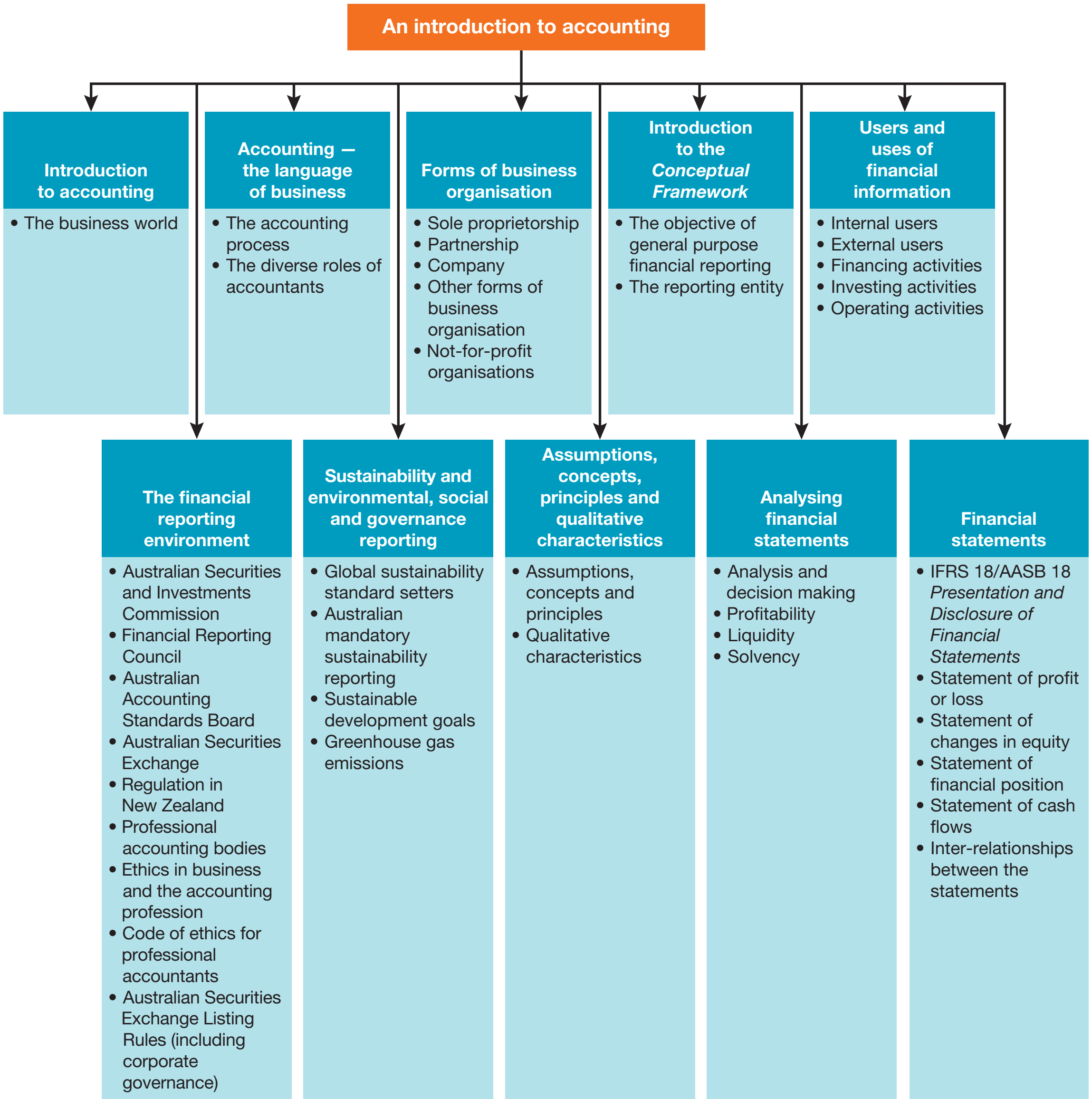
1.1 explain the business context and the need for decision making
1.2 define accounting, describe the accounting process and define the diverse roles of accountants
1.3 explain the characteristics of the main forms of business organisation
1.4 understand the *Conceptual Framework* and the purpose of financial reporting
1.5 identify the users of financial reports and describe users' information needs
1.6 identify the elements of each of the four main financial statements
1.7 describe the financial reporting environment
1.8 describe sustainability and environmental, social and governance reporting
1.9 explain the accounting assumptions, concepts, principles, qualitative characteristics and constraints underlying financial statements
1.10 calculate and interpret ratios for analysing an entity's profitability, liquidity and solvency.

Chapter preview

Welcome to the accounting journey, it is not just about recording numbers. Throughout this text you will explore the concepts and regulations that underlie the preparation of the accounting reports and the various decisions that need to be made in preparing the financial information and reports. As well, we will examine the decisions made using the accounting information as inputs into the decision-making process, both inside and outside the business organisation. Accounting information can help you understand a business entity's past performance and its current financial position, and provide some insight into its future prospects.

It is an exciting ever-changing business environment that keeps pace with the changes in technology and knowledge management. For example, Domino's Pizza Enterprises Ltd commenced as a single franchise in Australia and now is the largest franchisee of the US's largest pizza chain, Domino's Pizza, Inc., with operations in Europe, Japan, Australia and New Zealand. How did this occur? Why did it embrace technologies such as online ordering, including a mobile phone app and Facebook? Domino's effectively obtains information from customers using this technology, which feeds into the sale growth predictions and the strategic future directions of the business.

In this chapter we introduce the business environment, including the role of accounting, the forms of business organisation, the regulatory environment, the financial statements and some tools that can help you analyse financial statements for decision making. The content and organisation of this chapter are as follows.



1.1 Introduction to accounting

LEARNING OBJECTIVE 1.1 Explain the business context and the need for decision making.

The business world

What's your favourite business? Apple, Google, Nike? Would you like to start your own business? How do you start a business? How do you make it grow and become widely recognised like Domino's? How do you determine whether your business is making or losing money? How do you manage your resources? When you need to expand your operations, where do you get money to finance the expansion — should you borrow, should you issue shares, should you use your own funds? How do you convince lenders to lend you money or investors to buy your shares? Success in business requires countless decisions, and decisions require financial and other information. A **decision** is a choice among alternative courses of action.

Architects use technical and structural knowledge of the building codes together with their creative ability to design a model or plan of a building. Just like architects, in order to start and run a business you need not only your creative ideas and marketing plan, but also information on the business environment in order to understand the context of your business. Accounting provides an economic model of the business world. It plays a key role in the provision of financial information for decisions made by people inside and outside a business. The continued growth of Domino's in both the European and the Australian and New Zealand markets required a variety of information including the past and current performance of Domino's operations. Projections on future store sales growth and potential market share growth from opening new stores were also required in order to plan ahead and to help towards the achievement of targets. The provision of accounting information within the business entity is referred to as **management accounting**. **Financial accounting** is the term used to describe the preparation and presentation of financial reports for external users. However, both financial accounting and management accounting draw on the same information system used to record and summarise the financial implications of transactions and events. Businesses also need to provide information on the environment and the community within which the business operates. The concept of sustainability is explained later in this chapter.

The business environment is ever changing. Driven by technology, life cycles of businesses are shortening. New technologies, new processes, new products and faster information flows are driving changes. How often do you update your mobile phone? Everyone in society is affected by technological change. Computers provide the technology to process the information so more time is devoted to the analysis of the information to make the most informed decisions. Accountants work in businesses as part of management teams who analyse the information gathered to make decisions. So how do we go about the decision making?

The first step in the decision-making process is to identify the issue, or the decision to be made. The next step is to gather the relevant information required for the analysis. Once gathered, you identify the tool or technique that will assist analysis of the issue so a decision can be made. The final step is to evaluate the results of the analysis and make the decision. The decision-making toolkit summarises this process.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Which film your friends wish to see	Cinema times and films showing	Eliminate unsuitable times and films	Film most wish to see is the one chosen
	Who are the lead actors Personal preferences	Discuss which preferences are left and rank in popularity	If none suitable, re-evaluate or select another social activity and start the decision process again.

Note: Each chapter presents useful information about how decision makers use financial statements. Decision-making toolkits summarise discussions of key decision-making contexts and techniques.

For example, if you were wanting to choose which film a group of friends wish to watch, you would need information concerning each of your preferences for the genre and how flexible you are in your preferences, maybe who is in the leading roles and the times the movie is being shown. The tool would be to rank the films in order of preference, starting with what is showing at the times your group is available, then reducing the alternatives to which films are showing, and then eliminating any alternative which one of your group didn't want to see. You may end up with no suitable film or you may go back and change the parameters, which may include looking for another social activity. Even with this analysis your group may not enjoy the film as it was a dud, but that is the risk you take. Decisions are future oriented and you need to make informed judgements.

Similar to the social activity decision, in the business world, even with all the information available, the final outcome of the decision may not be what was expected. Next, we are going to consider what accounting is and how it is used in the decision-making process in the business environment.

TECHNOLOGY VIGNETTE

Using artificial intelligence and big data to inform business decisions

The same steps in decision making in everyday life apply to business decisions. Big data is providing businesses with the opportunity to harness data to inform decisions and improve performance. Big data is not only available to major customer-facing businesses, but with the economical availability of Cloud-based solutions even small businesses can accumulate digital data about their customers.

Data is being used to inform fraud prevention, market segmentation, capacity planning, pricing strategies, and to optimise advertising and promotional expenditure. Big data is being used to implement changes across industry sectors. Other benefits to the business include:

- understanding customer needs and identifying opportunities to innovate
- improving process efficiency and product quality
- improving website design based on the behaviours of visitors to their site
- improving employee recruitment and retention.

However, to benefit from big data, businesses need to have the right data, be able to analyse it and have the skills to ensure that insights are applied to create value. This requires developing the skills of employees, spanning from technical ability to commercial acumen and includes performance management and conformance to data management standards and policies (see figure 1.1).

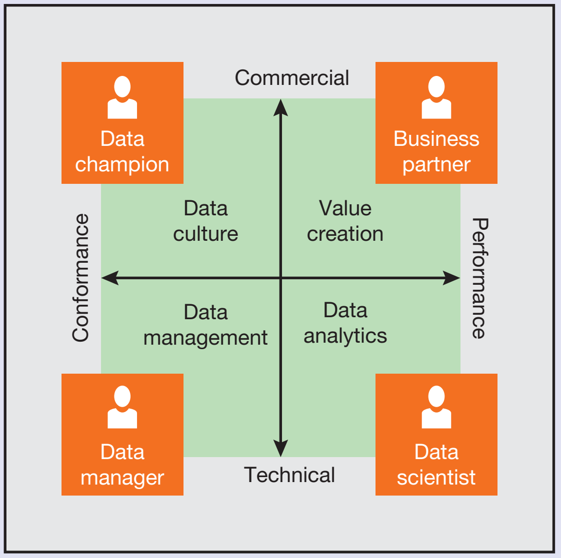
Due to the scale and complexity of big data sets now available, a data scientist may be required to conduct complex analysis using algorithms and predictive analytics to mine data. However, data visualisation tools may help businesses to analyse data using less advanced analysis tools.

Businesses need to ensure the integrity of data that they have captured and stored is maintained. Commercially sensitive data must be protected from cyberattacks and customers need to have confidence that their sensitive data is handled properly and maintained securely.

An appropriate data culture is required where data is valued as an important strategic asset that can enable new strategies and improve the competitive position of the business. To create value, analytical insights need to be translated into business opportunities where the best course of action is chosen. This requires collaboration between finance professionals, data scientists, IT professionals and business managers. However, according to the Chartered Institute of Management Accountants, management accountants are well placed to provide businesses with many of the skills required, especially as a finance business partner, data manager and data champion.

Source: Adapted from Chartered Institute of Management Accountants 2014 in Hoggett et al. 2021, pp. 3–4.

FIGURE 1.1 Potential roles for management accountants



Source: Chartered Institute of Management Accountants 2014, p. 7.

1.2 Accounting: the language of business

LEARNING OBJECTIVE 1.2 Define accounting, describe the accounting process and define the diverse roles of accountants.

The primary function of accounting is to provide reliable and relevant financial information for decision making. Accounting has been around for centuries and has developed significantly since its humble beginnings in ancient times when scribes recorded simple agreements between parties and other information on clay tablets. Today, almost every person engages in business transactions in relation to the financial aspects of life such as purchasing products and paying bills. This means that accounting plays a significant role in society.

Accounting can be referred to as the 'language of business' as it is a means of common communication where information flows from one party to others. In order for information to be effective it must be understood. Accounting, like many other professions, has its own terminology or jargon that is unique to the profession and can have alternative meanings in different contexts. Accounting terms, concepts and symbols are used to provide financial information to a variety of users including managers, shareholders and employees. You will need to learn these specialised terms and symbols in order to be able to prepare and use accounting information effectively. The definitions of key terms listed at the end of each chapter will support your learning. Providing reliable and relevant accounting information is a complex process.

The accounting process

Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation. Table 1.1 summarises these main steps.

TABLE 1.1 **The accounting process**

Identifying	Measuring	Recording	Communicating
Taking into consideration all transactions which affect the business entity	Quantifying in monetary terms	Analysing, recording, classifying and summarising the transactions	Preparing the accounting reports; analysing and interpreting

Identifying involves determining which economic events represent transactions. **Transactions** are economic activities relevant to a particular business and include, for example, the sale of a good to a customer or the purchase of office stationery from a supplier. Transactions are the basic inputs into the accounting process. **Measurement** is the process of quantifying transactions in monetary terms and must be completed in order to record transactions. The recording process results in a systematic record of all of the transactions of an entity and provides a history of business activities. To enhance the usefulness of the recorded information, it must be classified and summarised.

Classification allows for the reduction of thousands of transactions into meaningful groups and categories. For example, all transactions involving the sales of goods can be grouped as one total sales figure and all cash transactions can be grouped to keep track of the amount of money remaining in the business's bank account. The process of summarisation allows the classified economic data to be presented in financial reports for decision making by a variety of users. These reports summarise business information for a specific period of time such as a year, 6 months, one quarter or even a month. Domino's provides 6-monthly reports that are available to the general public via the securities exchange website.

Communicating is the final stage in the accounting cycle. Communicating involves preparing accounting reports for potential users of the information. There are many reasons for maintaining accurate financial accounting records, including legal and other reporting requirements. The Australian Taxation Office (ATO) and the New Zealand Inland Revenue (NZIR) require businesses to provide a variety of financial information to comply with legal requirements. Users of financial information, both internal and external to the entity, will require financial information to make decisions in relation to the business. Once the users have acquired the information, they can use a variety of techniques to analyse and interpret the data. In most of the chapters, there are sections which demonstrate a variety of techniques that are useful for analysing and interpreting financial statements. These sections are intended to support the development of your skills in analysis and interpretation of financial information, and to enhance your understanding of accounting.

Accounting provides an economic model of the business world and plays a key role in the provision of financial information for decision making. It is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation to users of financial information. The first three activities of identifying, measuring and recording the business information are commonly referred to as **bookkeeping**. Bookkeeping forms the foundation of the activities underlying accounting, and these processes are explained in detail in the early chapters of this text using a manual accounting system. In the early part of the twentieth century, the role of the accountant did not extend much beyond this bookkeeping function. Today, many bookkeeping and routine accounting activities can be aided using computer systems and artificial intelligence (AI). However, the roles and responsibilities extend far beyond preparing accounting records and human accountants are still necessary at every stage of the process.

The diverse roles of accountants

Accountants practise accounting in four main areas: commercial accounting, public accounting, government accounting and not-for-profit accounting.

Commercial accounting

Commercial accountants work in industry and commerce. Companies like Domino's and Qantas employ a number of accountants in different roles, such as management accounting and financial accounting. The accounting information system provides these accountants with the information they need for planning, decision making and compiling reports for a range of users. The **chief financial officer (CFO)** is a senior manager in an organisation and directs the accounting operations. Financial accountants oversee the recording of all of the transactions and prepare reports for users external to the business entity, such as shareholders and creditors. Management accountants focus on providing information for internal decision making as they prepare specifically tailored reports for use by management. Commercial accountants are employed within organisations, and their work is directed by their employers. Public accountants, on the other hand, run their own businesses and are, therefore, more autonomous.

Public accounting

Public accountants, as the name suggests, provide their professional services to the public. They can practise in business organisations that range from small single-person-run offices to very large organisations with branches all over the world and thousands of employees. Public accountants tend to specialise in one or more areas of accounting when providing services to the public. Auditing is one of the primary services provided by large public accounting firms such as Deloitte and KPMG. An **audit** is an independent examination of the accounting data presented by an entity in order to provide an opinion as to whether the financial statements fairly present the results of the operations and the entity's financial position. Public accounting firms also provide a wide range of taxation services including advice for minimising an entity's tax liability, of course within the law, and preparation of tax returns, among other things. In more recent years, management advisory services have been a growing area for public accountants. Services include provision of advice on improving their clients' business efficiency and effectiveness, design and installation of accounting information systems, and assistance with strategic planning. Public accounting firms may also provide advisory services to government organisations or be employed by the government.

Government accounting

Government accountants, employed within government entities, engage in a variety of roles and activities, such as financial accounting and auditing. Local councils, state governments and federal government receive and pay out large amounts of funds each year and these activities need to be accounted for. Nowadays, many of the issues and decisions faced by government entities are the same as those in the commercial sector. As a result, these entities often follow accounting policies and practices similar to those in the private sector. Although most government entities are not-for-profit, some government departments, such as the Brisbane City Council, run profit-making businesses.

Not-for-profit accounting

Not-for-profit accountants, working in the not-for-profit sector, engage in many activities including planning, decision making, and preparing financial and management reports for both internal and external users. Management processes, accounting systems and operational methods are often similar between profit-making and not-for-profit entities. However, there is one major difference and that is the *profit motive*.

A **not-for-profit entity** focuses on successfully fulfilling its mission and administrative goals, rather than focusing on making a profit. Not-for-profit entities include public hospitals, clubs, some schools and charities. For example, the World Vision charity works with poor, marginalised people and communities to improve their lives and help them take control of their futures. Not-for-profit entities are exempt from income taxes on activities related to their exempt purpose and have fiduciary responsibilities to members, contributors and other constituents, and their activities may require reporting to supervising government entities.

In summary, accountants have many diverse roles and can work in different forms of organisation from small one-person businesses to large corporations with a worldwide presence. Once trained as an accountant, you can also work in organisations in non-traditional accounting roles or be better equipped to run your own business.

Would you like to run your own business? How would you decide how to structure your business and what resources would be required? In the next section, we explore the different forms of business organisation in more depth.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What information would you require to set up and run your own business?
2. What is the primary objective of accounting?
3. Accountants practise accounting in four main areas. Describe these areas, with examples.

Note: Review it questions at the end of major text sections prompt you to stop and review the key points you have just studied. Sometimes these questions stand alone; other times they are accompanied by practice exercises called *Do it*.

1.3 Forms of business organisation

LEARNING OBJECTIVE 1.3 Explain the characteristics of the main forms of business organisation.

Business organisations can be classified into profit-oriented businesses such as sole proprietorship, partnership or company, and not-for-profit entities such as charities and government departments. Throughout this text, we concentrate on preparing financial reports for the profit sector. However, many of the concepts and regulations apply equally to the not-for-profit sector.

Suppose you graduate with a marketing degree and open your own marketing agency. One of the first important business decisions you will need to make is the organisational structure under which the business will operate. You have three choices: sole proprietorship, partnership or company. Figure 1.2 outlines the three main forms of business organisation.

FIGURE 1.2 Characteristics of the main forms of business organisation

Sole proprietorship

- Simple to establish
- Owner controlled

Partnership

- Simple to establish
- Shared control
- Broader skills and resources

Company

- Easier to transfer ownership
- Easier to raise funds
- Limited liability

In selecting a suitable business structure, some of the factors to consider are:

- establishment fees and maintenance costs
- asset protection (business and personal assets)
- the type of business and how it impacts on your record keeping
- legitimate tax minimisation.

Sole proprietorship

A **sole proprietorship** is a business owned by one person. It is the simplest form of business structure and has very few legal formalities. It is quick and inexpensive to establish and inexpensive to wind down. Under this structure, the owner of the business has *no separate legal existence* from the business. You might choose the sole proprietorship form if you have a marketing agency. You would be referred to as a *sole trader*. As a sole trader, the business is fully owned by you and you have total autonomy over the business's strategic direction and all business decisions. The assets and profits belong solely to you. The business's income is treated as the business owner's individual income (hence, no separate legal existence). Sole traders pay the same tax as individual taxpayers, according to the marginal tax rates. Depending on the level of profits from the business, this could be a disadvantage. In the 2024–25 financial year, at an income level of around $140 000, the effective average tax rate of an individual is equal to 30.4%. The company tax rate of a smaller company is 25% (larger companies is 30%). So in a situation like this it may be better from a tax point of view to operate as a company and not a sole trader. Other disadvantages are that the business is limited by the owner's skills, the funds available to invest and the time available for running the business, as well as bearing full personal liability for the business's debts. Small owner-operated businesses such as restaurants, dentists and panel beaters are often sole proprietorships, as are farms and small retail shops.

Partnership

Another possibility for your new marketing agency is for you to join forces with other individuals to form a partnership, in which all partners share control. A **partnership** is a relationship or association between two or more entities carrying on a business in common with a view to making a profit. Entities forming the partnership may be individuals or companies.

There is little formality involved in creating a partnership. Partnerships are often formed because one individual does not have enough economic resources to initiate or expand the business, or because partners bring unique skills or resources to the partnership. You and your partner(s) should formalise your duties and contributions in a written partnership agreement. All partnerships should be formed on the basis of an agreement (which may be made in writing, verbally or by implication). In Australia, partnerships are governed on a state-by-state basis by the Partnership Act in each Australian state. In New Zealand, the *Partnership Act 1908* is the national legislation. Partners must also decide how profit (or losses) should be allocated among the partners. Accounting information is often used to determine each partner's share, as specified in the partnership agreement.

Traditionally, partnerships have not been incorporated. This means that, like a sole proprietorship structure, the business structure has **unlimited liability**, so each partner is personally liable for all the debts of the partnership even if they are caused by decisions made by other partners. More recently, changes to state and territory legislation have allowed for limited liability partnerships (LLPs). Similarly, New Zealand introduced limited partnerships in 2008. These are an emerging trend and are often used for raising venture capital for new businesses, such as a new mining venture. However, because *limited partnerships* are taxed as companies and the general partner still bears unlimited liability, this form of business structure is not very popular. Another disadvantage of a partnership structure is that a partnership has a limited life. If a partner wishes to sell or leave the partnership, or a partner dies, a new partnership agreement must be formed. The partnership agreement often has conditions on who can be admitted as a new partner in the event of a partner wishing to sell their share of the business. Finally, if there are disputes between the partners, it can be costly and damaging to the business, as well as to friendships.

Partnerships are often used to organise retail and service-type businesses, including professional services such as accounting, medical and legal practices.

Company

As a third alternative, a marketing agency can be organised as a company. A **company** or corporation is a separate legal entity formed under the *Corporations Act 2001* (Cwlth) in Australia or the New Zealand *Companies Act 1993* (Public Act). The process of setting up a company is called *incorporation*. The owners of a company are called **shareholders** (or *stockholders* in the United States) and their ownership interests are represented by the number of shares they own in the company.

Under a company structure, the company can sue and be sued and enter into contracts in its own name. As a result, the shareholders of most companies have *limited liability*. **Limited liability** means the shareholders are liable for the debts of the business only to the extent of amounts unpaid on their shares. If a company breaches an agreement, it is generally solely liable — unless there is some misconduct by the directors or officers, such as misrepresentation or misleading or deceptive conduct. If misconduct or misrepresentation is proven, it is possible for the company directors to be held personally liable for debts. Another advantage of the corporate form is that a company has an indefinite life. The owners can more easily transfer their ownership interest by selling their shares in the company to other investors.

Companies vary in size from small privately owned and often family-run companies (proprietary limited companies — Pty Ltd) to large public companies listed on a securities exchange (limited companies — Ltd) managed by directors, with thousands of shareholders. If you use a company structure, there are establishment costs and ongoing fees and regulations to comply with. These make it more expensive to run than unincorporated business structures. We will discuss these issues in more depth in chapter 10.

When considering the business structure of your marketing agency, you need to decide on two factors: the decision-making structure you want for your business (sole trader, partnership or company) and the financial and legal ramifications of the structure you choose. Will the business be an incorporated or unincorporated business? A sole trader, for example, has all the decision-making power but also has full responsibility (is liable) for the actions of the business. A company, on the other hand, has limited liability but, if there is more than one director, the decision making is usually a shared responsibility. Thus, the decision to incorporate or to remain unincorporated has distinct legal and financial ramifications. Many businesses start as sole proprietorships or partnerships and eventually incorporate.

Other forms of business organisation

Although sole proprietorship, partnership and company are the most common forms of business structure, other forms such as trusts, cooperatives and not-for-profits are discussed next.

Trusts

A **trust** is a relationship or association between two or more parties, whereby one party holds property in trust for the other — that is, they are vested with the property. A trust, in its simple form, has:

- a settlor (who sets up the trust)
- a trustee (who is the legal owner and manages the trust property — investments, assets etc. — and pays out any net income for the benefit of the beneficiaries)
- beneficiaries (the person or people who are the equitable owners and for whom the investments or assets are held and to whom income is paid).

The trustee has full control over the assets held by the trust, so it is important that the trustee be entirely trustworthy and able to manage all aspects of trust administration. Trusts may be made expressly in writing or implied from the circumstances. Trusts can range from relatively simplified structures to more complex structures. It is possible, for example, for a family member to act as a trustee for a family trust. It is very common in family-owned small businesses for a Pty Ltd company to be the trustee and the family members the beneficiaries, which means the business has the protection of limited liability for asset protection but profits can be split effectively for taxation. It is also possible for a company to trade as the trustee of a trust.

Cooperatives

A **cooperative** is a form of business organisation that is member-owned, controlled and used. It must consist of five or more people. Cooperatives are legislated at state level in Australia. They are distinctive for fostering a highly participative and democratic style of work, pooling resources to be more competitive and sharing skills. Cooperatives play an important role in the community. They supply goods and services to their members and to the general public in areas as diverse as retailing, recycling, manufacturing, labour hiring, printing and agriculture. Examples include Australian Forest Growers, South Gippsland Herd Improvement Association Inc., Ballina Fishermen's Co-operative Ltd and Bermagui Pre School Co-operative Society Limited.

Not-for-profit organisations

Not-for-profit is one of the more interesting forms of business organisation. This sector includes associations such as clubs, charities and the government sector.

Associations

Small non-profit, community-based groups often form **associations**. Associations can be, but are not always, incorporated. An incorporated association provides a relatively inexpensive and easier means of establishing a legal entity than forming a company. In other words, an association is an alternative to a company. An incorporated association has similar advantages to a company but is not as expensive to set up or maintain. An association can trade as a profit organisation, but this cannot be its main objective. Any profit from the trading must be put back into the association and not given to its members. Although associations tend to be small community groups, they can be specialist interest groups such as sports associations, industry associations, animal breeder associations and hobby associations. The Australian Medical Association and the Epilepsy Association of Australia are two examples of groups that are focused on a particular area.

Government

The government sector is also called the **public sector**. The distinguishing feature is that the organisations are owned by the government, whether it be federal, state or local. Within this sector there may be departments or segments which are operated as business enterprises and have a profit-making objective or aim to generate a return on the resources they control. Examples include public hospitals, public schools and the ATO.

Because the majority of business is transacted by companies, the emphasis in this text is on the corporate form of business structure. Generally, the techniques for recording transactions, the basic accounting equation, the principles underlying accounting and financial reporting, and the major financial statements are common to all business forms. Recall that the primary role of accounting is to provide financial information for decision making. How do accountants know what information to provide? The *Conceptual Framework for Financial Reporting*, referred to as the ***Conceptual Framework*** throughout this textbook, provides guidance to preparers of financial information by defining who is required to report and who the users are likely to be.

1.4 Introduction to the *Conceptual Framework*

LEARNING OBJECTIVE 1.4 Understand the *Conceptual Framework* and the purpose of financial reporting.

In this section we introduce the *Conceptual Framework*. We will piece it together frame by frame throughout the chapter. A conceptual framework consists of a set of concepts to be followed by preparers of financial statements and standard setters. We will use the image of a window to present the *Conceptual Framework*, because a window is a lens through which we can view the world, in the same way as preparing external financial statements using a conceptual framework allows us to view the economic world in a particular way.

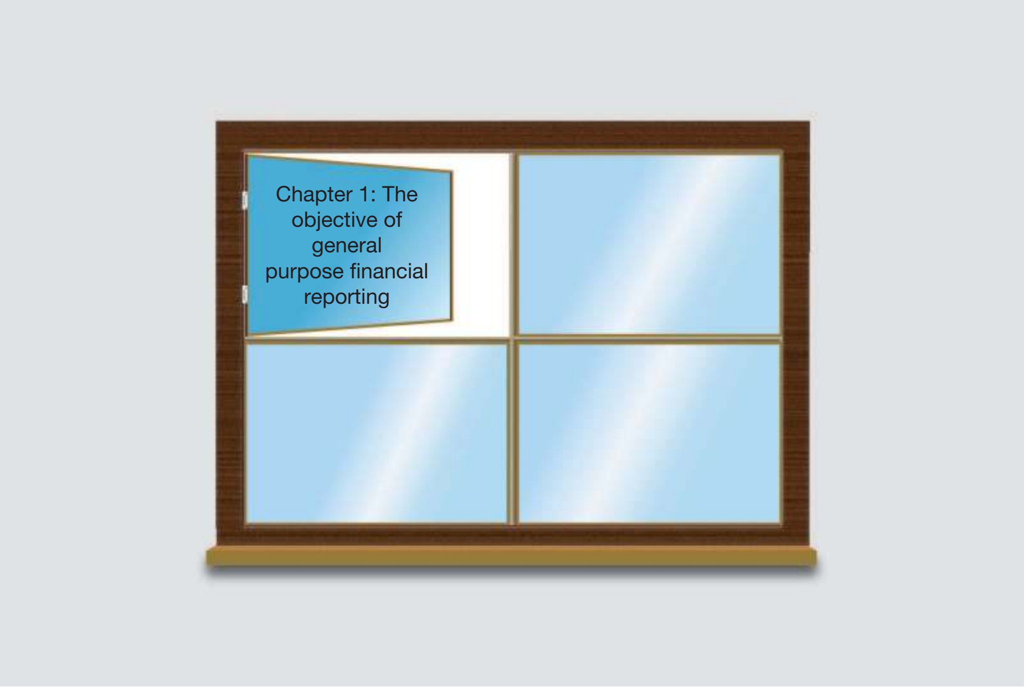
The *Conceptual Framework* has undergone an extensive review process over many years. In March 2018, the International Accounting Standards Board (IASB) issued a revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). Throughout this text, the *Conceptual Framework* content is based on the 2018 version.

The *Conceptual Framework* consists of eight chapters. Chapter 1 is the objective of general purpose financial reporting, as represented in figure 1.3.

The objective of general purpose financial reporting

The objective of general purpose financial reporting forms the foundation of the *Conceptual Framework*. All the other elements flow from the objective. If we know why we need to report, then it follows we can determine who needs to report and what and how information is to be reported. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making their decisions about providing resources to the entity. This definition highlights the primary users of **general purpose financial reports** to be existing and potential shareholders, lenders and other creditors. It also acknowledges that other groups may also be interested in the financial information. The management of the reporting entity is one such group, but it was decided that management does not need to rely on general purpose financial reports because it can obtain the financial information it needs internally. Other parties such as regulators and members of the public may also find general purpose financial reports useful.

FIGURE 1.3 Building the *Conceptual Framework* — Chapter 1



It is acknowledged that general purpose financial reports do not provide an evaluation of an entity but provide information that, together with other sources of information such as general economic conditions, political climate and industry conditions, allows primary users to estimate the value of the reporting entity. As we will see in a following section, the financial information needed by investors and other capital providers has been expanded to include sustainability information, such as how a company is addressing the risks and opportunities arising from climate change. To this end the definition of 'general purpose financial reporting' has been expanded in recent years to include not only general purpose financial statements but also sustainability information.

Now that the objective of general purpose financial reporting has been discussed, the next step is to decide who needs to prepare general purpose financial reports.

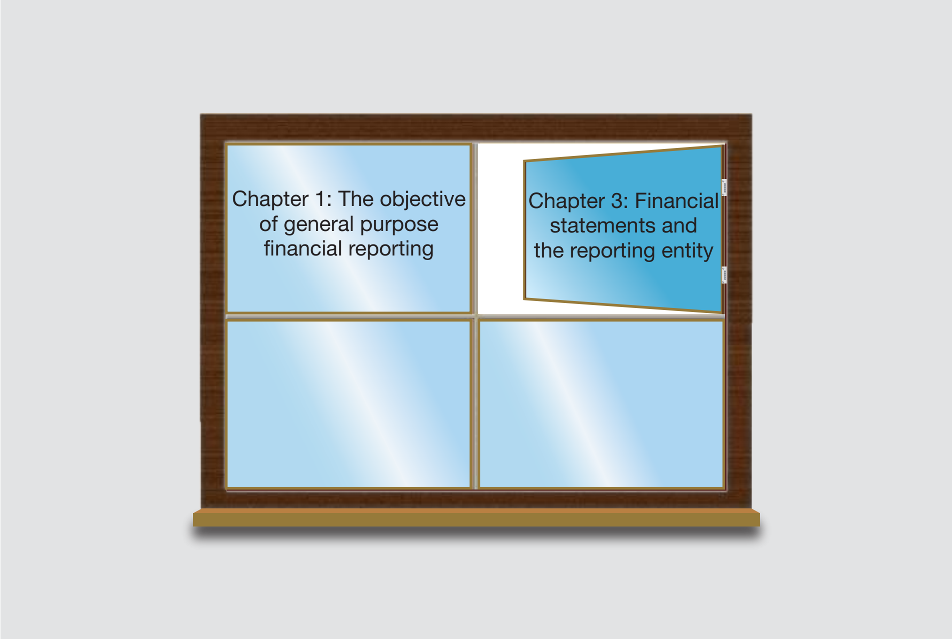
The reporting entity

Figure 1.4 represents another piece of the *Conceptual Framework*, Chapter 3: Financial statements and the reporting entity.

Prior to 2018, the *Conceptual Framework* did not include a section on the reporting entity and therefore Australian business entities and standard setters referred to that section from the previous Australian conceptual framework developed by the Australian Accounting Standards Board.

In the previous section, we described a number of different forms of business organisation. While each of these forms of business prepares some kind of information for a variety of users, not all businesses are classified as reporting entities. The **reporting entity** is discussed in paragraphs 3.10–3.14 of the *Conceptual Framework* (2018). Paragraph 3.10 states that 'a reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity'.

FIGURE 1.4 Building the *Conceptual Framework* — Chapter 3



It is important to determine the boundary of the reporting entity. The information needs of the primary users of the reporting entity's financial statements are the driving factor. As previously stated, the primary users of general purpose financial statements are existing and potential investors, lenders and other creditors. These users require relevant information that 'faithfully represents' what it purports to represent. Faithful representation requires a reporting entity to maintain a complete set of economic activities resulting in neutral information (paragraph 3.14).

It is important to determine whether an organisation is a reporting entity as reporting entities must prepare *external* general purpose financial reports that comply with accounting standards. All other entities will prepare information for internal use.

Reporting entities tend to be larger organisations and the financial information provided in external general purpose financial reports tends to be quite condensed. Both reporting and non-reporting entities also prepare internal reports that contain more detailed information. Examples of both internal and external reports are provided in the latter part of this chapter. Possible new developments and differential reporting are explored in chapter 13.

The information arising from businesses, regardless of their structure, is useful to a variety of users. In the next section, we explore the users of financial statements and users' information needs.

1.5 Users and uses of financial information

LEARNING OBJECTIVE 1.5 Identify the users of financial reports and describe users' information needs.

Now that we know which entities are required to prepare general purpose financial reports and the objective for financial reporting, let's take a closer look at the users of financial reports and their information needs. We begin with an exploration of the users and their information needs as outlined in the *Conceptual Framework* for financial reporting and then discuss other users of financial reporting.

Figure 1.5 sets out the primary users of the general purpose financial reports being those users who provide resources to the entity and therefore require information to make decisions concerning the provision of those resources.

Investors contribute to the equity of an entity by investing resources (usually cash) for the purpose of receiving a return and include shareholders, holders of partnership interests and other equity owners. **Lenders** contribute to an entity by lending resources (usually cash) for the purpose of receiving a return in the form of interest. Some questions that may be asked by investors and creditors about a company include the following.

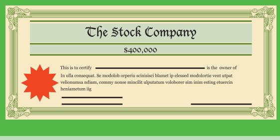
- Is the company earning satisfactory profit?
- How does the company compare in size and profitability with its competitors?

- Will the company be able to pay its debts as they fall due?
- Is the company paying regular dividends to its shareholders?
- Is the company's business operations exposed to climate-related risks?

FIGURE 1.5 Categories of primary users of general purpose financial reports

Resource providers

Investors



- Shareholders (existing and potential)
- Holders of partnership interests
- Other equity owners

Lenders

- Lenders (e.g. banks)
- Purchasers of traded debt instruments (e.g. debentures)

Other creditors

- Employees*
- Suppliers*
- Customers*
- Other groups*

*Only in their capacity as resource providers, otherwise they are not considered primary users.

Other creditors may provide resources to an entity as a result of their relationship with the entity, even though they are not primarily resource providers. For example, suppliers extend credit to facilitate a sale, employees provide their services (human capital) in exchange for remuneration and customers may prepay for goods or services that are to be provided in the future. These parties are only considered resource providers to the extent that they provide the entity with resources in the form of credit, and they make decisions based on providing such resources. When they are not in this capacity they are referred to as other users.

Other users include government agencies, members of the public, suppliers, customers and employees (when not resource providers). While these other users have specialised information needs, they may find the financial information that meets the needs of resource providers useful. However, it is made clear that financial reporting is not primarily directed to other users but rather to resource providers. The information needs and questions of other external users vary considerably. For example, taxation authorities such as the ATO want to know whether the entity complies with the tax laws. Regulatory agencies such as the Australian Securities and Investments Commission (ASIC) or the Australian Competition and Consumer Commission (ACCC) want to know whether the entity is operating within prescribed rules. Table 1.2 provides a list of external users and examples of their information needs.

TABLE 1.2 External users of accounting information and their information needs

Users	Information needs
Investors	Information to determine whether to invest based on future profitability, return or capital growth
Creditors	Information to determine whether to grant credit based on risks and ability of the entity to repay debts
Customers	Information on whether an entity will continue to honour product warranties and support its product lines
Employees and trade unions	Information on whether the entity has the ability to pay increased wages and benefits, and offer job security
Government authorities	Information to calculate the amount of tax owing and whether the entity complies with tax laws
Regulatory agencies	Information to determine whether the entity is operating within prescribed rules

The common information needs of other users include an assessment of the entity's future cash flows (amount, timing and uncertainty) and evidence that management has discharged its responsibilities to use the entity's resources efficiently and effectively. Has management put in place systems to protect the entity's resources against the unfavourable effects of economic factors such as price and technology change? Has management complied with applicable laws, regulations and contractual commitments? Has management addressed climate-related risks and other uncertainties in their business models? This information concerning management's responsibilities is partly provided in an entity's financial report in the corporate governance statement.

Internal users

Internal users of accounting information are managers who plan, organise and run a business. They do not need to rely on general purpose financial reports as they can obtain the financial information they need internally. Internal users include marketing managers, production supervisors, directors and other managers. In running a business, managers of large companies like Domino's must answer many important questions, including the following.

- Is there sufficient cash to pay debts?
- What is the cost of manufacturing each unit of product?
- Can we afford to give employees pay rises this year?
- How should we finance our expansion into Europe?

To answer these and other questions, users need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of alternative plans, projections of revenue from new sales campaigns and forecasts of cash needs for the next year. In addition, internal users rely on summarised financial information presented in the form of financial statements.

External users

Although the needs of the various users differ, there are some common information needs that are intended to be met by external general purpose financial reports — that is, the published financial statements (consisting of the primary financial statements and notes) of an entity prepared in accordance with applicable accounting standards as well as financial sustainability information required by a jurisdiction.

External users have an interest in financial information about the three main types of activities — financing, investing and operating. These activities are common to all businesses. The accounting information system keeps track of the results of each of these business activities. Let's look in more detail at each type of business activity.

Financing activities

It takes money to make money. The two main sources of outside funds for companies are borrowing money from lenders and selling shares to investors. For example, Domino's may borrow money in a variety of ways. It can take out a loan at a bank or borrow from many lenders by issuing debt securities. Two types of debt securities are unsecured notes and debentures. The main difference is that debentures are secured by a charge over the issuer's assets. This means that specified assets can be sold to pay the debenture holders if the issuer defaults.

A company may also obtain funds by selling shares to investors. When a business initially becomes a company, shares are often issued to a small group of individuals who have an interest in starting the company. However, as the business grows, it becomes necessary to sell shares more broadly to obtain additional financing. **Share capital** is the term used to describe the total amount paid in by shareholders for the shares. The shareholders are the owners of the company.

Helpful hint: Companies may issue several types of shares, but the shares that represent the main ownership interest are called **ordinary shares**.

The claims of creditors differ from those of shareholders. If you lend money to a company, you are one of its creditors. In lending money, you specify a payment schedule (e.g. payment at the end of 3 months). As a creditor, you have a legal right to be paid at the agreed time. In the event of non-payment, you may legally force the company to take action, such as selling its property to pay its debts. The law requires that creditors' claims be paid before ownership claims; that is, owners have no claim on corporate resources until the claims of creditors are satisfied. If you buy a company's shares instead of lending it money, you have no right to expect any payments until all of its creditors are paid. However, many companies make payments to shareholders on a regular basis as long as they are solvent — that is, after the dividend is paid there are sufficient resources to cover expected payments to creditors. These payments to shareholders are called **dividends**. Dividends are a distribution of profit; they are not repayment of capital.

Investing activities

Investing activities involve purchasing the resources an entity needs in order to operate. During the early stages of an entity's life it must acquire many assets. For example, computers, delivery trucks, furniture and buildings are assets obtained from investing activities. Different types of assets are given different names. Domino's plant and equipment are referred to as *property, plant and equipment*, but can also be known as *fixed assets* or *non-current assets*.

While many of the entity's assets are purchased through investing activities, others result from operating activities. For example, if Domino's sells goods to a customer and does not receive cash immediately, it has a right to expect payment from that customer in the future. This right to receive money in the future is an asset called **accounts receivable**.

Operating activities

Once a business has the assets it needs to get started, it can begin its operations. Domino's is in the business of selling fast food. We call the results from the sale of these products *revenues*. **Revenues** are sales and other increases in equity that arise from the ordinary activities of an entity. For example, Domino's records revenue when it sells a pizza.

Revenues arise from different sources and are identified by various names depending on the nature of the business. For instance, Domino's main source of revenue is the sale of goods. However, it also generates store asset rental revenue and revenue from royalties. Sources of revenue common to many businesses are sales revenue, service revenue and interest revenue.

Before the business can sell a single pizza, it must purchase the ingredients to make the product. It also incurs costs such as salaries, rent and electricity. All these costs are necessary to sell the product. In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.

Expenses take many forms and are identified by various names depending on the type of asset consumed or service used. For example, the business keeps track of these types of expenses: cost of sales, selling expenses (such as the costs associated with delivering pizzas), marketing expenses (such as the cost of advertising), administrative expenses (such as the salaries of administrative staff, and telephone and heating costs incurred in the office) and interest expense (amount of interest paid on various debts).

Domino's compares the revenues of a period with the expenses of that period to determine whether it has earned a profit. When revenues exceed expenses, a **profit** results. When expenses exceed revenues, a **loss** results.

Accountants today not only need to record the transactions and events that are then recognised and reported in the financial statements, but also need to be aware of sustainability issues for business and how to report them.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the three main forms of business organisation and the advantages of each?
2. What is the purpose of the *Conceptual Framework*?
3. Distinguish between internal and external users of financial information. Give examples of each.
4. Identify three categories of users identified by the *Conceptual Framework*. Give examples of each.
5. What are the three types of business activity?

Do it

Classify the following activities as financing, investing or operating: (1) issuing shares, (2) purchasing a building, (3) selling pizza and (4) repaying a loan.

Solution

(1) financing, (2) investing, (3) operating and (4) financing.

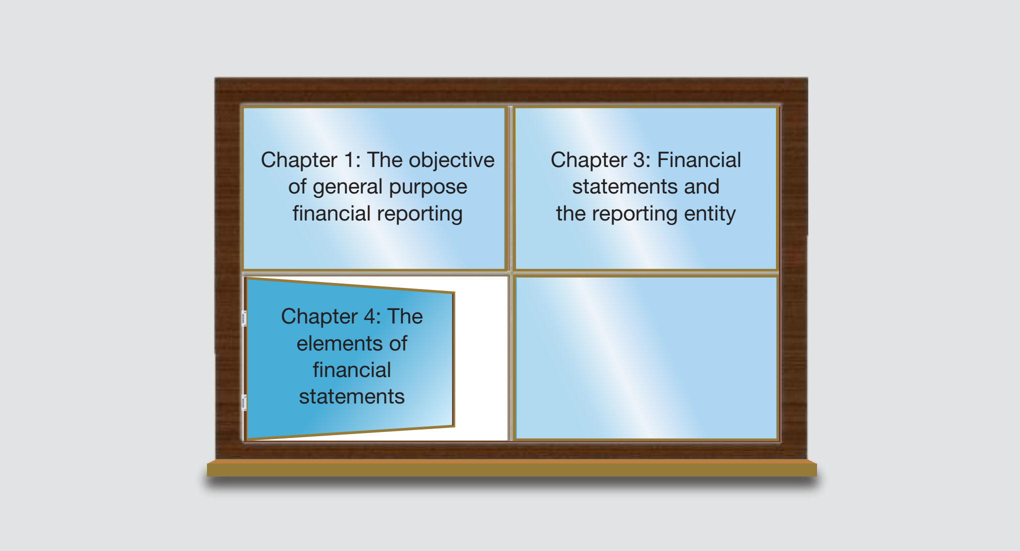
Note: Do it exercises, like the one here, ask you to put newly acquired knowledge to work. Sometimes, they outline the reasoning necessary to complete the exercise and show a solution.

1.6 Financial statements

LEARNING OBJECTIVE 1.6 Identify the elements of each of the four main financial statements.

Financial position, financial performance and cash flows are of interest to users of accounting information. How does an entity decide on the content of the financial statements? The definition of the elements of financial statements is another pane in the *Conceptual Framework* as represented in figure 1.6.

FIGURE 1.6 Building the *Conceptual Framework* — Chapter 4



The *Conceptual Framework* defines the elements of financial statements. In this section, we explore the **financial statements** that provide vital information to users when making a variety of decisions. This information is presented in four main financial statements, referred to as the primary financial statements, that form the backbone of financial accounting.

To present a picture at a point in time of what your business controls (its assets), what it owes (its liabilities) and the owner's investment in the business (equity), you would prepare a **statement of financial position**. **Assets** are formally defined in the *Conceptual Framework* as a 'present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits' (paragraphs 4.3 and 4.4). **Liabilities** are formally defined in the *Conceptual Framework* as a 'present obligation of the entity to transfer an economic resource as a result of past events' (paragraph 4.26). We will look at assets and liabilities in more detail in later chapters.

To show how successfully your business performed during a period of time, you would report its revenues and expenses in the *statement of profit or loss*. The **statement of changes in equity** explains all changes in equity during a period of time. **Equity** is defined in the *Conceptual Framework* as 'the residual interest in the assets of the entity after deducting all of its liabilities' (paragraph 4.63). Finally, of particular interest to bankers and other creditors is the **statement of cash flows**, which shows where the business obtained cash during a period of time and how that cash was used. The statement of cash flows is considered in more detail in chapter 11. The term 'financial statements' refers to the primary financial statements (which include the statement of financial position, a statement (or statements) of financial performance, statement of changes in equity and statement of cash flows) together with detailed notes to the financial statements.

IFRS 18/AASB 18 *Presentation and Disclosure of Financial Statements*

In June 2024, the AASB approved AASB 18 *Presentation and Disclosure of Financial Statements* for application by Australian entities preparing financial statements in accordance with Australian Accounting Standards. Based on IFRS 18 *Presentation and Disclosure of Financial Statements*, AASB 18 replaces AASB 101 *Presentation of Financial Statements.* IFRS 18/AASB 18 applies to for-profit entities (other than superannuation entities) for annual reporting periods beginning on or after 1 January 2027. For not-for-profit private sector entities, not-for-profit public sector entities and superannuation entities, IFRS 18/AASB 18 is effective for annual periods beginning on or after 1 January 2028. In this textbook we have implemented the changes arising from IFRS 18/AASB 18.

The aim of IFRS 18/AASB 18 is to improve transparency and comparability of financial performance to assist investors and others to analyse an entity's performance and compare performance between entities. Many investors use sub-totals in the statement of profit or loss as the start of their analysis, yet some of these sub-totals were defined differently by various entities.

Many requirements and disclosures contained in IAS 1/AASB 101 remain unchanged in the new IFRS 18/AASB 18 or in other standards. Some requirements from IAS 1/AASB 101 have been inserted into a revised version of IAS 8/AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, which has been retitled *Basis for Preparation of Financial Statements*. IFRS 18/AASB 18 is accompanied by limited amendments to the requirements of other standards, such as IAS 7/AASB 107 *Statement of Cash Flows*.

The key changes arising from IFRS 18/AASB 18 are changes to:

- statement of profit or loss
- disclosure of management-defined performance measures
- statement of cash flows.

Changes to the statement of profit or loss — categories of income and expenses

Income and expenses must be classified in the statement of profit or loss into one of five categories: investing, financing, income taxes, discontinued operations and operating.

IFRS 18/AASB 18 requires a company to determine its 'main business activities' to decide which income and expenses belong in the operating category. Some companies' main business activity is investing in assets or providing financing to customers, such as banks. Income and expenses that would otherwise be classified in the investing or financing categories by most companies would form part of the operating category for such companies.

Two new mandatory subtotals must be shown on the face of the statement: operating profit or loss and profit or loss before financing and income taxes.

Table 1.3 provides an example of the new format of the statement of profit or loss.

TABLE 1.3 **Example: Statement of profit or loss arising from IFRS 18/AASB 18**

	$	Classification of income and expenses	Comments
Revenue	10 000	Operating	
Cost of sales	(6 000)	Operating	
Gross profit	4 000	Operating	Subtotal not mandated, but allowed
Other operating income	500	Operating	
Selling expenses	(300)	Operating	
Research and development expenses	(200)	Operating	
General and administrative expenses	(900)	Operating	
Other operating expenses	(100)	Operating	
Operating profit	3 000		New mandatory subtotal
Share of profit from associates	500	Investing	
Profit before financing and income tax	3 500		New mandatory subtotal
Interest expense	(200)	Financing	
Profit before income taxes	3 300		Subtotal already required
Income tax expense	(1 000)	Income tax	
Profit from continuing operations	2 300		Subtotal already required
Loss from discontinued operations	(100)	Discontinued operations	
Profit	2 200		Total already required

Source: Adapted from IFRS Foundation 2024.

Operating category

The operating category provides information about a company's operations; the 'operating profit' is a starting point for investors to assess company performance and estimate future cash flows. This is a residual category of income and expenses not classified into any of the other categories.

The operating category includes all income and expenses arising from a company's main business activities. Income and expenses from other business activities, such as income and expenses from additional activities, are also classified in the operating category if those income and expenses do not meet the requirements to be classified in any of the other categories.

IFRS 18/AASB 18 requires a company to present expenses in the operating category in the most useful structured way based on their nature or function, or a combination. The nature of an expense refers to the economic resources consumed to accomplish the company's activities, for example, raw materials, salaries and advertising costs. The function of expenses is based on the activity to which the consumed resource relates to, for example, cost of sales, distribution costs and administrative expenses. A 'combination' presentation of operating expenses by nature (e.g. salaries) and function (e.g. cost of sales) may be appropriate. If a company presents one or more line items for operating expenses classified by function, they are required to disclose the following five expenses by nature related to each line item in the operating category of the statement of profit or loss: depreciation, amortisation, employee benefits, impairment losses and reversals of impairment losses, and write-downs and reversals of write-downs of inventories.

Investing category

The investing category provides information about income and expenses from stand-alone investments and includes rentals from an investment property, dividends from shares in other companies, income and expenses from cash and cash equivalents, and share of profits from an associate.

Financing category

The financing category provides information on income and expenses relating to how the entity is financed and includes income and expenses from liabilities arising from pure financing transactions (such as bank loans and bonds) and interest income and expenses on all other liabilities not involved in the raising of finance (e.g. payables for goods and services and lease liabilities).

Income taxes category

The income taxes category consists of income tax expense (or tax income) that is included in profit or loss.

Discontinued operations category

The discontinued operations category consists of income and expenses from discontinued operations.

There are new rules for labelling, aggregation and disaggregation of items in the financial statements.

Changes to the disclosure of management-defined performance measures arising from IFRS 18/AASB 18

Management-defined performance measures (MPMs) are the subtotals of income and expenses that a company uses in public communications outside financial statements to present management's view of an aspect of the financial performance of the company as a whole, that are not defined by IFRS/AASB accounting standards; they are sometimes called 'alternative performance measures' or 'non-GAAP measures'.

Many companies have been disclosing MPMs in their investor briefings and management commentary section of their annual reports (i.e. outside of the financial statements). The computation of the MPMs has been inconsistent between companies and often not transparent. Not all subtotals are regarded as MPMs. MPMs specifically relate to subtotals of income and expenses (i.e. not to the statement of financial position or statement of cash flows). The MPM also needs to present management's view relating to the financial performance of the organisation as a whole. IFRS 18/AASB 18 specifies some subtotals of income and expenses are *not* MPMs, such as gross profit, profit before income taxes. IFRS 18/AASB 18 does not define EBITDA (earnings before interest, tax, depreciation and amortisation); rather, the standard specifies that 'operating profit or loss before depreciation, amortisation and impairments within the scope of IAS 36, is not an MPM.

IFRS 18/AASB 18 specifies that MPM disclosures should be in a single note to the financial statements and include a reconciliation between the MPM and the closest subtotal in the statement of profit or loss.

Changes to statement of cash flows

IFRS 18/AASB 18 has resulted in consequential amendments to other accounting standards, including IAS 7/AASB 107 *Statement of Cash Flows*.

Key changes to IAS 7/AASB 107 as a result of IFRS 18/AASB 18 include:

- Indirect method for operating cash flows. The starting point is the new mandatory subtotal in the statement of profit or loss, 'operating profit or loss' (previously the starting point was 'profit or loss'). This may be a change for many companies and may change the reconciling items.
- Removing the presentation choices related to interest and dividend cash flows. The requirements are that they be classified as follows.
  - Interest cash inflows — classified as investing cash flows (previously companies could choose an accounting policy of operating or investing cash flows)
  - Dividend cash inflows — classified as investing cash flows (previously companies could choose an accounting policy of operating or investing cash flows)
  - Interest cash outflow — classified as a financing cash flow (previously companies had an accounting policy choice between operating or financing cash flows)
  - Dividend cash outflow — classified as a financing cash flow (previously companies had an accounting policy choice between operating or financing cash flows)

As highlighted, the changes to the statement of cash flows arising from IFRS 18/AASB 18 bring consistency to the presentation of interest and dividend cash inflows and outflows by removing the policy choice of companies. At present, there isn't complete alignment between the operating, investing and financing categories in the statement of profit or loss and the statement of cash flows; this may be addressed in future standard setting.

IFRS 18/AASB 18, thus, specifies the following for most companies (i.e. other than banks and asset managers whose primary business is investing and financing):

- investing activity — includes interest cash inflows and dividend cash inflows
- financing activity — includes interest cash outflows and dividend cash outflows.

In this textbook, we will apply the new requirements of IFRS 18/AASB 18.

The next section of this chapter outlines and explains the regulation of external financial reporting in detail. To introduce you to the main financial statements, we have prepared the financial statements for a marketing agency, Wong Pty Ltd (figure 1.7). Take some time now to look at their general form and categories in preparation for the more detailed discussion that follows. Note that:

- a simplified statement of profit or loss is shown; a fully classified statement of profit or loss is provided in figure 4.6
- a simplified statement of financial position is shown; a fully classified statement of financial position is provided in figure 1.16
- Wong's financial statements are internal reports generated for internal use. External financial statements are presented in a different format as illustrated in the Giorgina's Pizza Limited statements later in the chapter.

FIGURE 1.7 Wong Pty Ltd's financial statements

WONG PTY LTD
Statement of profit or loss
for the month ended 31 October 2026

Service revenues		$10 600
EXPENSES		
Salaries expense	$ 3 200	
Supplies expense	1 500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	5 740
Profit before tax		4 860
Tax expense		2 000
Profit		1 **$ 2 860**

WONG PTY LTD **Statement of financial position** as at 31 October 2026		
ASSETS		
Cash		**$15 200**
Accounts receivable		200
Advertising supplies		1 000
Prepaid insurance		550
Office equipment		4 960
Total assets		21 910
LIABILITIES		
Accounts payable	$ 2 500	
Interest payable	50	
Revenue received in advance	800	
Salaries payable	1 200	
Bank loan	5 000	
Total liabilities		9 550
Net assets		$12 360
EQUITY		
Share capital		$10 000
Retained earnings		**2 360**
Total equity		$12 360

WONG PTY LTD **Calculation of retained earnings** for the month ended 31 October 2026	
Retained earnings, 1 October 2026	$ —
Profit	**2 860**
Less: Dividends	(500)
Retained earnings, 31 October 2026	2 **$ 2 360**

WONG PTY LTD **Statement of cash flows** for the month ended 31 October 2026		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from operating activities	$11 200	
Cash payments for operating activities	(5 500)	
Net cash provided by operating activities		$ 5 700
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchased office equipment	(5 000)	
Net cash used by investing activities		(5 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issue of shares	10 000	
Proceeds from bank loan	5 000	
Payment of dividend	(500)	
Net cash provided by financing activities		14 500
Net increase in cash		15 200
Cash at beginning of period		—
Cash at end of period		**$15 200**

1 Note that final sums in the statements are double-underlined. Also note the interrelationships of the four financial statements as illustrated by the amounts in bold.

2 The calculation of retained earnings is part of the statement of changes in equity, but is usually shown as a note in the financial statements (see figure 1.15).

Statement of profit or loss

The purpose of the statement of profit or loss is to report the success or failure of the entity's operations for a period of time. To indicate that Wong's statement reports the results of operations for a period of time, the statement is dated 'for the month ended 31 October 2026'. The **statement of profit or loss** lists the entity's income (i.e. revenues and gains), followed by its expenses. Finally, the profit (or loss) is determined by deducting expenses from income. This result is the famed *bottom line* often referred to in business.

Why are financial statement users interested in the bottom line? We explain this using the 'decision-making toolkit' that follows. Resource providers (investors and lenders) use the statement of profit or loss to determine if the entity is profitable. If the revenues exceed the expenses, then a profit is reported; but if expenses exceed the revenues, then it is a loss. If investors believe that Wong Pty Ltd will be even more successful in the future, they may be willing to invest more funds. Investors are interested in an entity's past profit because it provides some information about future profit. Similarly, creditors also use the statement of profit or loss to predict future performance. When a bank lends money to an entity, it does so in the belief that it will be repaid in the future. If it didn't think it was going to be repaid, it wouldn't lend the money. Therefore, before making the loan, the bank loan officer will use the statement of profit or loss as a source of information to predict whether the entity will be profitable enough to repay its loan. Note also that managers allocate resources based on their beliefs about an entity's future performance.

The issue of shares and dividend distributions are not used in determining profit. For example, $10 000 of cash received from issuing new shares was not treated as revenue by Wong Pty Ltd, and dividends paid of $500 were not regarded as a business expense.

For external financial reports, the statement of profit or loss must also include all changes in equity other than owner/shareholder changes. This statement is called a 'statement of profit or loss and other comprehensive income'. The new standard permits an option of presenting one statement of profit or loss and other comprehensive income in two sections or two statements (a separate profit or loss section and a separate comprehensive income section). If a company does not have any additional items (such as asset revaluations), the statement of profit or loss and the statement of profit or loss and other comprehensive income are identical. The statement of profit or loss and other comprehensive income is illustrated in chapter 10.

Helpful hint: The heading of every statement of profit or loss includes the name of the entity, the name of the statement and the time period covered by the statement. Usually, another line is added to indicate the unit of measure; when it is used, this fourth line usually indicates that the data are presented 'in thousands' ($'000) or 'in millions'.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Are the entity's operations profitable?	Statement of profit or loss	The statement of profit or loss reports on the success or failure of the entity's operations by reporting its revenues and expenses.	If the entity's revenues exceed its expenses, it will report a profit; if expenses exceed revenues, it will report a loss.

Statement of changes in equity

The *statement of changes in equity* reports the total comprehensive income for the period and other changes in equity, such as adjustments to retained earnings (accumulated prior-year profits) for changes in accounting standards, changes in accounting policies and corrections of errors. The statement of changes in equity must also report details of transactions with the owners of the company (share capital movements and dividend payments) and, finally, a reconciliation of the movement in each component of equity. However, for simplicity we will illustrate only that part of the statement that reports on retained earnings; a full statement of changes in equity is illustrated later in this chapter using Giorgina's Pizza Limited. **Retained earnings** refers to the accumulated profit that has not been distributed as dividends to owners. This is an important part of the statement of changes in equity because it reports on dividends and explains the link between the statement of profit or loss and the statement of financial position.

As shown in figure 1.7, the statement of changes in equity shows the profit for the current period, which is the same as the amount reported in the statement of profit or loss. In this simple example, there are no other income or expense items or adjustments to retained earnings. The current period profit is the only item increasing retained earnings during the reporting period. The amount of retained earnings at the start of the period, which is nil for Wong Pty Ltd as it only commenced business at the beginning of the month, is added to profit.

Dividends reduce equity because they are a distribution to owners. In the Wong Pty Ltd example, dividends of $500 are deducted to calculate the closing amount of retained earnings. Note that this is equal to the amount of retained earnings reported in the statement of financial position.

Shareholders can see how much profit has been distributed as dividends by reading the statement of changes in equity. An entity could pay all of its profits for a period as dividends to shareholders. But few entities choose to do this. Why? Because they want to retain part of the profits to allow for further expansion. High-growth entities often choose to pay low or no dividends.

Statement of financial position

The *statement of financial position* reports assets and claims to those assets at a specific point in time. Claims are subdivided into two categories: claims of creditors and claims of owners. Claims of creditors are called *liabilities*. Claims of owners are called **equity** (or *shareholders' equity*). This relationship is shown in equation form in figure 1.8. This equation is referred to as the **basic accounting equation**.

FIGURE 1.8 Basic accounting equation

Assets = Liabilities + Equity

Assets must be in balance with the claims to the assets. As you can see from looking at Wong Pty Ltd's statement of financial position in figure 1.7, assets are listed first, followed by liabilities and equity. Equity comprises two parts: (1) share capital and (2) retained earnings and reserves. As noted earlier, share capital results when the entity issues shares. Wong Pty Ltd has share capital of $10 000. (Other names for share capital are *paid-up capital, issued capital* and *contributed equity*.)

Without any complex adjustments, which are considered in later chapters, the amount of retained earnings reported in the statement of financial position at the end of the period is the amount of retained earnings at the beginning of the period, plus profit after tax for the period, less any amount distributed as a dividend during the period.

Reserves also form part of equity. Some reserves are accumulated profit and result from transferring amounts from retained earnings to reserves. Other reserves result from the application of accounting standards involving, for example, asset revaluations.

Wong Pty Ltd has no reserves. The equity of Wong Pty Ltd is $12 360, consisting of share capital of $10 000 and retained earnings of $2360.

In figure 1.7 the statement of financial position is shown in a vertical format, which is the method used in the published financial statements of listed companies. An alternative format is the horizontal (or account) format shown in figure 1.9, where the layout of the statement of financial position is closely aligned to the basic accounting equation shown in figure 1.8.

FIGURE 1.9 Horizontal format of the statement of financial position

WONG PTY LTD
Statement of financial position
as at 31 October 2026

ASSETS		LIABILITIES	
Cash	$15 200	Accounts payable	$ 2 500
Accounts receivable	200	Interest payable	50
Advertising supplies	1 000	Revenue received in advance	800
Prepaid insurance	550	Salaries payable	1 200
Office equipment	4 960	Bank loan	5 000
		Total liabilities	9 550
		EQUITY	
		Share capital	10 000
		Retained earnings	2 360
		Total equity	12 360
Total assets	**$21 910**	**Total liabilities and equity**	**$21 910**

Using the decision-making toolkit, creditors can use the statement of financial position as another source of information to determine the likelihood they will be repaid. They carefully evaluate the nature of an entity's assets and liabilities. For example, does the entity have assets that could easily be sold to repay its debts? Managers use the statement of financial position with the statement of profit or loss to determine, for example, whether inventory is adequate to support future sales. The statement of financial position is also useful in assessing whether cash on hand is sufficient for immediate cash needs. The decision demonstrated in the toolkit looks at the relationship between debt (liabilities) and equity to determine whether the entity relies more on creditors or owners for its financing. Managers use this analysis to determine whether they have the best proportion of debt and equity financing.

Helpful hint: The heading of a statement of financial position includes the name of the entity, the name of the statement and the date.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Does the entity rely mainly on debt or equity to finance its assets?	Statement of financial position	The statement of financial position reports the entity's resources and claims to those resources. There are two types of claims: liabilities and equity.	Compare the amount of liabilities (debt) with the amount of equity to determine whether the entity relies more on creditors or owners for its financing.

Statement of cash flows

The main purpose of a *statement of cash flows* is to provide financial information about the cash receipts and cash payments of a business for a specific period of time. To help investors, creditors and others in their analysis of an entity's cash position, the statement of cash flows reports the cash effects of an entity's: (1) operating activities, (2) investing activities and (3) financing activities. In addition, the statement of cash flows shows the net increase or decrease in cash during the period, and the cash amount at the end of the period.

Users are interested in the statement of cash flows because they want to know what is happening to an entity's most important resource. The statement of cash flows provides answers to the following simple but important questions.

- Where did cash come from during the period?
- How was cash used during the period?
- What was the change in the cash balance during the period?

The statement of cash flows for Wong Pty Ltd in figure 1.7 shows that cash increased by $15 200 during the year. This resulted because operating activities (services to clients) increased cash by $5700, financing activities increased cash by $14 500 and investing activities used $5000 cash for the purchase of equipment. The decision demonstrated in the decision-making toolkit is to determine if the entity is generating enough cash from its operations to fund its investing activities. Comparing the cash provided from operating activities with the amount of cash used in investing activities provides the answer.

If there is any deficiency (i.e. cash used by investing activities is greater than that generated from operating), then the funds must be provided from financing activities.

Helpful hint: The heading of a statement of cash flows must identify the entity, the type of statement and the time period covered by the statement.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Does the entity generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of cash provided or used by operating activities, investing activities and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating and investing activities must be made up with cash from financing activities.

Interrelationships between the statements

Because the results on some statements are used as inputs to other statements, the statements are interrelated. These interrelationships are evident in Wong Pty Ltd's statements in figure 1.7.

1. The statement of financial position depends on the results of the statement of profit or loss and statement of changes in equity. Wong Pty Ltd reported profit of $2860 for the period. This amount is added to the beginning amount of retained earnings as part of the process of determining ending retained earnings.
2. The statement of cash flows and the statement of financial position are also interrelated. The statement of cash flows shows how the cash account changed during the period by showing the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the $15 200 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows is reflected in amounts reported on the statement of financial position.

Study these interrelationships carefully. To prepare financial statements you must understand the sequence in which these amounts are determined and how each statement affects the next.

The classified statement of financial position

As explained, the statement of financial position shows a snapshot of an entity's financial position at a point in time. (Prior to periods commencing 1 January 2009, the statement of financial position was called a balance sheet.) To improve users' understanding of an entity's financial position, entities group similar assets and similar liabilities together. This is useful because it tells you that items within a group have similar economic characteristics. IFRS 18/AASB 18 *Presentation and Disclosure in Financial Statements* prescribes minimum disclosures on the face of a classified statement of financial position. A **classified statement of financial position** is one in which assets and liabilities are classified as current and non-current (see figure 1.16). The most commonly reported items are listed in table 1.4.

TABLE 1.4 **Minimum disclosures on the statement of financial position**

Assets	**Liabilities**
Cash assets	Trade and other payables
Trade and other receivables	Financial liabilities
Other financial assets	Tax liabilities
Inventories	Provisions
Investment in property	**Equity**
Property, plant and equipment	Capital and reserves
Tax assets	Retained earnings or accumulated losses
Intangible assets	

Before we dive in, we need to explain three points.

1. To demonstrate a classified statement of financial position, we use a fictitious company, Giorgina's Pizza Limited.
2. Giorgina's Pizza Limited, like most entities, presents its financial statements for more than one year. This allows users to compare the business's financial position and performance for an accounting period with that of the previous period.
3. Note that numbers are reported in thousands on Giorgina's financial statements — that is, numbers are rounded to the nearest thousand. Thus, the entity's total inventories for 2026 were $5 014 000 not $5014 (see figure 1.10).

IFRS 18/AASB 18 also requires that the assets and liabilities be classified as current and non-current, unless categorisation by liquidity provides more relevant information. Almost all entities, other than financial institutions and insurance companies, choose the current/non-current categories for presentation of the statement of financial position. Although not as informative as liquidity categories, the current/non-current categories provide a crude measure of: (1) whether the entity has enough assets to pay its debts as they come due, and (2) the claims of short-term and long-term creditors on the entity's total assets. This is discussed in more detail in the section on analysing financial statements (section 1.9). Current and non-current categories are used extensively for internal and external reporting. These categories can be seen in the statement of financial position for our example company, Giorgina's Pizza Limited. Each of the categories is explained next.

Helpful hint: Liquidity — the sooner an asset converts to cash, the more liquid it is said to be.

FIGURE 1.10 Current assets section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED Statement of financial position (partial) as at 30 June 2026			
	Note	2026 $'000	2025 $'000
CURRENT ASSETS			
Cash and cash equivalents	14	14 017	30 255
Trade and other receivables	15	19 809	15 764
Inventories	16	5 014	4 280
Current tax assets	17	143	—
Other current assets	22	5 701	4 673
		44 684	54 972
Assets held for sale	18	602	528
Total current assets		**45 286**	**55 500**

Current assets

Current assets include assets that are cash, held for the purpose of being traded, or expected to be converted to cash or used in the business within 1 year or within the operating cycle, whichever is longer. The **operating cycle** is the average time taken to acquire goods and services and convert them to cash in producing revenues. Giorgina's reported current assets of $45 286 000 in 2026. For most businesses the cut-off for classification as current assets is 1 year from the end of the reporting period. For example, accounts receivable are included in current assets because they will be converted to cash through collection within 1 year. Inventories are current assets because we expect they will be used in the business within 1 year (hopefully, the raw materials sooner!).

Common types of current assets are: (1) cash, (2) marketable securities, such as shares held as a short-term investment, (3) receivables (notes receivable, accounts receivable and interest receivable), (4) inventories and (5) prepaid expenses (insurance and supplies). Figure 1.10 shows the current assets that are reported in Giorgina's 2026 consolidated financial statements.

An entity's current assets are important in assessing its short-term debt-paying ability, as explained later in the chapter.

Non-current assets

Non-current assets are assets that are not expected to be consumed or sold within 1 year or the operating cycle. They encompass a diverse range of assets. The most common types of non-current assets include receivables that are due more than 1 year from the date of the statement of financial position; property, plant and equipment; and intangible assets. Figure 1.11 shows the non-current assets reported in Giorgina's 2026 financial statements.

FIGURE 1.11 Non-current assets section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED Statement of financial position (partial) as at 30 June 2026			
	Note	2026 $'000	2025 $'000
NON-CURRENT ASSETS			
Property, plant and equipment	19	37 270	26 273
Deferred tax assets	17	30	622
Goodwill	20	42 835	35 195
Other intangible assets	21	13 070	9 607
Other non-current assets	22	3 821	4 294
Total non-current assets		**97 026**	**75 991**

Property, plant and equipment

Property, plant and equipment (sometimes called *fixed assets*) are assets with relatively long useful lives that are used in operating the business. This category includes land, buildings, machinery and equipment, delivery vehicles, and furniture. Giorgina's reported property, plant and equipment of $37 270 000, as shown in its statement of financial position in figure 1.11.

Depreciation is the practice of allocating the cost of assets to a number of periods, rather than simply expensing the full purchase price of the asset in the year of purchase. Assets that the entity depreciates should be reported on the statement of financial position at cost less accumulated depreciation. For example, Giorgina's reported accumulated depreciation of $17 069 000 for property, plant and equipment will be reported in the notes to the financial statements. The accumulated depreciation is the total amount of depreciation to date over the *life of the asset*.

Intangible assets

Many entities have assets, other than financial assets, that have no physical substance yet often are very valuable. These assets are referred to as **intangible assets**. They include patents, copyrights and trademarks or trade names that give the entity exclusive right of use for a specified period of time. Goodwill is similar but not the same as an intangible assets. Giorgina's reported goodwill of $42 835 000, as shown in figure 1.11. Non-current assets will be discussed further in chapter 8.

Current liabilities

In the liabilities section of the statement of financial position, the first grouping is current liabilities. **Current liabilities** are obligations that are to be paid within the coming year or the entity's operating cycle. Common examples are accounts payable, wages payable, bank loans payable, interest payable, taxes payable, and current maturities of long-term obligations (payments to be made within the next year on long-term obligations).

Within the current liabilities section of the statement of financial position, payables are usually listed first, followed by short-term borrowings, tax liabilities and provisions. Figure 1.12 shows the current liabilities reported in Giorgina's 2026 consolidated financial statements.

FIGURE 1.12 Current liabilities section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED
Statement of financial position (partial)
as at 30 June 2026

	Note	2026 $'000	2025 $'000
CURRENT LIABILITIES			
Trade and other payables	23	28 541	25 629
Borrowings—short term	24	5 312	8 651
Current tax liabilities	25	1 913	2 658
Provisions—short term	26	2 332	1 770
Other current liabilities	27	381	—
Total current liabilities		**38 479**	**38 708**

Non-current liabilities

Obligations that are not classified as current liabilities must be classified as **non-current liabilities**. Liabilities in this category include debentures payable, mortgages payable, unsecured notes payable and lease liabilities. Many entities report long-term borrowings maturing after 1 year as a single amount in the statement of financial position and show the details of the debt in notes to the financial statements. Others list the various types of long-term liabilities. In its statement of financial position, Giorgina's reported non-current liabilities as shown in figure 1.13. Liabilities will be discussed further in chapter 9.

FIGURE 1.13 Non-current liabilities section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED **Statement of financial position (partial)** as at 30 June 2026	Note	2026 $'000	2025 $'000
NON-CURRENT LIABILITIES			
Borrowings—long term	24	24 442	1 882
Provisions—long term	26	331	431
Deferred tax liabilities	25	1 796	2 324
Other non-current liabilities	27	330	365
Total non-current liabilities		**26 899**	**5 002**

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the major sections in a classified statement of financial position?
2. Explain the difference between current assets and non-current assets.
3. What was Giorgina's largest type of current asset at 30 June 2026? (The answer to this question is at the end of the chapter.)

Do it

The following information relates to Hoffman Ltd's statement of financial position at 30 June 2026. All receivables are due within 30 days.

Short-term investments	$ 2 300
Cash	800
Property, plant and equipment	10 700
Inventory	3 400
Accumulated depreciation	2 700
Accounts receivable	1 100

Prepare the assets section of a classified statement of financial position for Hoffman Ltd.

Reasoning

Assets are classified as current and non-current in a classified statement of financial position. Current assets are cash and other resources that are reasonably expected to be consumed in 1 year. Accumulated depreciation should be subtracted from property, plant and equipment to determine net property, plant and equipment.

Solution

HOFFMAN LTD **Statement of financial position (partial)** as at 30 June 2026		
ASSETS		
Current assets		
Cash	$ 800	
Accounts receivable	1 100	
Inventory	3 400	
Short-term investments	2 300	
Total current assets		$ 7 600
Non-current assets		
Property, plant and equipment	10 700	
Less: Accumulated depreciation	2 700	
Total non-current assets		8 000
Total assets		**$15 600**

A quick look at Giorgina's financial reports

So far, we have examined Giorgina's classified statement of financial position. Now let's put all the financial statements together. The same relationships that you observed among the internal financial statements of Wong Pty Ltd are evident in Giorgina's financial statements, which are presented in figures 1.14 to 1.19. We have simplified the financial statements to assist your learning — but they may look complicated anyway. Do not be alarmed by their apparent complexity. (If you could already read and understand them, there would be little reason to take this course!) By the end of this text, you'll have a great deal of experience in reading and understanding financial statements such as these.

Statement of profit or loss

Giorgina's statement of profit or loss is presented in figure 1.14. It reports total revenues and other gains in 2026 of $223 840 000 ($141 473 000 + $79 694 000 + $2 673 000). It then subtracts 11 types or categories of expenses to arrive at a profit of $21 400 000. This is a 5% decrease from the profit of $22 560 000 for the previous year.

Helpful hint: The percentage change in any amount from one year to the next is calculated as:

$$\frac{\text{Change during period}}{\text{Previous value}} \times \frac{100}{1}$$

Thus, the percentage change in profit is:

$$\frac{\text{Change in profit}}{\text{Previous year's profit}} \times \frac{100}{1}$$

FIGURE 1.14 Giorgina's statement of profit or loss (partial)

GIORGINA'S PIZZA LIMITED Statement of profit or loss (partial) for the year ended 30 June 2026			
	Note	2026 $'000	2025 $'000
Sales revenue	3	141 473	126 350
Other revenue	4	79 694	72 316
Other gains and losses	5	2 673	2 371
Food and packaging expenses	8	(63 863)	(59 009)
Employee benefits expense	9	(57 195)	(44 954)
PPE maintenance expenses		(6 998)	(6 441)
Depreciation and amortisation expense	10	(9 594)	(7 522)
Rent expense		(6 827)	(5 878)
Finance expenses		(304)	(338)
Marketing expenses		(8 573)	(8 608)
Restaurant expenses		(5 387)	(4 415)
Telephone expenses		(4 763)	(5 002)
Other expenses	11	(29 764)	(26 642)
Profit before tax		**30 572**	**32 228**
Income tax expense	12	(9 172)	(9 668)
Profit from continuing operations	**13**	**21 400**	**22 560**

Note: Prior to 1 July 2012, the statement of profit or loss and other comprehensive income was called the statement of comprehensive income, and if the separate statement of profit or loss was presented it was called an income statement. Some companies still use the old terminology when labelling their external reports. See chapter 10 for further discussion.

Statement of changes in equity

To refresh your memory about this statement you might like to review the earlier 'Statement of changes in equity' section. Giorgina's presents information about its retained earnings in the notes to the financial statements in 2026 (figure 1.15). The amount of $47 784 000 reported as retained earnings at 30 June 2026 reflects the retained profits of $45 857 000 at the beginning of the reporting period, plus $21 400 000 profit for the year, less dividends of $19 473 000.

FIGURE 1.15 Note 30, Movement in retained earnings, from Giorgina's financial statements

GIORGINA'S PIZZA LIMITED Notes to the financial statements for the year ended 30 June 2026	2026 $'000	2025 $'000
30. RETAINED EARNINGS		
Balance at beginning of year	45 857	36 013
Profit	21 400	22 560
Payment of dividends (note 31)	(19 473)	(12 716)
Balance at end of year	**47 784**	**45 857**

Statement of financial position

Giorgina's statement of financial position is shown in figure 1.16. In the previous section, we examined the components of the statement of financial position separately. Now let's look at the full picture. The entity's total assets increased from $131 491 000 on 1 July 2025 to $142 312 000 on 30 June 2026. Its liabilities include trade and other payables as well as interest-bearing liabilities, such as borrowings.

FIGURE 1.16 Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED Statement of financial position as at 30 June 2026	Note	2026 $'000	2025 $'000
ASSETS			
Current assets			
Cash and cash equivalents	14	14 017	30 255
Trade and other receivables	15	19 809	15 764
Inventories	16	5 014	4 280
Current tax assets	17	143	—
Other current assets	22	5 701	4 673
Assets held for sale	18	602	528
Total current assets		45 286	55 500
Non-current assets			
Property, plant and equipment	19	37 270	26 273
Deferred tax assets	17	30	622
Goodwill	20	42 835	35 195
Intangible assets	21	13 070	9 607
Other non-current assets	22	3 821	4 294
Total non-current assets		97 026	75 991
Total assets		142 312	131 491
LIABILITIES			
Current liabilities			
Trade and other payables	23	28 541	25 629
Borrowing—short term	24	5 312	8 651
Current tax liabilities	25	1 913	2 658
Provisions—short term	26	2 332	1 770
Other current liabilities	27	381	—
Total current liabilities		38 479	38 708
Non-current liabilities			
Borrowing—long term	24	24 442	1 882
Provisions—long term	26	331	431
Deferred tax liabilities	25	1 796	2 324
Other non-current liabilities	27	330	365
Total non-current liabilities		26 899	5 002
Total liabilities		65 378	43 710
Net assets		**76 934**	**87 781**

	Note	2026 $'000	2025 $'000
EQUITY			
Capital and reserves			
Issued capital	28	30 640	52 404
Reserves	29	(1 490)	(10 480)
Retained earnings	30	47 784	45 857
Total equity		**76 934**	**87 781**

You can see that Giorgina's has slightly more equity financing than debt — 54% of its assets are financed by equity. As you learn more about financial statements, we will discuss how to interpret the relationships and changes in financial statement items.

Helpful hint: A statement of financial position which reports current and non-current categories for assets and liabilities is known as a fully classified statement of financial position.

Statement of cash flows

Giorgina's statement of cash flows is shown in figure 1.17. We can see that Giorgina's cash decreased by $17 836 000 during the year ended 30 June 2026. The reasons for this can be determined by examining the statement of cash flows in figure 1.17. The company generated $24 362 000 from its operating activities during the year. Its investing activities included capital expenditures (purchases of property, plant and equipment) as well as proceeds from the sale of non-current assets. The net effect of its investing activities was a decrease in cash of $21 970 000. Its financing activities involved the payment of cash dividends, repayment of borrowings, the return of share capital and proceeds from borrowings and share issues using net cash of $20 228 000. In all, the net effect of the cash generated from its operating activities, less the cash used in its investing and financing, plus the translation gain from cash held in foreign currencies was a decrease in cash of $16 238 000.

FIGURE 1.17 Giorgina's statement of cash flows

GIORGINA'S PIZZA LIMITED
Statement of cash flows
for the year ended 30 June 2026

	Note	2026 $'000	2025 $'000
CASH FLOWS FROM OPERATING ACTIVITIES			
Receipts from customers		245 357	221 324
Payments to suppliers and employees		(212 148)	(188 094)
Income taxes paid		(8 847)	(5 972)
Net cash generated by operating activities	35	24 362	27 258
CASH FLOWS FROM INVESTING ACTIVITIES			
Payment for investment and business operations		(14 308)	(8 907)
Loans repaid by third parties		1 887	1 580
Payments for property, plant and equipment		(18 778)	(13 244)
Proceeds from sale of non-current assets		15 802	17 193
Interest received		827	1 339
Payments for intangible assets		(7 400)	(5 606)
Net cash used in investing activities	36	(21 970)	(7 645)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from borrowings		32 791	—
Repayment of borrowings		(15 380)	(18)
Return of share capital		(22 532)	—
Interest paid		(304)	(338)
Dividends paid		(19 473)	(12 716)
Proceeds from issue of equity securities		4 670	4 012
Net cash used in financing activities	37	(20 228)	(9 060)
Net increase (decrease) in cash and cash equivalents		(17 836)	10 553
Cash and cash equivalents at the beginning of the year		30 255	21 064
Effects of changes in exchange rates on cash held in foreign currencies	38	1 598	(1 362)
Cash and cash equivalents at the end of the year	35	**14 017**	30 255

Note: The movement in cash is $17 836 000 less exchange rate differences of cash held in foreign currencies $1 598 000, a total net reduction of $16 238 000.

Other elements of an annual report

Companies that are publicly traded must provide their shareholders with an annual report each year. The **annual report** always includes the primary financial statements introduced in this chapter as well as other important sources of information such as notes to the financial statements, corporate governance statement, the directors' report and an independent auditor's report. If the concise form of financial reporting is used to report to shareholders, a general discussion and analysis section must be included. This is instead of some of the notes to the financial statements, which are included in the full financial report. No analysis of an entity's financial situation and prospects is complete without a review of each of these items. In 2024, following global trends, Australia made it mandatory for large companies (meeting certain thresholds) to report on their climate-related risks and opportunities in their general purpose financial reports. This is discussed further in section 1.7.

Notes to the financial statements

An entity's published primary financial statements are accompanied by explanatory notes and supporting schedules that form part of the statements. The **notes to the financial statements** clarify information presented in the primary financial statements, as well as expand on it where additional detail is needed. Information in the notes does not always have to be quantifiable (numeric). Examples of notes are descriptions of the accounting policies and methods used in preparing the statements, explanations of uncertainties and contingencies, and statistics and details too voluminous to be included in the statements. The notes are essential to understanding an entity's operating performance and financial position.

Figure 1.18 is an extract from the notes to Giorgina's financial statements for 2026. It describes the methods the company uses to account for revenues.

FIGURE 1.18 Extract from the notes to Giorgina's financial statements

GIORGINA'S PIZZA LIMITED
Notes to the financial statements (extract from Note 2.2)
for the year ended 30 June 2026

2.2 REVENUE RECOGNITION
Revenue is measured at the fair value of the consideration paid or to be received.

2.2.1 Sale of goods
Revenue from the sale of goods is recognised when the entity transfers to the purchaser the significant risks and rewards of ownership of the goods.

2.2.2 Other revenue
Dividend revenue from investments is recognised when it is established that the shareholders have the right to receive payment.

Interest revenue is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable.

Corporate governance statement

In 2002, the Australian Securities Exchange (ASX) established the ASX Corporate Governance Council, which produced a document entitled *Principles of good corporate governance and best practice recommendations* (released in March 2003). The guidelines were updated in 2007 (*Corporate governance principles and recommendations*, 2nd edition) and 2010 (*Corporate governance principles and recommendations with 2010 amendments*). In 2012, there was a comprehensive review and a third edition of the principles and recommendations was released. Since 2012, further comprehensive reviews have been performed and the fourth and latest edition of the principles and recommendations was released in February 2019. All Australian listed entities as part of the ASX listing requirements (LR4.10.3) are required to disclose the extent to which they have followed the ASX corporate governance recommendations, and, if they have not followed the recommendations, the reasons for adopting alternative governance practices. For some smaller listed entities, the **corporate governance statement** is part of the directors' report. In 2024, a revised 5th edition to the *Corporate governance principles and recommendations* was released to the public for consultation. Changes to the *Corporate governance principles and recommendations* require the support of a broad consensus of members. Unfortunately, it was announced in February 2025, that consensus could not be reached, as such the current 4th edition will remain in effect without change.

Directors' report

The **directors' report** section covers a number of issues which might affect users' interpretation of the financial statements. The contents of the report in Australia are governed by the Corporations Act,