

INTRODUCTION

NATURE AND FUNCTION OF ACCOUNTING FOR SERVICE FIRMS

Aim

Discuss basic purposes and scope of bookkeeping for service firms, the uses of financial information, and accounting standards and conventions.

Accounting provides a framework for the collection, preparation and recording of financial data from which information can be drawn so that informed decisions can be made, implemented and evaluated.

The accounting system can be tailored to the needs of any individual, non-profit organisation, small or large business. This course will concentrate on the needs of small business. A business is an economic entity created for the purpose of increasing the wealth of its owner or owners by generating profits from the provision of goods and/or services. A small business is one where all major decisions are the responsibility of one, two or a few people who are usually the owners.

Financial transactions are often referred to as 'economic events' where there has been an exchange of something of value between two or more entities. For example, a common business transaction could be the sale of a good or service by a business to an individual in exchange for cash.

A business can help control its financial future through its accounting system. Information relating to financial transactions can be used to prepare budgets and set future financial goals. Businesses need this information to help answer a number of questions, such as:

- Will the business have enough cash to pay its bills?
- How much are the assets of the business worth?
- Can the business afford to borrow money?
- Is the business financial enough to expand its operation?
- Should the selling price be changed?

SERVICE FIRMS AND THE USES OF FINANCIAL INFORMATION

A **service firm** is a business which earns its income primarily by charging customers a fee for providing a particular service. Examples of service firms are lawyers, doctors, accountants, cinemas, hairdressers and plumbers. Some service firms may also maintain a trading department. An example of this would be a hairdressing salon. Although it earns the bulk of its income through its hairdressing services, it may be supplemented by the sale of hairdressing goods such as shampoo and hairspray. A petrol station may be both a service and a trading firm – for as well as selling petrol and spare parts, its also provides repair services.



Financial Information

When looking at a business, the owner/manager needs to know whether the firm is earning a profit. No matter how small the business is, accounting should be seen as part of the overall management strategy, with financial information relating to all facets of the business being readily available.

Financial information helps owners/managers to know whether:

- The firm's profit is improving or declining
- The owner is earning a sufficient return on the investment in the business
- How much money (if any) the owner can withdraw from the business
- The business has enough liquidity to continue trading
- The firm can meet repayments of any outstanding loans
- The firm is financially stable
- The firm's credit customers are paying on time
- What the value of the firm's assets is and how they are financed

If a business owner is well informed in relation to all aspects of the firm, it has a better chance of not only surviving, but of being successful. Financial information helps management to make better decisions. In order to do this, financial data must be collected, sorted, classified, recorded and finally reported in a meaningful form. These steps make up the basic accounting process.

Users of Financial Information

There are many different applications of financial information and the nature of these varies according to its intended purpose. It is the user of the financial information who determines how it is to be used. Accounting must meet the needs of the individual users and therefore must be flexible enough to satisfy a variety of purposes. Some of the main users of accounting information and their areas of interest are:

- *Owner/manager*: profit, liquidity, stability, sales, growth, budgets, stock management, debtors, creditors, rates of return
- *Prospective owners*: budgets, future earnings, predicted returns, stability, growth
- *Banks/Lenders*: liquidity, stability, budgets
- *Suppliers of Materials*: credit rating, reliability, stability
- *Government Departments*: eg. Taxation department, Bureau of Statistics, Small Business Corporation – these have specific needs pertaining to their own specialist areas
- *Employees/Unions*: stability of employment, profits, likelihood of wage increases.



ACCOUNTING CONVENTIONS AND STANDARDS

Both accounting conventions and accounting standards have an influence on accounting practice.

Accounting Conventions

Accounting conventions (or assumptions) are the basic rules of accounting which have become acceptable procedures over time. They are the basic rules of accounting. Accounting standards are laws for members of the professional bodies to follow.

Together they form a set of rules which allow accounting records and reports to be prepared in a similar fashion, regardless of the type of business or the form of ownership. The more important conventions are as follows:

The accounting entity convention is the basic principle that the personal transactions of the owner(s) should be kept separate from those of the business. The business is always viewed as a separate entity, regardless of whether the firm is a sole trader, a partnership or a company.

The historical cost convention is a rule which states that all transactions are recorded at their original value, and adjustments are not made for inflation. This means that assets are not valued at what they could be sold for at the present time. All items stay in the accounting records at their historical or original price. This method is quite objective, as it relies on document evidence such as invoices and receipts. There are some exceptions to this rule, for example with land. Unlike most assets which lose value over time, land normally appreciates in value and may be revalued in some circumstances.

The going concern assumption conceives that a business will continue as a 'going concern' for an indefinite period. By following this rule, accountants can report long-term assets in a balance sheet. Otherwise they would all have to be written off as costs in their year of purchase. The going concern rule also allows accountants to cater for transactions which overlap over two consecutive years, as is the case with many credit transactions.

The accounting period convention endeavours to address the problem which arises once it is assumed that a business will go on forever. People are interested in how a business is performing in terms of profit, but do not want to wait until the business ceases to see how successful it was. Therefore, the continuous life of a business is divided into equal periods of time for the purpose of calculating profit or loss. These arbitrary periods are known as *accounting periods*. The length of an accounting period may be a week, a month, a quarter, or a full year, but must not be any longer due to taxation requirements.

The matching principle endeavours to calculate a profit or loss figure for an accounting period by matching revenue for that period with the expenses over the same period of time. There are two basic methods of applying this matching principle. (1) Cash accounting, where profit is calculated by matching revenue received with expenses paid. (2) The accrual method where profit is determined by matching revenue earned with expenses incurred.

The consistency principle requires that the accounting methods used are applied consistently from one accounting period to the next. By applying the same accounting techniques, comparisons of performance can be made over time.

Verifiability is the concept that evidence should be available whenever possible to verify or check the details of financial transactions. Business documents such as invoices, receipts and cheque stubs are the tools of verifiability.

Conservatism (prudence). Accounting, in some cases, involves a degree of estimation. It is generally accepted that when trying to predict the future, it is better to err on the safe side. There is a tendency to allow for all possible losses and to recognise gains if reasonably certain that they will occur.

General Accounting Concepts

In addition to accounting conventions and assumptions, accounting is also influenced by several underlying concepts.

- **Relevance.** Accounting information needs to be relevant to the entity under examination. Only events relevant to the business entity are recorded and reported.
- **Reliability.** Because a wide range of financial decisions are made/influenced by accounting reports, there is a high expectation that such reports contain reliable information.

- **Materiality.** All significant items must be reported in accounting reports. This allows for immaterial amounts to be omitted. The test of whether items are material is whether or not their omission would influence financial decision-making. For example, materiality leads to the omission of cents in accounting reports as they have an insignificant effect on the users of accounting information.
- **Comparability.** Accounting reports are used to track changes in a firm's performance over consecutive accounting periods. Users of reports must be able to compare results from different years. In order to do this, the same methods must be applied consistently from one accounting period to the next.



Accounting Standards

As economies grew, companies became bigger and more complex. The need arose for a set of commonly applied and accepted standards which could be followed by accountants.

Standards were established in many countries over the 20th century and as time moves forward, many countries move to align increasingly with each other through adoption of international standards. There may still be some variance from country to country.

For information on International Standards:
see the web site of the International Accounting Standards Board
<http://www.iasb.org/standards/index.asp>

Case Study

In Australia, for instance, the Australian Accounting Research Foundation (AARF) was formed in 1966. The aim of this body was to improve the reporting function of accounting through a more consistent approach across the profession. Between the years of 1966-78, thirteen accounting standards were introduced.

The Accounting Standards Board (the ASB) was established as a body within the AARF. In 1983 a need was identified for a further body to be established to oversee the formation of accounting standards specifically designed for the public sector. The Public Sector Accounting Standard Board (the PSASB) was formed and the ASB continued as the responsible body for standards relating to the private sector. Both bodies remained under the control of the AARF.

The setting of accounting standards raised considerable criticism. There were concerns as to the problem of applying standards to all forms of accounting and how to enforce the standards. As a result, in 1984, the government established the Accounting Standards Review Board (ASRB). In 1984, the Companies Act was also amended to make accounting standards law for company accountants. The ASRB eventually took over the role of the ASB as the body responsible for setting standards for the private sector. The SRB was then replaced by the Australian Accounting Standards Board (AASB) in 1991 as part of revised legislation relating to corporations. This is backed by the Australian Securities Commission, thus giving the standards national coverage.

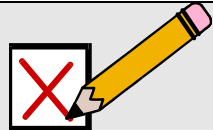
Australian Accounting Standards are denoted by the abbreviation AAS, followed by an identification number of the particular standard. This also applies to those standards issued by the ASRB or the AASB. For example: AAS1/AASB1018 - Profit and Loss or Other Operating Statements.

Many accounting issues covered by the Australian Accounting Standards are also covered by the International Accounting standards, and often the two sets are compatible and useable by those businesses operating in a number of different countries.

ACCOUNTING STANDARDS BOARD IN THE U.K.

In the U.K. the Accounting Standards Board is part of the Financial Reporting Council. It's role is to amend and withdraws accounting standards, with the aim of moving toward introduction of International Financial Reporting Standards.

For more information see the website: <http://www.asb.org.uk/>



SELF ASSESSMENT

Perform the self assessment test titled 'test 1.1'.

If you answer incorrectly, review the notes and try the test again.

The Doctrine of Materiality

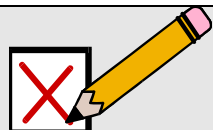
This refers to the reporting of significant financial information in accounting reports. Accounting Standard AAS5 relates specifically to this doctrine.

When deciding whether an item is immaterial or not, accountants must decide on the importance of including or not including that item. If an item was omitted from a report and, as a result, the user was misled as to the operation/verifiability of the business because of that omission, then that item would be deemed to be material and should have been included. An immaterial item is one where its omission has no impact on the user of the report. For Example: rounding off amounts to the nearest dollar.

Another example is in the case of balance day adjustments for petty items. A business may spend \$2000 on office stationery during an accounting period. On balance day, the business may still have on hand some pens/pencils to the value of \$10. Should an adjustment for stock on stationery be made on balance day? Or should the entire \$2000 be written off as stationery expense? The \$10 is such an insignificant amount it is extremely unlikely to adversely affect the users of the report. Thus it can be conceived as immaterial. However, \$10 of stationery may be conceived as material to a business if it only purchased \$20 worth of stationery during the accounting period.

Thus, when deciding on materiality of an item, the decision needs to be made on an individual basis. What may be immaterial to one business may be conceived as material for another.

Note: The doctrine of materiality only relates to the reporting of information. Every single transaction, no matter how small, must be recorded, but immaterial amounts do not have to be reported.



SELF ASSESSMENT

Perform the self assessment test titled 'test 1.2'.

If you answer incorrectly, review the notes and try the test again.

SET TASK

1. Search for information on taxes applying to goods and services in your country (eg. GST -Goods and Services Tax in Australia; VAT –Value Added Tax in the UK). You may search using the internet, online libraries, public libraries, or any other resources you have access to. You may also seek information by approaching the tax department or even discussing the issue with a business proprietor).

Spend no more than 1 hour undertaking this task.

Now undertake an internet search for Taxes on Goods and Services around the world. Some but not all other countries have this type of tax (eg. V.A.T. in the U.K.). Investigate this type of tax in a country other than where you live and write up to 250 words outlining that system.

NOTE: If you do business internationally, now or in the future, this type of tax may well apply in other countries.

2. Do a search on a major search engine for “International Accounting Standards”. Try to discover information that might be most relevant to you. Spend no more than an hour doing this. Take notes and write a brief description of the standards in the country you investigated. (100-200 words)



ASSIGNMENT

Download and do the assignment called 'Lesson 1 Assignment'.