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Preface

This book provides an introduction to accounting and finance. It is aimed at:

- Students who are not majoring in accounting or finance, but who are, nevertheless, studying introductory-level accounting and finance as part of their course. The course may be in business, economics, hospitality management, tourism, engineering or some other area. For these students, the book provides an overview of the role and usefulness of accounting and finance within a business or some other organisation.

- Students who are majoring in either accounting or finance. These students should find the book a helpful introduction to the main principles, which can serve as a foundation for further study.

The book does not focus on technical issues, but rather examines basic principles and underlying concepts. The primary concern throughout is the ways in which financial statements and information can be used to improve the quality of the decisions made by those who use them. To reinforce this practical emphasis, throughout the text, there are numerous illustrative extracts with commentary from real life including company reports, survey data and other sources.

The text is written in an ‘open-learning’ style. This means there are numerous integrated activities, worked examples and questions throughout each of the chapters to help you understand the topics fully. In framing these questions and tasks, we have tried to encourage critical thinking by requiring analysis and evaluation of various concepts and techniques. To help broaden understanding, questions and tasks often require readers to go beyond the material in the text and/or to link the current topic with material covered earlier in the book. Readers are encouraged to interact with the material and to check their progress continually. Irrespective of whether they are using the book as part of a taught course or for personal study, we have found that this approach is more ‘user-friendly’ and makes it easier for them to learn.

We recognise that most readers will not have studied accounting or finance before, and we have therefore tried to write in a concise and accessible style, minimising the use of technical jargon. We have also tried to introduce topics gradually, explaining everything as we go. Where technical terminology is unavoidable we try to provide clear explanations. In addition, you will find all of the key terms highlighted in the text. These are then listed at the end of each chapter with a page reference. They are also listed alphabetically, with a concise definition, in the glossary given in Appendix A towards the end of the book. This should provide a convenient point of reference from which to revise.
A further consideration in helping readers to understand and absorb the topics covered is the design of the text itself. The page layout and colour scheme have been carefully considered to enable easy navigation and digestion of material. The layout features a large page format, an open design and clear signposting of the various features and assessment material.

In this eleventh edition, we have taken the opportunity to make improvements suggested by students and lecturers who used the previous edition. We have, for example, substantially revised the discussion of the conceptual framework of accounting to reflect the very recent statements of the International Accounting Standards Board. We have updated and expanded the number of examples from real life and have continued to reflect the latest international rules relating to the main financial statements. To aid understanding, we have also increased the number of student progress questions (Activities) and explanatory diagrams.

This text is supported by its own MyLab Accounting which is an environment that gives unlimited opportunities for practice using a range of questions, and which provides timely feedback. Updates to MyLab Accounting for the 11th Edition include the addition of Case Studies that will be of use to encourage application of concepts to realistic business scenarios. Another notable tool within the MyLab is Accounting in Action: a feature that provides an extended scenario focusing on a small business as it develops, which contains work for readers to do; its aim is to bring together the reader’s understanding of a number of concepts.

For access to MyLab Accounting, students need both a course ID and an access card (see the advert on the inside back cover of the book).

For lecturers, the diagrams in the text, along with other diagrams and key learning points, are available as PowerPoint slides. These, plus an Instructor’s Manual, can be downloaded from the ‘Instructor resources’ section of the website www.pearsoned.co.uk/atrillmclaney.

Finally, the editorial team at Pearson would like to thank the following reviewers for their very valuable comments on the book:

Karen McFarlane, Glasgow Caledonian University
Steve Astbury, INTO University of Exeter
Dr Peng Wang, Southampton University
Dr Yasser Eliwa, Loughborough University
Mr David Carpenter, Aston University
Elayne Taylor, University of Dundee

We hope that you will find the book readable and helpful.

Eddie McLaney
Peter Atrill
Acknowledgements

Welcome to the world of accounting and finance! In this opening chapter, we provide a broad outline of these subjects. We begin by considering the roles of accounting and finance and then go on to identify the main users of financial information. We shall see how both accounting and finance can be valuable tools in helping users improve the quality of their decisions. In subsequent chapters, we develop this decision-making theme by examining in some detail the kinds of financial reports and methods used to aid decision-making.

For many of you, accounting and finance are not the main focus of your studies and you may well be asking, ‘Why do I need to study these subjects?’ So, after we have considered the key features of accounting and finance, we shall go on to discuss why some understanding of them is likely to be important to you.

Learning outcomes
When you have completed this chapter, you should be able to:
- explain the nature and roles of accounting and finance;
- identify the main users of financial information and discuss their needs;
- distinguish between financial accounting and management accounting; and
- explain why an understanding of accounting and finance is likely to be relevant to you.
Let us begin by trying to understand the purpose of each. **Accounting** is concerned with *collecting, analysing and communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. Unless the financial information being communicated can lead to better decisions being made, there really is no point in producing it. We shall see who uses financial information and for what kind of decisions it is useful a little later in the chapter.

Sometimes the impression is given that the purpose of accounting is simply to prepare financial (accounting) reports on a regular basis. While it is true that accountants undertake this kind of work, it does not represent an end in itself. These reports are prepared for a reason. As already mentioned, the ultimate aim of the accountant’s work is to give users financial information to improve the quality of their decisions. This decision-making perspective of accounting provides the theme for this book and shapes the way in which we deal with each topic.

**Finance** (or **financial management**), like accounting, exists to help decision-makers. It is concerned with the ways in which funds for a business are raised and invested. This lies at the very heart of what business is about. In essence, a business exists to raise funds from investors (owners and lenders) and then to use those funds to make investments (in equipment, premises, inventories and so on) in order to create wealth. As businesses often raise and invest large amounts over long periods, the quality of the financing and investment decisions can have a profound impact on their fortunes.

Funds raised may take various forms and the particular forms chosen should fit with the needs of the business. An understanding of finance should help in identifying:

- the main forms of finance available;
- the costs and benefits of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

Once funds have been raised, they must be invested in a suitable way. When deciding between the investment opportunities available, an understanding of finance can help in evaluating the risks and returns associated with each opportunity.

There is little point in trying to make a sharp distinction between accounting and finance; we have seen that both are concerned with the financial aspects of decision-making. Furthermore, there are many overlaps and interconnections between the two areas. Financial (accounting) reports, for example, are a major source of information when making financing and investment decisions.

### WHO ARE THE USERS OF ACCOUNTING INFORMATION?

For accounting information to be useful, the accountant must be clear *for whom* the information is being prepared and *for what purpose* it will be used. There are likely to be various...
groups of people (usually known as ‘user groups’) with an interest in a particular organisation, in the sense of needing to make decisions about it. For a typical private sector business, the more important of these groups are shown in Figure 1.1. Take a look at this figure and then try Activity 1.1.

**Figure 1.1** Main users of financial information relating to a business

**Activity 1.1**

Ptarmigan Insurance plc (PI) is a large motor insurance business. Taking the user groups identified in Figure 1.1, suggest, for each group, the sorts of decisions likely to be made about PI and the factors to be taken into account when making these decisions.

Your answer may be along the following lines:

<table>
<thead>
<tr>
<th>User group</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customers</td>
<td>Whether to take further motor policies with PI. This might involve an assessment of PI’s ability to continue in business and to meet customers’ needs, particularly in respect of any insurance claims made.</td>
</tr>
<tr>
<td>User group</td>
<td>Decision</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Competitors</td>
<td>How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This may involve competitors using various aspects of PI's performance as a ‘benchmark’ when evaluating their own performance. They may also try to assess PI's financial strength and to identify changes that may signal PI's future intentions (for example, raising funds as a prelude to market expansion).</td>
</tr>
<tr>
<td>Employees</td>
<td>Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions.</td>
</tr>
<tr>
<td>Government</td>
<td>Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions an assessment of PI's profits, sales revenues and financial strength would be made.</td>
</tr>
<tr>
<td>Community representatives</td>
<td>Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making these decisions, PI's ability to provide employment for the community, its use of community resources and its willingness to fund environmental improvements are likely to be important considerations.</td>
</tr>
<tr>
<td>Investment analysts</td>
<td>Whether to advise clients to invest in PI. This would involve an evaluation of the likely risks and future returns associated with PI.</td>
</tr>
<tr>
<td>Suppliers</td>
<td>Whether to continue to supply PI and, if so, whether to supply on credit. This would require an assessment of PI's ability to pay for goods and services supplied at the due dates.</td>
</tr>
<tr>
<td>Lenders</td>
<td>Whether to lend money to PI and/or whether to demand repayment of any existing loans. PI's ability to pay the interest due and to repay the principal sum on time would be important factors in such decisions.</td>
</tr>
<tr>
<td>Managers</td>
<td>Whether the performance of the business needs to be improved. Performance to date would be compared with earlier plans or some other ‘benchmark’ to decide whether action needs to be taken. Managers may also wish to consider a change in PI's future direction. This may involve determining whether it has the financial flexibility and resources to take on new challenges.</td>
</tr>
<tr>
<td>Owners</td>
<td>Whether to invest more in PI or to sell all, or part, of the investment currently held. As with investment analysts (see above) this would involve an evaluation of the likely risks and returns associated with PI. Owners may also have to decide on the rewards offered to senior managers. When doing so, the financial performance and position of the business would normally be considered.</td>
</tr>
</tbody>
</table>

Although this answer covers many of the key points, you may have identified other decisions and/or other factors to be taken into account by each group.
One way of viewing accounting is as a form of service. The user groups identified in Figure 1.1 can be seen as the ‘clients’ and the accounting (financial) information produced can be seen as the service provided. The value of this service to the various ‘clients’ can be judged according to whether the accounting information meets their needs.

To be useful to users, particularly investors and lenders, the information provided should possess certain qualities, or characteristics. In particular, it must be relevant and it must faithfully represent what it is meant to represent. These two qualities, relevance and faithful representation, are regarded as fundamental qualities and require further explanation:

**Relevance.** Accounting information should make a difference. That is, it should be capable of influencing user decisions. To do this, it should help to predict future events (such as predicting next year’s profit), or help to confirm past events (such as establishing last year’s profit), or do both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

To be relevant, accounting information must cross a threshold of materiality. An item of information is considered material, or significant, if its omission or misstatement would change the decisions that users make.

**Activity 1.2**

Do you think that what is material for one business will also be material for all other businesses?

No, it will normally vary from one business to the next. What is material will depend on factors such as the size of the business, the nature of the information and the amounts involved.

Ultimately, what is considered material is a matter of judgement. When making this kind of judgement, managers should consider how this information is likely to be used by users. If a piece of information is not considered material, it should not be included within the accounting reports. It will merely clutter them up and, perhaps, interfere with the users’ ability to interpret them.

**Faithful representation.** Accounting information should represent what it is meant to represent. To do so, the information provided must reflect the substance of what has occurred rather than simply its legal form. Take, for example, a manufacturer that provides goods to a retailer on a sale-or-return basis. The manufacturer may wish to treat this arrangement as two separate transactions. Thus, a contract may be agreed for the sale of the goods and a separate contract agreed for the return of the goods if unsold by the retailer. This may result in a sale being reported when the goods are delivered to the retailer even though they are returned at a later date. The economic substance,
however, is that the manufacturer made no sale as the goods were subsequently returned. They were simply moved from the manufacturer’s business to the retailer’s business and then back again. Accounting reports should reflect this economic substance. To do otherwise would be misleading.

To provide a perfectly faithful representation, the information should be complete. In other words, it should incorporate everything needed to understand what is being portrayed. Thus, information relating to a particular item would normally contain a description of its nature, some suitable numerical measurement and, where necessary, explanations of important facts. Information should also be neutral, which means that the it should be presented and selected without bias. No attempt should be made to manipulate the information in such a way as to influence user attitudes and behaviour. Finally, it should be free from error. This is not the same as saying that it must be perfectly accurate. Accounting information often contains estimates, such as futures sales or costs, which may turn out to be inaccurate. Nevertheless, estimates may still be faithfully represented providing they are accurately described and properly prepared.

Activity 1.3

In practice, do you think that each piece of accounting information produced will be perfectly complete, neutral and free from error?

Probably not – however, each piece of information should be produced with these aims in mind.

Accounting information should contain both fundamental qualities – relevance and faithful representation – in order to be useful. There is usually little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, even if it is faithfully represented.

Further qualities

Where accounting information is both relevant and faithfully represented, there are other qualities that, if present, can enhance its usefulness. These are comparability, verifiability, timeliness and understandability. Each of these qualities is now considered.

• Comparability. When choosing between alternatives, users of accounting information seek to make comparisons. They may want to compare performance of the business over time (for example, profit this year compared to last year). They may also want to compare certain aspects of business performance (such as the level of sales achieved during the year) to those of similar businesses. To help users make comparisons, items that are alike should be treated in the same way – both over time and between businesses. Items that are not alike, on the other hand, should not be treated as though they are. Users must be able to detect both similarities and differences in items being compared.
- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully portrays what it is supposed to portray. Accounting information is verifiable where different, independent experts can reach broad agreement that it provides a faithful portrayal. Verification can be direct, such as checking a bank account balance, or indirect, such as checking the underlying assumptions and methods used to derive an estimate of a future cost.

- **Timeliness.** Accounting information should be made available in time for users to make their decisions. A lack of timeliness undermines the usefulness of the information. Broadly speaking, the later accounting information is produced, the less useful it becomes.

- **Understandability.** Accounting information should be presented in as clear and as concise a form as possible. Nevertheless, some accounting information may be too complex to be presented in an easily digestible form. This does not mean, however, that it should be ignored. To do so would result in reporting only a partial view of financial matters (see Reference 1 at the end of the chapter).

**Activity 1.4**

Accounting reports are aimed at users with a reasonable knowledge of accounting and business and who are prepared to invest time in studying them. Do you think, however, that accounting reports should be understandable to users without any knowledge of accounting or business?

It would be very helpful if everyone could understand accounting reports. This, however, is unrealistic as complex financial events and transactions cannot normally be expressed in simple terms. Any attempts to do so are likely to produce a very distorted picture of reality.

It is probably best that we regard accounting reports in the same way that we regard a report written in a foreign language. To understand either of these, we need to have had some preparation. When producing accounting reports, it is normally assumed that the user not only has a reasonable knowledge of business and accounting but is also prepared to invest some time in studying the reports. Nevertheless, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible to non-accountants.

It is worth emphasising that the four qualities just discussed cannot make accounting information useful; they can only enhance the usefulness of information that is already relevant and faithfully represented.

**WEIGHING UP THE COSTS AND BENEFITS**

Even when a piece of accounting information may have all the qualities described, it does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.5.
In theory, a particular item of accounting information should be produced only if the costs of providing it are less than the benefits, or value, to be derived from its use. In practice, however, these costs and benefits are difficult to assess.

To illustrate the practical problems of establishing the value of information, let us assume that we accidentally reversed our car into a wall in a car park. This resulted in a dented boot and scraped paintwork. We would like the dent taken out and the paintwork re-sprayed at a local garage. We know that the nearest garage would charge £450 but we believe that other local garages may offer to do the job for a lower price. The only way of finding out the prices at other garages is to visit them, so that they can see the extent of the damage. Visiting the garages will involve using some fuel and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local garages? The answer, as we have seen, is that if the cost of discovering the price is less than the potential benefit, it is worth having that information.

To identify the various prices for the job, there are several points to be considered, including:

- How many garages shall we visit?
- What is the cost of fuel to visit each garage?
- How long will it take to make all the garage visits?
- At what price do we value our time?

The economic benefit of having the information on the price of the job is probably even harder to assess in advance. The following points need to be considered:

- What is the cheapest price that we might be quoted for the job?
- How likely is it that we shall be quoted a price cheaper than £450?

As we can imagine, the answers to these questions may be far from clear – remember that we have only contacted the nearest garage so far. When assessing the value of accounting information we are confronted with similar problems.

Producing accounting information can be very costly. The costs, however, are often difficult to quantify. Direct, out-of-pocket costs, such as salaries of accounting staff, are not usually a problem, but these are only part of the total costs involved. There are other costs such as the cost of users’ time spent on analysing and interpreting the information provided.
There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some ‘science’ to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, discussed above are summarised in Figure 1.2.

**Activity 1.6**

What about the economic benefits of producing accounting information? Do you think it is easier, or harder, to assess the economic benefits of accounting information than to assess the costs of producing it?

It is normally much harder to assess the economic benefits. We must bear in mind that accounting information will be only one factor influencing a decision; other factors will also be taken into account. Furthermore, the precise weight attached to each factor when making the decision cannot normally be established.

There are two fundamental qualities that determine the usefulness of accounting information. In addition, there are four qualities that enhance the usefulness of accounting information. The benefits of providing the information, however, should outweigh the costs.
ACCOUNTING AS AN INFORMATION SYSTEM

We have already seen that accounting can be viewed as the provision of a service to ‘customers’. Another way of viewing accounting is as a part of the business’s total information system. Users, both inside and outside the business, make decisions concerning the allocation of scarce resources. For these resources to be efficiently allocated, they often need financial (accounting) information on which to base decisions. It is the role of the accounting system to provide this information.

The accounting information system should have certain features that are common to all information systems within a business. These are:

- identifying and capturing relevant information (in this case financial information);
- recording, in a systematic way, the information collected;
- analysing and interpreting the information collected; and
- reporting the information in a manner that suits users’ needs.

The relationship between these features is set out in Figure 1.3.

![Figure 1.3 The accounting information system](image)

There are four sequential stages of an accounting information system. The first two stages are concerned with preparation, whereas the last two stages are concerned with using the information collected.

Given the decision-making emphasis of this book, we shall be concerned primarily with the last two elements of the process: the analysis and reporting of financial information. We shall focus on the way in which information is used by, and is useful to, users rather than the way in which it is identified and recorded.

Efficient accounting information systems are an essential ingredient of an efficient business. When they fail, the results can be disastrous. Real World 1.1 describes how spreadsheets, which are widely used to prepare accounting and financial information, may introduce errors that can lead to poor financial decisions.
Accounting is usually seen as having two distinct strands. These are:

- **management accounting**, which seeks to meet the accounting needs of managers; and
- **financial accounting**, which seeks to meet the needs of the other users identified, earlier in the chapter (see Figure 1.1).

The difference in their targeted user groups has led each strand of accounting to develop along different lines. The main areas of difference are as follows:

- **Nature of the reports produced.** Financial accounting reports tend to be general-purpose. Although they are aimed primarily at providers of finance such as owners and lenders, they contain financial information that will be useful for a broad range of users and
decisions. Management accounting reports, meanwhile, are often specific-purpose reports. They are designed with a particular decision in mind and/or for a particular manager.

- **Level of detail.** Financial accounting reports provide users with a broad overview of the performance and position of the business for a period. As a result, information is aggregated (that is, added together) and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular operational decision.

- **Regulations.** The financial accounting reports of many businesses are subject to regulations imposed by the law and by accounting rule makers. These regulations often require a standard content and, perhaps, a standard format to be adopted. Management accounting reports, on the other hand, are not subject to regulation and can be designed to meet the needs of particular managers.

### Activity 1.7

**Why do you think financial accounting reports are subject to regulation, whereas management accounting reports are not?**

Financial accounting reports are for external publication. To protect external users, who depend on the quality of information provided by managers, they are subject to regulation. Management accounting reports, on the other hand, are produced exclusively for managers and are for internal use only.

- **Reporting interval.** For most businesses, financial accounting reports are produced on an annual basis, though some large businesses produce half-yearly reports and a few produce quarterly ones. Management accounting reports will be produced as frequently as needed by managers. A sales manager, for example, may need routine sales reports on a daily, weekly or monthly basis so as to monitor performance closely. Special-purpose reports can also be prepared when the occasion demands: for example, where an evaluation is required of a proposed investment in new equipment.

- **Time orientation.** Financial accounting reports reveal the performance and position of a business for the past period. In essence, they are backward-looking. Management accounting reports, on the other hand, often provide information concerning future performance as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release forward-looking information to other users in an attempt to raise finance or to fight off unwanted takeover bids. Even the routine preparation of financial accounting reports for the past period typically requires making some judgements about the future (as we shall see in Chapter 3).

- **Range and quality of information.** Two key points are worth mentioning. First, financial accounting reports concentrate on information that can be quantified in monetary terms. Management accounting also produces such reports, but is also more likely to produce reports that contain information of a non-financial nature, such as physical volume of
inventories, number of sales orders received, number of new products launched, physical output per employee and so on. Second, financial accounting places greater emphasis on the use of objective, verifiable evidence when preparing reports. Management accounting reports may use information that is less objective and verifiable, but nevertheless provide managers with the information they need.

We can see from this that management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of reliability. The only real test to be applied when assessing the value of the information produced for managers is whether or not it improves the quality of the decisions made.

The main differences between financial accounting and management accounting are summarised in Figure 1.4.

![Figure 1.4 Management and financial accounting compared](image)

<table>
<thead>
<tr>
<th>Nature of the reports produced</th>
<th>Management accounting</th>
<th>Financial accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tend to be specific purpose</td>
<td>Tend to be general purpose</td>
<td></td>
</tr>
<tr>
<td>Level of detail</td>
<td>Often very detailed</td>
<td>Usually broad overview</td>
</tr>
<tr>
<td>Regulations</td>
<td>Unregulated</td>
<td>Usually subject to accounting regulation</td>
</tr>
<tr>
<td>Reporting interval</td>
<td>As short as required by managers</td>
<td>Usually annual or bi-annual</td>
</tr>
<tr>
<td>Time orientation</td>
<td>Often based on projected future information as well as past information</td>
<td>Almost always historical</td>
</tr>
<tr>
<td>Range and quality of information</td>
<td>Tend to contain financial and non-financial information, often uses non-verifiable information</td>
<td>Focus on financial information, great emphasis on objective, verifiable evidence</td>
</tr>
</tbody>
</table>

Although management and financial accounting are closely linked and have broadly common objectives, there are a number of differences in emphasis.

**Figure 1.4** Management and financial accounting compared

The differences between management accounting and financial accounting suggest differences in the information needs of managers and those of other users. While differences undoubtedly exist, there is also a good deal of overlap between the information needs of both.
To some extent, differences between the two strands of accounting reflect differences in access to financial information. Managers have much more control over the form and content of the information that they receive. Other users have to rely on what managers are prepared to provide or what financial reporting regulations insist must be provided. Although the scope of financial accounting reports has increased over time, fears concerning loss of competitive advantage and user ignorance about the reliability of forecast data have meant that other users do not receive the same detailed and wide-ranging information as that available to managers.

**SCOPE OF THIS BOOK**

This book covers both financial accounting and management accounting topics. The next five chapters (Part 1, Chapters 2 to 6) are broadly concerned with financial accounting, and the following three (Part 2, Chapters 7 to 9) with management accounting. The final part of the book (Part 3, Chapters 10 to 12) is concerned with the financial management, that is, with issues relating to the financing and investing activities of the business.

**THE CHANGING FACE OF ACCOUNTING**

Over the past four decades, the business environment has become increasingly turbulent and competitive. Various reasons have been put forward to explain these changes, including:

- the increasing sophistication of customers;
- the development of a global economy where national frontiers become less important;
- rapid changes in technology;
- the deregulation of domestic markets (for example, electricity, water and gas);
- increasing pressure from owners (shareholders) for competitive economic returns; and
- the increasing volatility of financial markets.

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**Activity 1.8**

Can you think of any areas of overlap between the information needs of managers and those of other users? *(Hint: Think about the time orientation and the level of detail of accounting information.)*

Two points that spring to mind are:

- Managers will, at times, be interested in receiving a historical overview of business operations of the sort provided to other users.
- Other users would be interested in receiving detailed information relating to the future, such as the planned level of profits and non-financial information, such as the state of the sales order book and the extent of product innovations.
This new, more complex environment has brought fresh challenges for managers and other users of accounting information. Their needs have changed and both financial accounting and management accounting have had to respond. This has led to a radical review of the kind of information to be reported.

The changing business environment has given added impetus to the search for a clear conceptual framework, or framework of principles, upon which to base financial accounting reports. Various attempts have been made to clarify their purpose and to provide a more solid foundation for the development of accounting rules. The conceptual frameworks that have been developed try to address fundamental questions such as:

- Who are the users of financial accounting information?
- What kinds of financial accounting reports should be prepared and what should they contain?
- How should items such as profit and asset values be measured?

The internationalisation of businesses has created a need for accounting rules to have an international reach. It can no longer be assumed that users of accounting information are based in the country in which the particular business operates or are familiar with the accounting rules of that country. Thus, there has been increasing harmonisation of accounting rules across national frontiers.

**Activity 1.9**

How should the harmonisation of accounting rules benefit:

(a) An international investor?
(b) An international business?

An international investor should benefit because accounting terms and policies used in preparing financial accounting reports will not vary across countries. This should make the comparison of performance between businesses operating in different countries much easier.

An international business should benefit because the cost of producing accounting reports in order to comply with the rules of different countries can be expensive. Harmonisation can, therefore, lead to significant cost savings. It may also broaden the appeal of the business among international investors. Where there are common accounting rules, they may have greater confidence to invest.

In response to criticisms that the financial reports of some businesses are opaque and difficult for users to interpret, great efforts have been made to improve reporting rules. Accounting rule makers have tried to ensure that the accounting policies of businesses are more comparable and more transparent and that the financial reports portray economic reality more faithfully.

Management accounting has also changed by becoming more outward-looking in its focus. In the past, information provided to managers has been largely restricted to that collected within the business. However, the attitude and behaviour of customers and rival
businesses have now become the object of much information-gathering. Increasingly, successful businesses are those that are able to secure and maintain competitive advantage over their rivals.

To obtain this advantage, businesses have become more ‘customer driven’ (that is, concerned with satisfying customer needs). This has led to the production of management accounting information that provides details of customers and the market, such as customer evaluation of services provided and market share. In addition, information about the costs and profits of rival businesses, which can be used as ‘benchmarks’ by which to gauge competitiveness, is gathered and reported.

To compete successfully, businesses must also find ways of managing costs. The cost base of modern businesses is under continual review and this, in turn, has led to the development of more sophisticated methods of measuring and controlling costs.

**WHY DO I NEED TO KNOW ANYTHING ABOUT ACCOUNTING AND FINANCE?**

At this point you may well be asking yourself, ‘Why do I need to study accounting and finance? I don’t intend to become an accountant!’ Well, from the explanation of what accounting and finance is about, which has broadly been the subject of this chapter so far, it should be clear that the accounting/finance function of a business, or of most other types of organisation, is a central part of its management information system. On the basis of information provided by the system, managers make decisions concerning the allocation of resources. These decisions may concern whether to:

- continue with certain business operations;
- invest in particular projects; or
- sell particular products.

These decisions can have a profound effect on all those connected with the organisation.

It is important, therefore, that all of those who intend to work in a managerial position should have a fairly clear idea of certain important aspects of accounting and finance. These aspects include:

- how financial reports should be read and interpreted;
- how financial plans are made;
- how investment decisions are made;
- how businesses are financed; and
- how costs are managed.

Many, perhaps most, students have a career goal of being a manager within a business – perhaps a human resources manager, production manager, marketing manager or IT manager. If you are one of these students, an understanding of accounting and finance is very important. When you become a manager, even a junior one, it is almost certain that you will have to use financial reports to help you to carry out your role. It is equally certain that it is
partly, perhaps largely, on the basis of financial information and reports that your performance as a manager will be judged.

As part of your management role, it is likely that you will be expected to help in plotting the future path of the business. This will often involve the preparation of forward-looking financial reports and setting financial targets. If you do not understand what the financial reports really mean and the extent to which the financial information is reliable, you will find yourself at a distinct disadvantage to those who do. Along with other managers, you will also be expected to help decide how the limited resources available to the business should be allocated between competing options. This will require an ability to evaluate the costs and benefits of the different options available. Once again, an understanding of accounting and finance is important to carrying out this management task.

This is not to say that you cannot be an effective and successful human resources production, marketing or IT manager unless you are also a qualified accountant. It does mean, however, that you need to become a bit ‘streetwise’ in accounting and finance if you are to succeed. This book aims to give you that street wisdom.

THE QUEST FOR WEALTH CREATION

A business is normally formed to enhance the wealth of its owners. Throughout this book we shall assume that this is its main objective. This may come as a surprise, as other objectives might be pursued that would fulfil the needs of others with a stake in the business.

Activity 1.10

What other objectives might a business pursue? Try to think of at least two.

A business may seek:
- to provide well-paid jobs and good working conditions for its employees;
- to conserve the environment for the local community;
- to produce products or services that will benefit its customers; and/or
- to support local suppliers.

You may have thought of others.

Although a business may pursue other such objectives, it is normally set up primarily to increase the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

Within a market economy there are strong competitive forces at work that ensure that failure to enhance owners’ wealth will not be tolerated for long. Competition for the funds provided by the owners and competition for managers’ jobs will normally mean that the owners’ interests will prevail. If the managers do not provide the expected increase in ownership wealth, the owners have the power to replace the existing management team with a new team that is more responsive to owners’ needs.
MEETING THE NEEDS OF OTHER STAKEHOLDERS

The points made above do not mean that the needs of other groups with a stake in a business, such as employees, customers, suppliers, the community and so on, are unimportant. In fact, the opposite is true, if the business wishes to survive and prosper over the longer term. For example, a business with disaffected customers may well find that they turn to another supplier, resulting in a loss of owners’ wealth. Real World 1.2 provides examples of businesses that acknowledge the vital link between satisfying customers’ needs and creating wealth (value) for their owners (shareholders).

Other stakeholders that contribute towards the wealth-creation process must also be considered. A dissatisfied workforce can lead to low productivity and strikes while dissatisfied suppliers can withhold vital supplies, or give lower priority to orders received. A discontented community can withdraw access to community resources. In each case, the owners’ wealth will suffer.

REAL WORLD 1.2

Expressing its position

National Express plc, a leading transport provider, states its approach as follows:

At National Express we believe our business model should start with our customers. By serving our customers with operational excellence, we are able to create profit and cash, thereby generating shareholder value.

Adopting a customer focus

John Menzies plc, a distribution and aviation logistics business, states:

We believe that the passion of our people, and their commitment to delivering great customer experiences, are crucial to delivering shareholder value – and this belief informs our entire approach to doing business.


Real World 1.3 describes how one well-known business came to recognise that future success depended on the support of key stakeholder group – its customers.

It is clear from what we have just discussed that creating wealth for the owners is not the same as trying to maximise the current year’s profit. Wealth creation is concerned with the longer term; it relates not only to this year’s profit but to that of future years as well. In the short term, corners can be cut and risks taken that improve current profit at the expense of future profit.
REAL WORLD 1.3

The price of clothes

Nike is a highly successful business with a globally-recognised brand. However, it was not so long ago that the business was mired in controversy. It had become a focal point for protesters who regarded the business as a byword for ‘sweatshop’ labour practices. In 1992, an article was published that exposed the low wages and poor working conditions of those producing Nike products in Indonesia. Subsequent protests and further revelations resulted in unwanted media attention to which the business was, at first, slow to properly respond. However, by 1998, weakening demand for its products meant that the issue could no longer be lightly dismissed. Nike publicly acknowledged the reputation it had gained for ‘sweatshop’ labour practices and the adverse effect this was having on customer attitudes.

Its management realised that, if nothing else, it was good business to improve the working lives of those producing Nike products in third world countries. This resulted in a commitment to better working conditions, higher wages and a minimum working age. A code of conduct for Nike suppliers concerning the treatment of their workforce was established and independent audits were implemented to monitor adherence to the code. The business also committed to greater transparency: it now publishes reports on its responsibilities and the ways in which these have been fulfilled.

Although Nike was not the only large business engaged in sweatshop practices, it took a lead in trying to eradicate them and, by doing so, removed the stain from its reputation. This has been rewarded by a continuing demand for its products.


REAL WORLD 1.4 provides some examples of how the focus on short-term profit, without any consideration of the long-term consequences, can be very damaging.

REAL WORLD 1.4

Short-term gains, long-term problems

For many years, under the guise of defending capitalism, we have been allowing ourselves to degrade it. We have been poisoning the well from which we have drawn wealth. We have misunderstood the importance of values to capitalism. We have surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made.
Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them was not their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was thirty years ago. Public anger at the crisis will make visible what was previously hidden. Take the building up of huge portfolios of loans to poor people on US trailer parks. These loans were authorised without proper scrutiny of the circumstances of the borrowers. Somebody else then deemed them fit to be securitised and so on through credit default swaps and the rest without anyone seeing the transaction in terms of its ultimate human origin.

Each of the decision-makers thought it okay to act like the thoughtless footwear buyer of the 1970s. The price was attractive. There was money to make on the deal. Was it responsible? Irrelevant. It was legal, and others were making money that way. And the consequences for the banking system if everybody did it? Not our problem.

The consumer has had a profound shock. Surely we could have expected the clever and wise people who invested our money to be better at risk management than they have shown themselves to be in the present crisis? How could they have been so gullible in not challenging the bankers whose lending proved so flaky? How could they have believed that the levels of bonuses that were, at least in part, coming out of their savings could have been justified in ‘incentivising’ a better performance? How could they have believed that a ‘better’ performance would be one that is achieved for one bank without regard to its effect on the whole banking system? Where was the stewardship from those exercising investment on their behalf?

The answer has been that very few of them do exercise that stewardship. Most have stood back and said it doesn’t really pay them to do so. The failure of stewardship comes from the same mindset that created the irresponsible lending in the first place. We are back to the mindset that has allowed us to poison the well: never mind the health of the system as a whole, I’m making money out of it at the moment. Responsibility means awareness for the system consequences of our actions. It is not a luxury. It is the cornerstone of prudence.


BALANCING RISK AND RETURN

All decision-making involves the future and financial decision-making is no exception. The only thing certain about the future, however, is that we cannot be sure what will happen. Things may not turn out as planned and this risk must be carefully considered when making financial decisions.

As in other aspects of life, risk and return tend to be related. Evidence shows that returns relate to risk in something like the way shown in Figure 1.5.
Activity 1.11

Look at Figure 1.5 and state, in broad terms, where an investment in:
(a) UK government savings account; and
(b) shares in an oil business

should be placed on the risk–return line.

A UK government savings account is normally a very safe investment. Even if the government were in financial difficulties, it may well be able to print more money to repay investors. Returns from this form of investment, however, are normally very low.

Investing in shares in a commercial business runs a risk of losing part or, possibly, the entire amount invested. On the other hand, such an investment can produce very high positive returns.

Thus, the government savings account should be placed towards the far left of the risk–return line and the oil business shares towards the far right.

This relationship between risk and return has important implications for setting financial objectives for a business. The owners will require a minimum return to induce them to invest at all, but will require an additional return to compensate for taking risks; the higher the risk, the higher the required return. Managers must be aware of this and must strike the appropriate balance between risk and return when setting objectives and pursuing particular courses of action.

The turmoil in the banking sector in the early 2000s has shown, however, that the right balance is not always struck. Some banks have taken excessive risks in pursuit of higher returns and, as a consequence, have incurred massive losses. They are now being kept afloat with taxpayers’ money. Real World 1.5 discusses the collapse of one leading bank, in which the UK government took a majority stake, and argues that the risk appetite of banks must now change.
REAL WORLD 1.5

Banking on change

The taxpayer has become the majority shareholder in the Royal Bank of Scotland (RBS). This change in ownership, resulting from the huge losses sustained by the bank, will shape the future decisions made by its managers. This does not simply mean that it will affect the amount that the bank lends to homeowners and businesses. Rather it is about the amount of risk that it will be prepared to take in pursuit of higher returns.

In the past, those managing banks such as RBS saw themselves as producers of financial products that enabled banks to grow faster than the economy as a whole. They did not want to be seen as simply part of the infrastructure of the economy. It was too dull. It was far more exciting to be seen as creators of financial products that created huge profits and, at the same time, benefited us all through unlimited credit at low rates of interest. These financial products, with exotic names such as ‘collateralised debt obligations’ and ‘credit default swaps’, ultimately led to huge losses that taxpayers had to absorb in order to prevent the banks collapsing.

Now that many banks throughout the world are in taxpayers’ hands, they are destined to lead a much quieter life. They will have to focus more on the basics such as taking deposits, transferring funds and making simple loans to customers. Is that such a bad thing?

The history of banking has reflected a tension between carrying out banks’ core functions and the quest for high returns through high-risk strategies. It seems, however, that for some time to come banks will have to concentrate on the former and will be unable to speculate with depositors’ cash.


NOT-FOR-PROFIT ORGANISATIONS

Although the focus of this book is accounting as it relates to private sector businesses, there are many organisations that do not exist mainly for the pursuit of profit.

Activity 1.12

Can you think of at least four types of organisation that are not primarily concerned with making profits?

We thought of the following:

- charities;
- clubs and associations;
- universities;
- local government authorities;
- national government departments;
- churches; and
- trade unions.

You may have thought of others.
All of these organisations need to produce accounting information for decision-making purposes. Once again, various user groups need this information to help them to make better decisions. These user groups are often the same as, or similar to, those identified for private sector businesses. They usually have a stake in the future viability of the organisation and may use accounting information to check that the wealth of the organisation is being properly managed and used in a way that matches its objectives.

Some not-for-profit organisations, such as charities, however, can suffer from a lack of financial skills among its trustees and managers. **Real World 1.6** contains extracts from the Guardian newspaper, which describes how one high-profile UK charity collapsed amid claims of weak accounting controls and financial mismanagement.

**REAL WORLD 1.6**

No kidding?

Senior directors at the charity Kids Company repeatedly warned trustees of the need to build up financial reserves or face going to the wall, the Guardian can reveal, as an analysis of the accounts show that its funding increased by more than 75% in five years.

Two finance directors at Kids Company left in less than three years because of their frustrations that no one – from the board of trustees, led by the BBC’s Alan Yentob, to the chief executive, Camila Batmanghelidjh – heeded warnings of the need to build a financial cushion to protect the charity from catastrophe, the Guardian understands.

“If you keep building an organisation without building reserves, then it’s a house of cards and it will fall down,” said one source who worked in a senior role at the charity for several years.

A Guardian analysis of five years of accounts show how the charity got itself into dire financial straits. Despite receiving millions of pounds in government funding, it lived hand to mouth, never built up any reserves, and spent almost all its income each year.

Analysis of the charity’s accounts from 2009 to 2013 shows the organisation was receiving huge injections of funding, which included millions of pounds in government grants. Between 2009 and 2013, its income increased by 77% from £13m to £23m, but the charity was spending almost every penny it brought in. In the same period, its outgoings increased by 72%.

Despite repeated warnings on the accounts seen by trustees and presented to the Charity Commission, no consistent reserve was built up.

In March 2014, an audit of the charity was commissioned by the Cabinet Office and carried out by accountancy firm PKF Littlejohn. It noted that the charity was facing a “serious cashflow” issue.

**Historical note:** The charity collapsed in August 2015.

The main points of this chapter may be summarised as follows.

**What are accounting and finance?**
- Accounting provides financial information to help various user groups make more informed judgements and decisions.
- Finance also helps users to improve the quality of their decisions and is concerned with the financing and investing activities of the business.

**Accounting and user needs**
- For accounting to be useful, it must be clear for whom and for what purpose the information will be used.
- Owners, managers and lenders are important user groups but there are several others.

**Providing a service**
- Accounting can be viewed as a form of service as it involves providing financial information to various users.
- To provide a useful service, accounting must possess certain qualities, or characteristics. The fundamental qualities are relevance and faithful representation. Other qualities that enhance the usefulness of accounting information are comparability, verifiability, timeliness and understandability.
- Providing a service to users can be costly and financial information should be produced only if the cost of providing the information is less than the benefits gained.

**Accounting information**
- Accounting is part of the total information system within a business. It shares features common to all information systems within a business, which are the identification, recording, analysis and reporting of information.

**Management accounting and financial accounting**
- Accounting has two main strands – management accounting and financial accounting.
- Management accounting seeks to meet the needs of the business’s managers. Financial accounting is primarily concerned with meeting the needs of owners and lenders but will also be useful to other external user groups.
- These two strands of accounting differ in terms of the types of reports produced, the level of reporting detail, the time orientation, the degree of regulation and the range and quality of information provided.
The changing face of accounting

- Changes in the economic environment have led to changes in the nature and scope of accounting.
- Financial accounting has improved its framework of rules and there has been greater international harmonisation of accounting rules.
- Management accounting has become more outward-looking, and so new methods for managing costs have been developed to help a business gain competitive advantage.

Why study accounting?

- Accounting and finance exert an enormous influence over the ways in which a business operates. As a result, everyone connected with business should be a little ‘streetwise’ about these areas.

The quest for wealth creation

- The key financial objective of a business is to enhance the wealth of its owners.
- To achieve this objective, the needs of other groups connected with the business, such as customers, employees and the community, cannot be ignored.
- When setting financial objectives, the right balance must be struck between risk and return.

Not-for-profit organisations

- Produce accounting information for decision-making purposes in much the same manner as do commercial businesses.
- They have user groups that are similar to, or the same as, those of private-sector businesses.

KEY TERMS

For definitions of these terms, see Appendix A.

- accounting p. 2
- finance p. 2
- financial management p. 2
- relevance p. 5
- faithful representation p. 5
- materiality p. 5
- comparability p. 6
- verifiability p. 6
- timeliness p. 6
- understandability p. 6
- accounting information system p. 10
- management accounting p. 11
- financial accounting p. 11
REFERENCE


FURTHER READING

If you would like to explore the topics covered in this chapter in more depth, we recommend the following books:


CRITICAL REVIEW QUESTIONS

Solutions to these questions can be found at the back of the book on pages 532–533.

1.1 Accounting is sometimes described as ‘the language of business’. Why do you think this is the case? Is this an apt description of what accounting is?

1.2 Identify the main users of accounting information for a university. For what purposes would different user groups need information? Is there a major difference in the ways in which accounting information for a university would be used compared with that of a private sector business?

1.3 ‘Not-for-profit organisations are not interested in making a profit.’ Is this statement true? Does accounting and finance have a less important role to play in not-for-profit organisations than for businesses?

1.4 Financial accounting statements tend to reflect past events. In view of this, how can they be of any assistance to a user in making a decision when decisions, by their very nature, can only be made about future actions?
MEASURING AND REPORTING FINANCIAL POSITION

INTRODUCTION

We begin this chapter by taking an overview of three major financial statements that form the core of financial accounting. We examine the relationship between these financial statements and consider how each one contributes towards an assessment of the overall financial position and performance of a business.

Following this overview, we shall undertake a more detailed examination of one of these financial statements: the statement of financial position. We identify the key elements of this statement and consider the interrelationships between them. We also consider the main accounting conventions, or rules, that are followed when preparing the statement of financial position.

We saw in Chapter 1 that accounting information should be useful to those seeking to make decisions about a business. We end the chapter by considering the value of the statement of financial position for decision-making purposes.

Learning outcomes

When you have completed this chapter, you should be able to:

- explain the nature and purpose of the three major financial statements;
- prepare a simple statement of financial position and interpret the information that it contains;
- discuss the accounting conventions underpinning the statement of financial position; and
- discuss the uses and limitations of the statement of financial position for decision-making purposes.
THE MAJOR FINANCIAL STATEMENTS – AN OVERVIEW

The major financial accounting statements aim to provide a picture of the financial position and performance of a business. To achieve this, a business’s accounting function will normally produce three financial statements on a regular, recurring basis. These three statements are concerned with answering the following questions relating to a particular period:

- What cash movements took place?
- How much wealth was generated?
- What is the accumulated wealth of the business at the end of the period and what form does it take?

To address each of these questions, there is a separate financial statement. The financial statements are:

- the statement of cash flows;
- the income statement (also known as the profit and loss account); and
- the statement of financial position (also known as the balance sheet).

Together they provide an overall picture of the financial health of the business.

Perhaps the best way to introduce these financial statements is to look at an example of a very simple business. From this we shall be able to see the sort of information that each of the statements can usefully provide. It is, however, worth pointing out that, while a simple business is our starting point, the principles for preparing the financial statements apply equally to the largest and most complex businesses. This means that we shall frequently encounter these principles again in later chapters.

Example 2.1

Paul was unemployed and unable to find a job. He therefore decided to embark on a business venture. With Christmas approaching, he decided to buy gift wrapping paper from a local supplier and to sell it on the corner of his local high street. He felt that the price of wrapping paper in the high street shops was unreasonably high and that this provided him with a useful business opportunity.

He began the venture with £40 of his own money, in cash. On Monday, Paul’s first day of trading, he bought wrapping paper for £40 and sold three-quarters of it for £45 cash.

What cash movements took place in Paul’s business during Monday?
For Monday, a statement of cash flows showing the cash movements (that is, cash in and cash out) for the day can be prepared as follows:

<table>
<thead>
<tr>
<th>Statement of cash flows for Monday</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash introduced (by Paul)</td>
<td>40</td>
</tr>
<tr>
<td>Cash from sales of wrapping paper</td>
<td>45</td>
</tr>
<tr>
<td>Cash paid to buy wrapping paper</td>
<td>(40)</td>
</tr>
<tr>
<td>Closing balance of cash</td>
<td>45</td>
</tr>
</tbody>
</table>
The statement shows that Paul placed £40 cash into the business. The business received £45 cash from customers, but paid £40 cash to buy the wrapping paper. This left £45 of cash by Monday evening. Note that we are taking the standard approach found in financial statements of showing figures to be deducted (in this case the £40 paid out) in brackets. We shall take this approach consistently throughout the chapters dealing with financial statements.

**How much wealth (that is, profit) was generated by the business during Monday?**

An income statement can be prepared to show the wealth generated (profit) on Monday. The wealth generated arises from trading and will be the difference between the value of the sales made and the cost of the goods (that is, wrapping paper) sold.

**Income statement for Monday**

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>45</td>
</tr>
<tr>
<td>Cost of goods sold ((\frac{3}{4}) of £40)</td>
<td>(30)</td>
</tr>
<tr>
<td>Profit</td>
<td>15</td>
</tr>
</tbody>
</table>

Note that it is only the cost of the wrapping paper sold that is matched against (and deducted from) the sales revenue in order to find the profit, not the whole of the cost of wrapping paper acquired. Any unsold inventories (also known as stock) will be charged against the future sales revenue that it generates. In this case the cost of the unsold inventories is \(\frac{1}{4}\) of £40 = £10.

**What is the accumulated wealth on Monday evening and what form does it take?**

To establish the accumulated wealth at the end of Monday’s trading, we can draw up a statement of financial position for Paul’s business. This statement will also list the forms of wealth held at the end of that day.

**Statement of financial position as at Monday evening**

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (closing balance)</td>
<td>45</td>
</tr>
<tr>
<td>Inventories of goods for resale ((\frac{1}{4}) of £40)</td>
<td>10</td>
</tr>
<tr>
<td>Total assets</td>
<td>55</td>
</tr>
<tr>
<td>Equity</td>
<td>55</td>
</tr>
</tbody>
</table>

Note the terms assets and equity that appear in this statement. Assets are business resources (things of value to the business) and include cash and inventories. Equity is the word used in accounting to describe the investment, or stake, of the owner(s) – in this case Paul – in the business. Both of these terms will be discussed in some detail a little later in this chapter. Note that the equity on Monday evening was £55. This represented the £40 that Paul put in to start the business, plus Monday’s profit (£15) – profits belong to the owner(s).

Let us now continue by looking at what happens on the following day.
We can see from the financial statements in Example 2.1 that each statement provides part of a picture of the financial performance and position of the business. We begin by showing the cash movements. Cash is a vital resource that is necessary for any business to function effectively. It is required to meet debts that become due and to acquire other resources (such as inventories). Cash has been described as the ‘lifeblood’ of a business.

Reporting cash movements alone, however, is not enough to portray the financial health of the business. To find out how much profit was generated, we need an income statement. It is important to recognise that cash and profits rarely move in unison. During Monday, for example, the cash balance increased by £5, but the profit generated, as shown in the income statement, was £15. The cash balance did not increase in line with profit because part of the wealth (£10) was held in the form of inventories.

Example 2.1 (continued)

On Tuesday, Paul bought more wrapping paper for £20 cash. He managed to sell all of the new inventories and all of the earlier inventories, for a total of £48.

The statement of cash flows for Tuesday will be as follows:

<table>
<thead>
<tr>
<th>Statement of cash flows for Tuesday</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance (from Monday evening)</td>
<td>45</td>
</tr>
<tr>
<td>Cash from sales of wrapping paper</td>
<td>48</td>
</tr>
<tr>
<td>Cash paid to buy wrapping paper</td>
<td>(20)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>73</td>
</tr>
</tbody>
</table>

The income statement for Tuesday will be as follows:

<table>
<thead>
<tr>
<th>Income statement for Tuesday</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>48</td>
</tr>
<tr>
<td>Cost of goods sold (£20 + £10)</td>
<td>(30)</td>
</tr>
<tr>
<td>Profit</td>
<td>18</td>
</tr>
</tbody>
</table>

The statement of financial position as at Tuesday evening will be:

<table>
<thead>
<tr>
<th>Statement of financial position as at Tuesday evening</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (closing balance)</td>
<td>73</td>
</tr>
<tr>
<td>Inventories</td>
<td>–</td>
</tr>
<tr>
<td>Total assets</td>
<td>73</td>
</tr>
<tr>
<td>Equity</td>
<td>73</td>
</tr>
</tbody>
</table>

We can see that the total business wealth has increased to £73 by Tuesday evening. This represents an increase of £18 (that is, £73 – £55) over Monday’s figure – which, of course, is the amount of profit made during Tuesday, as shown in the income statement.

We can see from the financial statements in Example 2.1 that each statement provides part of a picture of the financial performance and position of the business. We begin by showing the cash movements. Cash is a vital resource that is necessary for any business to function effectively. It is required to meet debts that become due and to acquire other resources (such as inventories). Cash has been described as the ‘lifeblood’ of a business.

Reporting cash movements alone, however, is not enough to portray the financial health of the business. To find out how much profit was generated, we need an income statement. It is important to recognise that cash and profits rarely move in unison. During Monday, for example, the cash balance increased by £5, but the profit generated, as shown in the income statement, was £15. The cash balance did not increase in line with profit because part of the wealth (£10) was held in the form of inventories.
The statement of financial position that was drawn up as at the end of Monday’s trading shows the total wealth of the business. A business’s wealth can be held in various forms. For Paul’s business, wealth was held in the form of cash and inventories. This means that, when drawing up the statement of financial position, both forms will be listed. For a large business, many other forms of wealth may be held, such as property, equipment, motor vehicles and so on.

**Activity 2.1**

On Wednesday, Paul bought more wrapping paper for £46 cash. However, it was raining hard for much of the day and sales were slow. After Paul had sold half of his total inventories for £32, he decided to stop trading until Thursday morning.

Have a go at drawing up the three financial statements for Paul’s business for Wednesday.

<table>
<thead>
<tr>
<th>Statement of cash flows for Wednesday</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance (from the Tuesday evening)</td>
</tr>
<tr>
<td>Cash from sales of wrapping paper</td>
</tr>
<tr>
<td>Cash paid to buy wrapping paper</td>
</tr>
<tr>
<td>Closing balance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income statement for Wednesday</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
</tr>
<tr>
<td>Cost of goods sold ((1/2) of £46)</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position as at Wednesday evening</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (closing balance)</td>
</tr>
<tr>
<td>Inventories ((1/2) of £46)</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
<tr>
<td>Equity</td>
</tr>
</tbody>
</table>

Note that the total business wealth has increased by £9 (that is, the amount of Wednesday’s profit) even though the cash balance has declined. This is because the business is holding more of its wealth in the form of inventories rather than cash, compared with the position on Tuesday evening.

By Wednesday evening, the equity stood at £82. This arose from Paul’s initial investment of £40, plus his profits for Monday (£15), Tuesday (£18) and Wednesday (£9). This represents Paul’s total investment in his business at that time. The equity of most businesses will similarly be made up of injections of funds by the owner plus any accumulated profits.
We can see that the income statement and statement of cash flows are both concerned with measuring flows (of wealth and cash respectively) during a particular period. The statement of financial position, however, is concerned with the financial position at a particular moment in time. Figure 2.1 illustrates this point.

**Figure 2.1** The relationship between the major financial statements

The three financial statements discussed are often referred to as the **final accounts** of the business.

For external users of the financial statements (that is, virtually all users except the managers of the business concerned), these statements are normally backward looking because they are based on information concerning past events and transactions. This can be useful in providing feedback on past performance and in identifying trends that provide clues to future performance. However, the statements can also be prepared using projected data to help assess likely future profits, cash flows and so on. Normally, this is done only for management decision-making purposes.

Now that we have an overview of the financial statements, we shall consider each one in detail. The remainder of this chapter is devoted to the statement of financial position.
saying that it sets out the assets of a business, on the one hand, and the claims against the business, on the other. Before looking at the statement of financial position in more detail, we need to be clear about what these terms mean.

**Assets**

As an asset is essentially a resource held by a business. To qualify as an asset for inclusion in the statement of financial position, however, a resource must possess the following characteristics:

- *It must be an economic resource.* This type of resource provides a right to potential economic benefits. These benefits must not, however, be equally available to others. Take, for example, what economists refer to as *public goods.* These include resources such as the road system, GPS satellites or official statistics. Although these may provide economic benefits to a business, others can receive the same benefits at no great cost. A public good cannot, therefore, be regarded as an asset of a business for accounting purposes.

  Economic benefits flowing from a particular resource can take various forms depending on how it is used by a business.

**Activity 2.2**

**What forms might economic benefits take? Try to think of at least two.**

These may include:

- cash generated from producing goods or services;
- cash received from the proceeds of selling the resource;
- the value received when exchanged for another economic resource;
- the value received when used to satisfy debts incurred by the business;
- cash generated from renting or leasing it.

You may have thought of others.

Note that an economic resource need only have the potential to generate benefits. They need not be certain or even probable.

- *The economic resource must be under the control of the business.* This gives a business the exclusive right to decide how the resource is used as well as the right to any benefits that flow. Control is usually acquired by a business through legal ownership or through a contractual agreement (for example, leasing equipment).
The event, or transaction, leading to control of the resource must have occurred in the past. In other words, the business must already exercise control over it (see Reference at the end of the chapter).

The economic resource must be capable of measurement in monetary terms. Often, an economic resource cannot be measured with a great deal of certainty. Estimates may be used that ultimately prove to be inaccurate. Nevertheless, it can still be reported as an asset for inclusion in the statement of financial position as long as a reasonably faithful representation can be produced. There are cases, however, where uncertainty regarding measurement is so great that this cannot be done. Take, for example, the title of a magazine (such as Hello! or Vogue) that has been created by its publisher. While it may be extremely valuable to the publishing business, any attempt to measure this resource would be extremely difficult: it would have to rely on arbitrary assumptions being made. As a result, any measurement produced is unlikely to be useful. The publishing title will not, therefore, appear as an asset in the statement of financial position.

Note that all the characteristics identified must exist if a resource is to qualify for recognition. This will strictly limit the resources that are regarded as an asset for inclusion in the statement of financial position. Once included, an asset will continue to be recognised until the economic benefits are exhausted, or the business disposes of it.

Figure 2.2 summarises the above discussion in the form of a decision chart.

### Activity 2.3

Assume a business owns a 50 per cent stake in a gold mine. As this ownership stake will not give control over the whole of the gold mine, can this resource be regarded as an asset of the business?

In this case, the asset of the business will be the 50 per cent share of the mine that is under its control, rather than the whole of the gold mine.

### Activity 2.4

Indicate which of the following items could appear as an asset on the statement of financial position of a business. Explain your reasoning in each case.

1. £1,000 owed to the business by a credit customer who is unable to pay.
2. A patent, bought from an inventor, that gives the business the right to produce a new product. Production of the new product is expected to increase profits over the period during which the patent is held.
3. A recently hired new marketing director who is confidently expected to increase profits by over 30 per cent during the next three years.
4. A recently purchased machine that will save the business £10,000 each year. It is already being used by the business but it has been acquired on credit and is not yet paid for.
Under normal circumstances, a business would expect a customer to pay the amount owed. Such an amount is therefore typically shown as an asset under the heading ‘trade receivables’ (or ‘debtors’). However, in this particular case, the customer is unable to pay.

**Figure 2.2 Identifying an asset for inclusion in the statement of financial position**

An item must possess all of the four characteristics identified to be regarded as an asset that could appear on a conventional statement of financial position.

Your answer should be along the following lines:

1. Under normal circumstances, a business would expect a customer to pay the amount owed. Such an amount is therefore typically shown as an asset under the heading ‘trade receivables’ (or ‘debtors’). However, in this particular case, the customer is unable to pay.
As a result, the item lacks the potential to provide future economic benefits and the £1,000 owing would not be regarded as an asset. Debts that are not paid are referred to as bad debts.

2 The patent would have all the characteristics identified and would, therefore, be regarded as an asset.

3 The new marketing director would not be considered as an asset. One argument in support of this position is that the business does not have rights of control over the director. Nevertheless, it may have control over the services that the director provides. Even if these services become the focus of attention, however, it is usually impossible to measure them in monetary terms with any degree of certainty.

4 The machine has the characteristics identified and so would be considered an asset even though it is not yet paid for. Once the business has contracted to buy the machine, and has accepted it, it gains ownership even though payment is still outstanding. (The amount outstanding would be shown as a claim, as we shall see shortly.)

The sorts of items that often appear as assets in the statement of financial position of a business include:

- property;
- plant and equipment;
- fixtures and fittings;
- patents and trademarks;
- trade receivables (debtors); and
- investments outside the business.

**Activity 2.5**

Can you think of two additional items that might appear as assets in the statement of financial position of a typical business?

You may be able to think of a number of other items. Two that we have met so far, because they were held by Paul’s wrapping paper business (in Example 2.1), are inventories and cash.

Note that an asset does not have to be a physical item – it may be a non-physical one that gives a right to potential benefits. Assets that have a physical substance and can be touched (such as inventories) are referred to as **tangible assets**. Assets that have no physical substance but which, nevertheless, may provide future benefits (such as patents) are referred to as **intangible assets**.

**Claims**

A claim is an obligation of the business to provide cash, or some other form of benefit, to an outside party. It will normally arise as a result of the outside party providing assets for use by the business. There are essentially two types of claim against a business:
**Equity.** This represents the claim of the owner(s) against the business. This claim is sometimes referred to as the *owner’s capital.* Some find it hard to understand how the owner can have a claim against the business, particularly when we consider the example of a sole-proprietor-type business, like Paul’s, where the owner is, in effect, the business. For accounting purposes, however, a clear distinction is made between the business and the owner(s). The business is viewed as being quite separate from the owner. It is seen as a separate entity with its own separate existence. This means that, when financial statements are prepared, they relate to the business rather than to the owner(s). Viewed from this perspective, any funds contributed by the owner will be seen as coming from outside the business and will appear as a claim against the business in its statement of financial position.

**Liabilities.** Liabilities represent the claims of other parties, apart from the owner(s). They involve an obligation to transfer economic resources (usually cash) as a result of past transactions or events. Liabilities normally arise when individuals, or organisations, supply goods and services, or lend money, to the business. A liability incurred by a business cannot be avoided. It will, therefore, remain a liability until it is settled.

Now that the meanings of the terms *assets,* *equity* and *liabilities* have been established, we can consider the relationship between them. This relationship is quite straightforward. If a business wishes to acquire assets, it must raise the necessary funds from somewhere. It may raise these funds from the owner(s), or from other outside parties, or from both. Example 2.2 illustrates this relationship.

**Example 2.2**

Jerry and Company is a new business that was created by depositing £20,000 in a bank account on 1 March. This amount was raised partly from the owner (£6,000) and partly from borrowing (£14,000). Raising funds in this way will give rise to a claim on the business by both the owner (equity) and the lender (liability). If a statement of financial position of Jerry and Company is prepared following these transactions, it will appear as follows:

<table>
<thead>
<tr>
<th>Jerry and Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of financial position as at 1 March</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
</tr>
<tr>
<td>Cash at bank</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
</tr>
<tr>
<td><strong>EQUITY AND LIABILITIES</strong></td>
</tr>
<tr>
<td>Equity</td>
</tr>
<tr>
<td>Liabilities – borrowing</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
</tr>
</tbody>
</table>

We can see from the statement of financial position that the total claims (equity and liabilities) are the same as the total assets. Thus:

**Assets = Equity + Liabilities**
This equation – which we shall refer to as the accounting equation – will always hold true. Whatever changes may occur to the assets of the business or the claims against it, there will be compensating changes elsewhere that will ensure that the statement of financial position always ‘balances’. By way of illustration, consider the following transactions for Jerry and Company:

2 March
Bought a motor van for £5,000, paying by cheque.

3 March
Bought inventories (that is, goods to be sold) on one month’s credit for £3,000. (This means that the inventories were bought on 3 March, but payment will not be due to be made to the supplier until 3 April.)

4 March
Repaid £2,000 of the amount borrowed, to the lender, by cheque.

6 March
Owner introduced another £4,000 into the business bank account.

A statement of financial position may be drawn up after each day in which transactions have taken place. In this way, we can see the effect of each transaction on the assets and claims of the business. The statement of financial position as at 2 March will be:

Jerry and Company
Statement of financial position as at 2 March

£

ASSETS
Cash at bank (20,000 – 5,000) 15,000
Motor van 5,000
Total assets 20,000

EQUITY AND LIABILITIES
Equity 6,000
Liabilities – borrowing 14,000
Total equity and liabilities 20,000

As we can see, the effect of buying the motor van is to decrease the balance at the bank by £5,000 and to introduce a new asset – a motor van – to the statement of financial position. The total assets remain unchanged. It is only the ‘mix’ of assets that has changed. The claims against the business remain the same because there has been no change in the way in which the business has been funded.

The statement of financial position as at 3 March, following the purchase of inventories, will be:

Jerry and Company
Statement of financial position as at 3 March

£

ASSETS
Cash at bank 15,000
Motor van 5,000
Inventories 3,000
Total assets 23,000