THE ROLE OF ACCOUNTING IN DECISION MAKING

1

ACCELERATORS LEARNING
Balance sheet
as at 30 June 2026

In this chapter, you'll explore the accounting equation (Assets = Liabilities + Equity), the foundation of the balance sheet.

	$	$	$		$
Assets				**Liabilities**	
Current assets:				Current liabilities:	
Cash		4,800		Accounts payable	48,700
Accounts receivable		2,600		Salary payable	900
Inventory		30,500		Interest payable	100
Office supplies		600		Unearned service revenue	400
Prepaid rent		2,000		Total current liabilities	50,100
Total current assets			40,500	Non-current liabilities:	
Non-current assets:				Loans payable	20,000
Office furniture	18,000			Total liabilities	70,100
Less: Accum. depn—office furniture	300	17,700			
Building	48,000				
Less: Accum. depn—building	200	47,800		**Owners' equity**	
Total non-current assets			65,500	Cai Wang, capital	35,900
Total assets			106,000	Total liabilities and owners' equity	106,000

THINK ABOUT A DECISION YOU HAVE MADE RECENTLY. While many decisions in our everyday life are routine and can be made without reference to detailed information, such as which clothes to wear in the morning, other decisions are more infrequent and have longer-lasting effects, such as choosing a mobile phone network and contract type. The bigger the decision, the more information you will want before making it. In the choice of which type of mobile phone to buy, in order to make the best decision you would need to know what each option provides (for example, the number of minutes included, and the amount of data allowed), as well as the cost of each plan. What you are doing is weighing up the costs and benefits of each option.

In a formal setting, organisations use accounting information to inform them prior to making important decisions. For example, if the retail giant Myer considered a bid to purchase rival David Jones, how much should it pay? The answer depends partly on what the accounting information says David Jones is worth.

The 'balance sheet' shown above is one of the most important and central financial statements prepared by accountants. Accounting information enables organisations to make better decisions.

LEARNING OBJECTIVES

- **LO 1** Explain the role of accounting and its importance to multiple stakeholders
- **LO 2** Describe the accounting equation, and define assets, liabilities and equity
- **LO 3** Use the accounting equation to analyse transactions
- **LO 4** Prepare financial statements
- **LO 5** Use financial statements and return on assets (ROA) to evaluate business performance
- **LO 6** Describe the organisations and principles that govern accounting
- **LO 7** Identify the three main types of business organisation
- **LO 8** Explain the role of ethics and sustainability in accounting

Accelerators Learning, whose balance sheet is illustrated, is a small business, but its balance sheet contains the same type of information as that shown in the balance sheet of very large organisations such as JB Hi-Fi. The same is true for the other financial statements that all well-run businesses prepare and use, and which you will learn about as you work your way through this text.

In this introductory chapter we introduce accounting in a small business context through Cai Wang's Accelerators Learning; and later, starting in Chapter 5 ('Retailing operations'), through Luca Millen's Millennial Platforms. You will see how Cai and Luca run successful businesses by treating people fairly, planning for activities that are sustainable, and capitalising on their general business and accounting acumen. You will also see how understanding financial statements like the balance sheet is one of the first steps towards business success. We will be following the fortunes of Accelerators Learning and Millennial Platforms throughout the text to see how different accounting concepts relate to their businesses. In addition, we will use examples from large firms to illustrate the fact that the same accounting principles apply to firms of any size. By the time you get to the chapter on the framework of accounting (Chapter 17), you will have a broad appreciation of how accountants prepare financial statements for all types of organisation.

1.1 WHY IS ACCOUNTING IMPORTANT?

LO 1

Explain the role of accounting and its importance to multiple stakeholders

You may have heard the term *accounting* before, and we have just said that it provides valuable information for decision making, but what exactly is it? **Accounting** measures business activities, processes the data into reports and communicates the results to decision makers. Examples of this information are the amount of profit a business has made and how much the items that the business owns are worth. Accounting is the language of business. The better you understand this language, the better you can manage your business and make decisions, be a worthy employee or creditor or owner, and manage your investments.

Accountants earn relatively high salaries and their work is interesting and important. If you are considering becoming an accountant, you need to develop professional skills, such as communication, teamwork and critical thinking, and have an understanding of ethics and sustainability. While all accountants need to be comfortable working with numbers, contemporary accounting is much more than simple recordkeeping or bookkeeping. In fact, accountants spend considerable time on decision making, using financial or non-financial information.

Through their knowledge of the language of business and the provision of financial information (see the *Concepts in action* feature), accountants make a real difference to the success of organisations they work in or clients they work for. This means that today's accountants are often found working at the very top of international businesses—for example, as chief financial officer (CFO).

CONCEPTS IN ACTION

The language of accounting

Warren Buffett often gets credit for being the first to say that accounting is the language of business. Back in 2014, Buffett pointed out that in some ways, accounting is literally like a foreign language that has to be learned before you can understand it. Like French to an English-speaker, accounting has many terms that sound foreign when you first encounter them: fixed assets, retained earnings, accounts receivable, revenue, cost versus expenses.

The advantage of learning the language is that you can speak it everywhere in the world. Surprisingly, although accounting is the language of business, many executives don't speak it. That's one reason they pay accountants to explain that stuff to them in plain English.

Speaking the language of business requires, at a minimum, understanding the fundamentals of three statements, known in accounting as financial statements: the *balance sheet*, which shows a firm's assets, liabilities and owners' equity at a given date; the *income statement*, which shows income and expenses for a given period, including money earned or owed but not paid; and the *cash flow statement*, which measures actual cash payments made or received during a specific period.

Source: Adapted from Elisabeth Natter, 'Why Is Accounting Often Referred to As the Language of Business?', *Chron Newsletter*, n.d., https://smallbusiness.chron.com/accounting-referred-language-business-63107.html, accessed 26 December 2024.

QUESTION TO THINK ABOUT

What disciplines (such as maths, languages, IT, economics, etc.) do students consider appropriate for training in accountancy? See the article sourced in the* Concepts in action *feature for one possible answer to this question.

Types of accounting

Accounting and the users of accounting information can be divided into two major fields—financial accounting and management accounting. They have different uses and often different users. **Financial accounting** provides information for external decision makers, such as external investors, government and lenders. Chapters 2–18 of this text deal primarily with financial accounting. **Management accounting** focuses on information for internal decision makers, such as business managers and production and supply chain managers. Chapters 19–23 cover management accounting.

Exhibit 1-1 illustrates the difference between financial and management accounting.

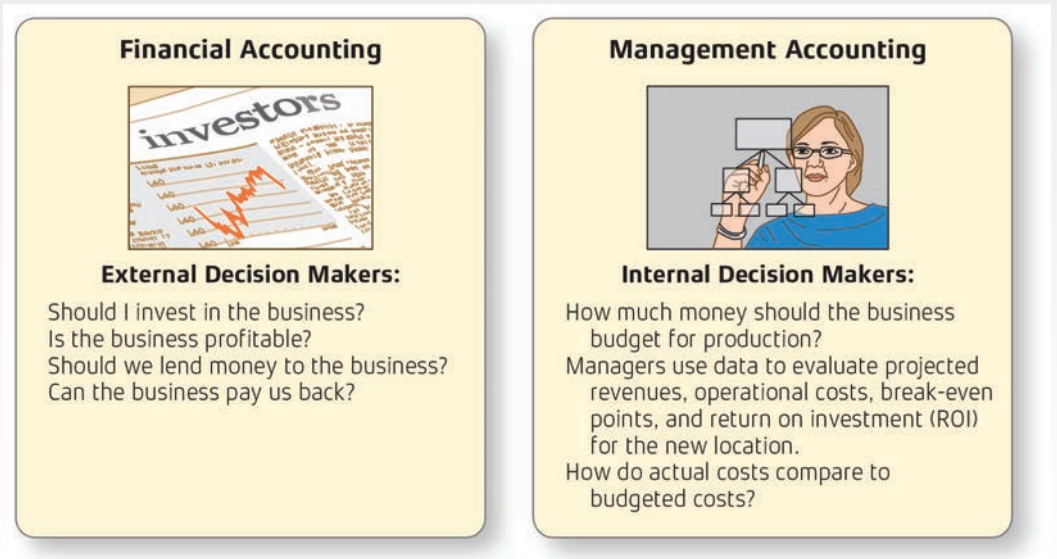
External decision makers

The following external decision makers are among those interested in financial accounting information.

Investors

External investors often provide the money to get a business started by acquiring an ownership interest. You might have the opportunity to invest in the stock market with some cash you have recently inherited or saved over the years. Which investments should you pick? Understanding a company's financial statements will help you decide. Once you have decided to invest, you can continue to analyse the company's financial statements to help decide whether to sell or hold on to your share of the company. You can view the financial statements of most large companies online.

EXHIBIT 1-1 Decision making: financial versus management accounting



Creditors

Any person or business to whom money is owed is a creditor. A creditor is often a bank, but not always. If your friend has lent you $10, they are your creditor. Before extending credit (lending money) to an organisation, a creditor evaluates the organisation's financial position or ability to repay by reviewing its financial statements. Banks follow the same process when you need to borrow money for a new car or a house. What does your financial position tell the creditor about your ability to pay off the loan? Are you a good risk for them?

Taxation authorities and other government agencies

Income tax and goods and services tax (GST) is calculated in Australia and New Zealand using accounting information. Good accounting records can help individuals and businesses take advantage of lawful methods to minimise tax. A government agency interested in accounting information in Australia is the **Australian Securities and Investments Commission** (ASIC), which is responsible for administering and enforcing Australian corporations law. Among other powers, ASIC can ban people from running companies (as directors) and prosecute individuals for corporate wrongdoing, which can result in financial penalties or prison terms for those involved (see *Connect to: ETHICS*). In New Zealand the parallel government agency is the **Financial Markets Authority** (FMA).

CONNECT TO: ETHICS

Former Western Australian company director convicted of fraud

Christopher Edward Eric Skelly, of Lark Hill, Queensland has been found guilty by a jury of one fraud-related charge brought by ASIC.

Mr Skelly, a former director of C & G Group Industries Pty Ltd ACN 168 873 578 (C&G) was found guilty of intent to defraud by deceit or fraudulent means and gaining a benefit, namely $529,380.72, for C & G between 11 December 2014 and 12 January 2015.

Mr Skelly deceived a factoring agency by emailing them an invoice and other documents that created the false impression that monies were owed to C&G by debtors, when in fact they were not. Relying on those documents, the factoring agency paid C&G a total of $529,380.72.

Mr Skelly was on trial in the Perth District Court between 18 March 2019 and 25 March 2019. The matter was adjourned for sentence on 17 April 2019 at the Perth District Court.

The Commonwealth Director of Public Prosecution prosecuted the matter.

Background

C&G was involved in the provision of crushing & screening services. The company was placed into administration on 28 April 2015 and liquidators were subsequently appointed on 29 May 2015. C&G had total liabilities of $4,089,386 owing to 54 creditors.

ASIC commenced an investigation after receiving a report from the liquidators of C&G, David Ross and Cameron Shaw of Hall Chadwick.

Source: ASIC media release, 19-075MR 'Former Western Australian company directory convicted of fraud', 3 April 2019, https://asic.gov.au. © Australian Securities and Investments Commission. Reproduced with permission.

Other external users

Employees and labour unions make wage demands partly based on their employer's reported profit. Consumer groups, suppliers and pressure groups are among others interested in the amount of profit that businesses earn. The media report the profits of businesses as details of these are released. Such news, based on accounting information, sometimes influences business decisions.

Internal users

The key internal decision makers in an organisation are senior and middle management. These managers use accounting information to set goals and targets (often called key performance indicators or KPIs), measure progress towards those goals, and make adjustments when needed. The accounting system gives managers the information they need to help make those decisions. It is important that the information is provided in a timely manner using contemporary systems such as big data. For example, imagine that you are in charge of setting sales targets over the next year for the fast food chain McDonald's. Where would you start? Probably with last year's sales numbers, which, as you probably guessed, come from the accounting system. It is believed that analysing big data allows accountants to gain a deeper insight into business and make informed decisions.

Big data

One question that all users of accounting information are concerned with is how the information now available from accounting systems can be integrated effectively, so that decision makers are not overwhelmed by massive amounts of data. Big data is having a massive impact on business. In practice, accountants have to undergo the wearying process of collecting and analysing enormous amounts of data. Further, the data are scattered and collected from various sources. Accountants need to ensure that there are no mistakes in the data collected and the analysis process. The absence of accurate data and analysis will lead to inaccurate decisions and loss to business. The following ***Concepts in action*** feature describes the use of big data and its implications.

CONCEPTS IN ACTION

Big data meets accounting

We have heard a great deal in the media about big data. '**Big data**' refers to large, complex, structured and unstructured data collections, characterised as having high volume, velocity and variety (the '3 Vs'), and the analysis of these. Much of the data cannot be stored and analysed using conventional data analysis techniques (e.g. spreadsheets). In other words, data at large scale cannot be stored and analysed using spreadsheets. The big data relevant to an organisation can vary widely depending on its industry, ownership, products, and so on.

Big data can come from a range of sources, including documents (Excel, PowerPoint, PDF), data from enterprise information systems, postings on social media (Facebook, X, Instagram), sensor data (smart electronic meters), media (photos, videos, audio recordings), log data (application logs), public records and archives.

Accountants within organisations in many industries are using big data. For example:

- Retail organisations monitor social networks to engage brand advocates and identify brand adversaries.
- Advertising and marketing agencies track comments on social media to gauge product preferences and sentiment.
- Hospitals analyse medical data and patient records to assist diagnosis.
- Financial service organisations identify customers who are likely to be attracted to increasingly targeted and sophisticated offers.
- Government departments and agencies keep records of citizens, for instance for issuing passports or driving licenses, maintaining electoral rolls or assessing demographic profiles.

Implications of big data in accounting

Big data affects nearly every aspect of accounting. In auditing, big data can produce more-data-driven audits, providing a better experience for the client and the auditor, and find patterns that indicate the possibility of fraud. It can also produce more valuable insights. In advisory services, big data can identify questions, help monitor and improve business performance, and build analytical models that support a variety of product or operational improvements. In tax, big data

offers the opportunity to analyse efficiencies more easily, identify tax-related opportunities for improvement, and aid in evaluating global opportunities. Finally, in managerial accounting, big data can help with risk identification and mitigation.

Source: Adapted from Adina Hannan, 'Big Data Meets Accounting', *The Plus Side*, 23 August 2016, https://www.beckerpinnacle.com.

Having established why accounting information is required, who some of its major users are, and the opportunities presented by modern IT systems, let's now learn how to prepare this information.

1.2 WHAT IS THE ACCOUNTING EQUATION?

LO 2
Describe the accounting equation, and define assets, liabilities and equity

Before we explain the accounting equation, let's run through a simple example to show that the fundamental concepts of accounting are perhaps more readily understandable than you would expect.

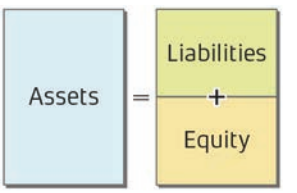
Suppose it's a Monday morning during the university holidays and you want to make some money. You had previously noticed that there was no store near the main business district in your home city that sold fruits and vegetables. So, as a trial, you start a business of buying and selling bananas by investing $50 of your savings. This means the business is 'worth' $50 at this point. That morning, you buy a 12 kg box of bananas in the market for $36. There are 110 bananas in the box and you sell them all to office workers at lunchtime for $1 each. As you sit down for a well-earned rest in the early afternoon, you try to work out how much profit your business made in its first few hours of life and how much your business is now worth. Try to work this out before reading on.

If you came up with a profit number of $110 − $36 = $74 (that is, sales – cost = profit), you have just correctly performed your first piece of accounting—an income statement! If you came up with the business being worth the original $50 cash plus the $74 profit = $124 then you have just correctly performed the first part of your balance sheet!

To understand the income statement and balance sheet better, you need to understand the basic tool of accounting, the **accounting equation**. It measures the resources of a business (what the business owns or has control of) and the claims to those resources (what the business 'owes' to lenders and the owners). The accounting equation consists of three parts—assets, liabilities and equity. Assets appear on the left side of the equation, and the liabilities and owners' equity appear on the right side (see Exhibit 1-2). As it is an *equation*, by definition the two sides must be equal.

So, what do accountants mean by the three key concepts of assets, liabilities and equities?

EXHIBIT 1-2 The accounting equation



Assets, liabilities and equity

Assets

An **asset** is an economic resource that is expected to benefit the business in the future. Assets are something the business owns or has control of that has value. Cash, merchandise inventory, furniture and land are examples of assets. Claims to these assets come from two sources: liabilities and equity.

Liabilities

Liabilities are what the business owes to creditors (banks and anyone else who has lent money to the business). As such, liabilities represent the creditors' claims on the business's assets. For example, a creditor who has loaned money to a business to purchase a factory has a claim over the business's assets until it pays the debt. Many liability accounts have the word *payable* in their titles. Examples of such accounts include Accounts Payable and Salaries Payable.

Equity

The owner's claims to the assets of the business are called **equity** (also called **owners' equity** or **capital**). Equity represents the amount of assets that are left over after the company has paid its liabilities.

Equity increases with owner contributions and revenues. Owners can contribute cash or other assets (such as equipment) to the business, receiving an equity interest in return, their 'capital'. **Revenues** are amounts received or receivable that result from selling goods or services to customers. Examples of revenues are sales revenue, service revenue and rent revenue.

Equity decreases with expenses and (owner) drawings. **Expenses** are amounts paid or payable for purchasing goods or services. Expenses are the opposite of revenues and, therefore, decrease equity. Examples of expenses are rent expense, salaries expense, advertising expense and electricity expense. ***Revenues less expenses equals profit***. Owner's **drawings** (or withdrawals) are payments to the owner—the owner is withdrawing or 'drawing' money out of the business. Drawings are the opposite of owner contributions and, therefore, decrease equity.

Formal definitions of assets, liabilities and equity by the Australian Accounting Standards Board are given in the following *Connect to: ACCOUNTING STANDARDS* feature.

CONNECT TO: ACCOUNTING STANDARDS

The 'principles' of accounting in Australia are known as *accounting standards* and are issued by the Australian Accounting Standards Board (AASB) with oversight exercised by the Financial Reporting Council (FRC). In New Zealand, accounting standards are issued by the New Zealand Accounting Standards Board (NZASB) with oversight exercised by the External Reporting Board (XRB).

These principles include the following general definitions:

- *An* **asset** *is 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.*
- *A* **liability** *is a present obligation of the entity to transfer an economic resource as a result of past events.*
- **Equity** *is the residual interest in the assets of the entity after deducting all of its liabilities.*

The expanded accounting equation

Using the information provided in the previous section on what makes up equity, we can expand the accounting equation as follows:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$
$$\text{Assets} = \text{Liabilities} + (\text{Capital} + \text{Revenues} - \text{Expenses} - \text{Drawings})$$
$$\text{Assets} = \text{Liabilities} + (\text{Capital} + \text{Profit} - \text{Drawings})$$

By subtracting liabilities from both sides of the equation, it becomes:

Assets − Liabilities = (Capital + Profit − Drawings)

In other words, the excess of assets over liabilities (sometimes referred to as *net assets*) equals the owners' equity in the business. Other than the owners themselves putting more money into the business as capital, the only way to increase net assets and hence equity is to *increase profit*.

Hence, for-profit businesses aim to increase owners' equity by increasing profit, which means increasing revenues and decreasing expenses. (*Note:* technically, revenue is a part of **income**, which is defined as being all increases in equity other than capital investments from owners.)

1.3 HOW DO YOU ANALYSE TRANSACTIONS?

LO 3
Use the accounting equation to analyse transactions

Accounting is based on actual transactions. A **transaction** is an event that involves at least two parties exchanging resources. From an accounting perspective, a transaction affects the financial position of the business and can be measured reliably. As such, transactions affect at least one of the assets, liabilities or equity. All transactions are classified into **accounts** for each specific type of asset, liability or equity. 'Office Equipment' is an example of an asset account. Accountants record those events that have dollar amounts that can be measured reliably, such as the purchase of a building, a sale of merchandise, and the payment of rent.

What are some of your personal transactions? You may have bought a car. Your purchase was a transaction. If you are making payments on a car loan, your payments are also transactions.

Transaction analysis for Accelerators Learning

To illustrate the procedures of accounting for a business, let's use a fictitious example—Accelerators Learning ('Accelerators'), an e-learning business that specialises in providing online courses in accounting, economics, marketing and management.

Assume that Cai Wang started the business by contributing capital of $30,000. Accelerators recorded the $30,000 separately from Cai's personal assets, such as Cai's house, clothes and car. To mix the $30,000 of business cash with Cai's personal assets would make it difficult to measure the success or failure of Accelerators. This separation is called the *accounting entity assumption* and requires that each organisation be accounted for separately from other businesses and from the owner's personal dealings. In the following sections we analyse this and several following transactions.

Transaction 1: Starting the business

On 1 May 2026, Cai Wang starts the business by depositing $30,000 in a bank account titled Accelerators. The effect of this transaction on the accounting equation of the Accelerators business entity is as follows:

Assets		=	Liabilities	+	Owners' equity
	Cash				Cai Wang, capital
(1)	+30,000				+30,000
	$30,000				$30,000

For every transaction, the amount on the left side of the equation must *equal* the amount on the right side. The first transaction increases both the assets (in this case, Cash) and the owners' equity (Cai Wang, capital) of the business.

Immediately after this first transaction, Accelerators can prepare a *balance sheet*. A balance sheet is a different, more formal way of presenting the accounting equation and reports the assets, liabilities and owners' equity of the business. The initial balance sheet of Accelerators would appear as follows on 1 May 2026:

ACCELERATORS LEARNING
Balance sheet
as at 1 May 2026

	$			$
Assets		=	**Liabilities**	
Cash	30,000		None	0
			+	
			Owners' equity	
			Cai Wang, capital	30,000
Total assets	30,000		Total liabilities and owners' equity	30,000

A balance sheet reports the financial position of an entity at a given date. In this case, on 1 May, Accelerators has $30,000 of cash, owes no liabilities and has owners' equity of $30,000.

Transaction 2: Purchase of land

Accelerators purchases land for an office location, paying cash of $20,000. The effect of this transaction on the accounting equation is as follows:

	Assets		=	Liabilities	+ Owners' equity
	Cash	+ Land			Cai Wang, capital
Bal	$30,000		=		$30,000
(2)	−20,000	+20,000			
Bal	$10,000	+ $20,000			$30,000
	$30,000			$30,000	

The cash purchase of land increases one asset, Land, and decreases another asset, Cash, by the same amount. After the transaction is completed, Accelerators has cash of $10,000, land of $20,000, no liabilities, and owners' equity of $30,000.

The Accelerators balance sheet after the business's first two transactions on 2 May is as follows:

ACCELERATORS LEARNING
Balance sheet
as at 2 May 2026

	$			$
Assets		=	**Liabilities**	
Cash	10,000		None	0
Land	20,000		+	
			Owners' equity	
			Cai Wang, capital	30,000
Total assets	30,000		Total liabilities and owners' equity	30,000

Now the business holds two assets, with the liabilities and owners' equity unchanged. After we move through a sequence of transactions, we will return to the Accelerators balance sheet. It is most common to prepare a balance sheet at the end of the accounting period.

Now let's account for additional transactions of Accelerators.

Transaction 3: Purchase of office supplies

Accelerators buys stationery and other office supplies on credit, agreeing to pay $500 within 30 days. This transaction increases both the assets of the business (the office supplies) and its liabilities, because Accelerators hasn't paid cash but rather has promised to pay within 30 days—in other words, it owes the supplier $500. (*Note*: Office supplies is an asset, not an expense, because the supplies can be used in the future.) The liability created by this transaction is an **account payable**.

The effect on the accounting equation is as follows:

	Assets					=	Liabilities	+	Owners' equity	
	Cash	+	Office supplies	+	Land		Accounts payable	+	Cai Wang, capital	
Bal	$10,000			+	$20,000				$30,000	
(3)			+500				+500			
Bal	$10,000	+	$500	+	$20,000		$500	+	$30,000	
	$30,500						$30,500			

Transaction 4: Earning of service revenue

Accelerators earns service revenue by providing training services for clients. The business earns $5,500 revenue by providing an online accounting course and collects this amount in cash. The effect on the accounting equation is an increase in the asset Cash and an increase in equity (Service revenue), as follows:

	Assets					=	Liabilities	+	Owners' equity		
	Cash	+	Office supplies	+	Land		Accounts payable	+	Cai Wang, capital	+	Service revenue
Bal	$10,000	+	$500	+	$20,000		$500	+	$30,000		
(4)	+5,500									+	+5,500
Bal	$15,500	+	$500	+	$20,000		$500	+	$30,000	+	$5,500
	$36,000						$36,000				

Transaction 5: Earning of service revenue on credit

Accelerators earns another $3,000 of revenue by providing an online economics course for a client who promises to pay within one month (rather than paying immediately). In return for its training services, Accelerators receives this client's promise to pay $3,000 within one month. This promise is an asset to Accelerators, an **account receivable**, because the business expects to collect the cash in the future. In accounting, we say that Accelerators performs this service *on credit*. When a business performs a service for a client, it earns the revenue regardless of whether the cash is collected immediately or later.

The act of *performing the service*, not collecting the cash, earns the revenue. This $3,000 of service revenue increases the wealth of Accelerators just like the $5,500 of revenue that it collected immediately in transaction 4. Accelerators records $3,000 of revenue on credit as follows:

	Assets							=	Liabilities	+	Owners' equity		
	Cash	+	Accounts receivable	+	Office supplies	+	Land		Accounts payable	+	Cai Wang, capital	+	Service revenue
Bal	$15,500			+	$500	+	$20,000		$500	+	$30,000	+	$5,500
(5)			+3,000										+3,000
Bal	$15,500	+	$3,000	+	$500	+	$20,000		$500	+	$30,000	+	$8,500
	$39,000								$39,000				

Transaction 6: Payment of expenses

During the month, Accelerators pays $3,300 in cash expenses: $600 to lease a computer, $1,100 for office rent, $1,200 for employee salaries, and $400 for electricity and gas. The effects on the accounting equation are as follows:

	Assets				=	Liabilities	+	Owners' equity	Type of owners' equity transaction
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+	Cai Wang, capital	
Bal	$15,500	$3,000	$500	$20,000		$500		$38,500	
(6)	−600							−600	*Computer lease expense*
(6)	−1,100							−1,100	*Office rent expense*
(6)	−1,200							−1,200	*Salary expense*
(6)	−400							−400	*Electricity and gas expense*
Bal	$12,200	$3,000	$500	$20,000		$500		$35,200	
		$35,700					$35,700		

Expenses have the opposite effect to revenues. Expenses cause the business to shrink, as shown by the decreased balance of owners' equity. We record the cash payment in a single amount as being the sum of the expenses: $3,300 ($600 + $1,100 + $1,200 + $400). As always, the 'balance' of the equation holds.

Transaction 7: Payment of account

Accelerators makes a partial payment of $300 to the store where it purchased $500 worth of office supplies in transaction 3. In accounting, we say that Accelerators pays $300 *on account*. The effect on the accounting equation is a decrease in the asset Cash and a decrease in the liability Accounts payable:

	Assets				=	Liabilities	+	Owners' equity
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+	Cai Wang, capital
Bal	$12,200	$3,000	$500	$20,000		$500		$35,200
(7)	−300					−300		
Bal	$11,900	$3,000	$500	$20,000		$200		$35,200
		$35,400					$35,400	

The payment of cash on account has no effect on Office supplies because the payment doesn't affect the supplies available to the business; instead, it is paying off some of the liability (Accounts payable decreased by $300) with cash (Cash decreased by $300). Remember, Accelerators already recorded the purchase of office supplies in transaction 3.

Transaction 8: Collection on account

In transaction 5, Accelerators performed services for a client on credit. The business now collects $1,000 from the client. We say that Accelerators collects the cash *on account*. Accelerators will record an increase in the asset Cash. Should it also record an increase in service revenue? No, because Accelerators already recorded the revenue when it was earned in transaction 5. The phrase 'collect cash on account' means to record an increase in the Cash account and a decrease in

the Accounts Receivable account. It is swapping one asset (accounts receivable) for another asset (cash). The effect on the accounting equation of Accelerators is as follows:

	Assets				=	Liabilities	+	Owners' equity
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+	Cai Wang, capital
Bal	$11,900	$3,000	$500	$20,000		$200		$35,200
(8)	+1,000	−1,000						
Bal	$12,900	$2,000	$500	$20,000		$200		$35,200
		$35,400					$35,400	

Transaction 9: Sale of land

Accelerators sells some land. The sale price of $9,000 is equal to the cost of the land to Accelerators. The firm receives $9,000 cash. The effect on the accounting equation is as follows:

	Assets				=	Liabilities	+	Owners' equity
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+	Cai Wang, capital
Bal	$12,900	$2,000	$500	$20,000		$200		$35,200
(9)	+9,000			−9,000				
Bal	$21,900	$2,000	$500	$11,000		$200		$35,200
		$35,400					$35,400	

Transaction 10: Withdrawal of cash

Cai Wang withdraws $2,000 cash from the business for personal use. The effect on the accounting equation is as follows:

	Assets				=	Liabilities	+ Owners' equity	Type of owners' equity transaction
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+ Cai Wang, capital	
Bal	$21,900	$2,000	$500	$11,000		$200	$35,500	
(10)	−2,000						−2,000	*Drawings*
Bal	$19,900	$2,000	$500	$11,000		$200	$33,200	
		$33,400					$33,400	

Cai Wang's withdrawal of $2,000 cash decreases the asset Cash and also decreases the owners' equity of the business. *The withdrawal doesn't represent an expense because the cash was used for the owner's personal affairs*, and we therefore record this decrease in owners' equity as drawings.

Transaction 11: Personal transaction

Cai Wang remodels the kitchen at home at a cost of $40,000, paying partly with cash from the withdrawal Cai made and partly from their savings account. This event is *not* a transaction of Accelerators Learning. It has no effect on Accelerators and therefore isn't recorded by the business. The withdrawal itself is a transaction that affects the business (transaction 10), but what the owner does with that money isn't relevant to the business. It is a transaction of the Cai Wang *personal* accounting entity, not the Accelerators accounting entity. This transaction illustrates the *accounting entity concept*, discussed later in this chapter.

A summary of the relevant transactions

A summary of all 10 transactions relevant to Accelerators (remember that transaction 11 isn't relevant to the business) is presented in Exhibit 1-3.

EXHIBIT 1-3 Analysis of transactions, Accelerators Learning

PANEL A—Details of transactions

1. Cai Wang invested $30,000 cash in the business.
2. Paid $20,000 cash for land.
3. Bought $500 of office supplies on credit.
4. Received $5,500 cash from clients for service revenue earned.
5. Performed training service for clients on credit, $3,000.
6. Paid cash expenses: computer lease, $600; office rent, $1,100; employee salary, $1,200; electricity and gas, $400.
7. Paid $300 on the account payable created in transaction 3.
8. Collected $1,000 on the account receivable created in transaction 5.
9. Sold land for cash at its cost of $9,000.
10. Withdrew $2,000 cash for personal expenses.
11. Remodelled Cai Wang's personal residence. This is not a transaction of the business.

PANEL B—Analysis of transactions

	Assets					Liabilities	+ Owners' equity	Type of owners' equity transaction
	Cash	+ Accounts receivable	+ Office supplies	+ Land	=	Accounts payable	+ Cai Wang, capital	
(1)	+30,000						+30,000	*Owner*
Bal	30,000						30,000	*investment*
(2)	−20,000			+20,000				
Bal	10,000			20,000			30,000	
(3)			+500			+500		
Bal	10,000		500	20,000		500	30,000	
(4)	+5,500						+5,500	*Service revenue*
Bal	15,500		500	20,000		500	35,500	
(5)		+3,000					+3,000	*Service revenue*
Bal	15,500	3,000	500	20,000		500	38,500	
(6)	−600						−600	*Computer lease expense*
(6)	−1,100						−1,100	*Office rent expense*
(6)	−1,200						−1,200	*Salary expense*
(6)	−400						−400	*Electricity and gas expense*
Bal	12,200	3,000	500	20,000		500	35,200	
(7)	−300					−300		
Bal	11,900	3,000	500	20,000		200	35,200	
(8)	+1,000	−1,000						
Bal	12,900	2,000	500	20,000		200	35,200	
(9)	+9,000			−9,000				
Bal	21,900	2,000	500	11,000		200	35,500	
(10)	−2,000						−2,000	*Drawings*
Bal	19,900	2,000	500	11,000		200	33,200	
(11)	Not a transaction of the business							
				33,400			33,400	

1.4 HOW DO YOU PREPARE FINANCIAL STATEMENTS?

LO 4
Prepare financial statements

We have now recorded Accelerators' transactions, and they are summarised in Exhibit 1-3. Notice how total assets equal total liabilities plus equity ($33,400 = $33,400).

But a basic question remains: how will people actually use this information? Exhibit 1–3 doesn't tell a lender whether Accelerators can pay off a loan. The data in the exhibit do not reveal whether the business is profitable. To address these important questions, we need **financial statements**, which re-format 'raw' accounting data like that in Exhibit 1-3 and present it in a more useful way.

Financial statements are business documents that are used to communicate information needed to make business decisions. There are four financial statements prepared, which are shown in Exhibit 1-4 for Accelerators. These statements are prepared in the following order:

1 **Income statement**—Answers the question of whether the business is profitable. The income statement summarises an entity's revenues and expenses and reports the profit or loss for a specific period. Where revenues exceed expenses a **profit** results, and where revenues are less than expenses a **loss** is the result. In accounting standards, the income statement is an optional title for part of the 'Statement of profit or loss and other comprehensive income' (in which other gains and losses are included); however, the term *income statement* is commonly used in practice.

2 **Statement of changes in equity**—Answers the question of how the business uses its earnings. Did the owner withdraw the earnings from the business, or did they keep the earnings to further invest in the business? The statement of changes in equity shows the changes in the owners' capital account for a specific period. The owners' capital account increases by the owners' contributions and profit and decreases by the owners' drawings and losses.

   We have shown owners' drawings, revenues and expenses as adjustments to equity during an accounting period. At the end of an accounting period, these amounts are 'rolled up' into the owners' capital.

3 **Balance sheet**—Answers the questions of what amount of assets a business has and who can claim those assets: creditors or owners. The balance sheet is another way of reporting the accounting equation, which gives the assets, liabilities and owners' equity of the business as at a specific date. In accounting standards it is also titled the '**statement of financial position**', but the term *balance sheet* is used more in practice.

4 **Cash flow statement** (or 'Statement of cash flows')—Answers the question of how much cash a business has generated over a specific period of time. This is unlikely to be the same as the profit because, for example, not all sales revenue will have resulted in cash receipts (e.g. see transactions 5 and 8 earlier in the chapter, where the customer still owes $2,000 at the end of May). Among other things, the cash flow statement shows whether or not the business is generating enough cash to pay its bills. We focus on the cash flow statement in Chapter 16 ('The cash flow statement').

CONNECT TO: ACCOUNTING INFORMATION SYSTEMS

The accounting information system (AIS) is the system that records the transactions for a business. Historically, this was a manual, paper-based system; today, most businesses use some sort of computerised system, which simplifies repetitive transactions. A system must be able not only to record transactions properly but also to comply with regulatory requirements issued by bodies such as the Australian Accounting Standards Board and ASIC. Another way to say this is that the AIS must be able to meet a variety of users' different reporting needs so that those users can get the information they require.

EXHIBIT 1-4 Financial statements of Accelerators Learning

ACCELERATORS LEARNING
Income statement
for the month ended 31 May 2026

	$	$
Revenue		
Service revenue		8,500
Expenses		
Salary expense	1,200	
Office rent expense	1,100	
Computer lease expense	600	
Electricity and gas expense	400	
Total expenses		3,300
Profit		5,200

ACCELERATORS LEARNING
Statement of changes in equity
for the month ended 31 May 2026

	$
Cai Wang, capital, 1 May 2026	0
Add: Investments by owner	30,000
Profit for the month	5,200
	35,200
Less: Drawings by owner	(2,000)
Cai Wang, capital, 31 May 2026	33,200

ACCELERATORS LEARNING
Balance sheet
as at 31 May 2026

	$		$
Assets		**Liabilities**	
Cash	19,900	Accounts payable	200
Accounts receivable	2,000		
Office supplies	500	**Owners' equity**	
Land	11,000	Cai Wang, capital	33,200
		Total liabilities and	
Total assets	33,400	owners' equity	33,400

ACCELERATORS LEARNING
Cash flow statement*
for the month ended 31 May 2026

	$	$
Cash flows from **operating** activities:		
Receipts:		
Collections from customers ($5,500 + $1,000)		6,500
Payments:		
To suppliers ($600 + $1,100 + $400 + $300)	(2,400)	
To employees	(1,200)	(3,600)
Net cash inflow from operating activities		2,900
Cash flows from **investing** activities:		
Acquisition of land	(20,000)	
Sale of land	9,000	
Net cash outflow from investing activities		(11,000)
Cash flows from **financing** activities:		
Investment by owner	30,000	
Drawings by owner	(2,000)	
Net cash inflow from financing activities		28,000
Net increase in cash		19,900
Cash balance, 1 May 2026		0
Cash balance, 31 May 2026		19,900

*Chapter 16 shows how to prepare this statement.

Make sure you look at Exhibit 1-4 carefully. Note that each financial statement has a heading which includes the:

- name of the business (such as Accelerators Learning)
- name of the financial statement (Income statement, Balance sheet, and so on), and
- date or time period covered by the statement.

Also note that:

1 The *income statement* for the month ended 31 May 2026:
- **a** Reports May's revenues and expenses. All income consists of revenues in this case. Expenses are listed in decreasing order of their amount, with the largest expense first.
- **b** Reports a *profit* for the period because total revenues exceed total expenses. If total expenses had exceeded total revenues, a *loss* would have been reported instead.

2 The *statement of changes in equity* for the month ended 31 May 2026:
- **a** Opens with the owners' capital balance at the beginning of the period.
- **b** Adds *investments by the owner* and also adds the profit (a loss would have been subtracted). The profit comes directly from the income statement (see arrow 1).
- **c** Subtracts drawings by the owner. Parentheses indicate a subtraction.
- **d** Ends with the owners' capital balance at the end of the period.

3 The *balance sheet* as at 31 May 2026:
- **a** Reports all assets, all liabilities and owners' equity at the end of the period.
- **b** Reports that total assets equal total liabilities plus total owners' equity.
- **c** Reports the owners' ending capital balance, taken directly from the statement of changes in equity (see arrow 2).

4 The *cash flow statement* for the month ended 31 May 2026:
- **a** Reports cash flows from three types of business activities (*operating*, *investing* and *financing* activities) during the month. Each category of cash flow activities includes both cash receipts (positive amounts) and cash payments (negative amounts, denoted by parentheses).
- **b** Reports a net increase in cash during the month and ends with the cash balance at 31 May 2026. This is the amount of cash to report on the balance sheet (see arrow 3).

1.5 HOW DO YOU USE FINANCIAL STATEMENTS TO EVALUATE BUSINESS PERFORMANCE?

LO 5
Use financial statements and return on assets (ROA) to evaluate business performance

In this chapter we have reviewed the transactions and financial statements of Accelerators Learning, a fictitious firm. Now it's time to apply what we have learned to real-world companies.

Imagine that you inherited $10,000 and are keen to invest it for the long term. You have decided to invest in either Woolworths or Qantas through buying shares in one of these companies.

One way to compare the companies is to compare their profits, but a better way might be to compare the return on assets that each business has delivered recently. Return on assets is a percentage measure (rather than a dollar measure), and this improves the comparability of businesses of differing sizes. Return on assets is calculated by dividing profit by the average assets to work out a percentage return, in much the same way as a bank quotes a 'return' or interest rate of, for example, 5% on money invested in a savings account.

An examination of Woolworths' 2023 statement of comprehensive income (of which the income statement is the most important component) reveals a profit of $1,618 million. The