ACCOUNTING AND FINANCE
AN INTRODUCTION

TENTH EDITION

Eddie McLaney
Peter Atrill

Pearson

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Preface

This text provides a comprehensive introduction to financial accounting, management accounting and core elements of financial management. It is aimed both at students who are not majoring in accounting or finance and those who are. Those studying introductory-level accounting and/or financial management as part of their course in business, economics, hospitality management, tourism, engineering or some other area should find that the book provides complete coverage of the material at the level required. Students, who are majoring in either accounting or finance, should find the book a useful introduction to the main principles and serve as a foundation for further study. The text does not focus on technical issues, but rather examines basic principles and underlying concepts. The primary concern throughout is how financial statements and other financial information can be used to improve the quality of decisions made by their users. 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 that there are numerous integrated activities, worked examples and questions through all of the chapters to help you to understand the subject 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. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you 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 you 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 B towards the end of the book. This should provide a convenient point of reference from which to revise.

A further consideration in helping you to understand 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 tenth edition, we have taken the opportunity to make improvements suggested by students and lecturers who used the previous edition. We have also revised the coverage of corporate governance regulations to reflect recent changes. 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. We have tried to introduce international comparisons where possible and useful. To aid understanding, we have also increased the number of student progress questions (Activities) and explanatory diagrams. We have also increased the number of questions that require readers to demonstrate critical thinking.

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

Eddie McLaney
Peter Atrill

How to use this book

We have organised the chapters to reflect what we consider to be a logical sequence and, for this reason, we suggest that you work through the text in the order in which it is presented. We have tried to ensure that earlier chapters do not refer to concepts or terms that are not explained until a later chapter. If you work through the chapters in the 'wrong' order, you will probably encounter concepts and terms that were explained previously.

Irrespective of whether you are using the book as part of a lecture/tutorial-based course or as the basis for a more independent mode of study, we advocate following broadly the same approach.

Integrated assessment material

Interspersed throughout each chapter are numerous **Activities.** You are strongly advised to attempt all of these questions. They are designed to simulate the sort of quick-fire questions that your lecturer might throw at you during a lecture or tutorial. Activities serve two purposes:

- To give you the opportunity to check that you understand what has been covered so far.
- To encourage you to think about the topic just covered, either to see a link between that topic and others with which you are already familiar, or to link the topic just covered to the next.

The answer to each Activity is provided immediately after the question. This answer should be covered up until you have deduced your solution, which can then be compared with the one given.

Towards the end of each chapter there is a **Self-assessment question.** This is more comprehensive and demanding than any of the Activities and is designed to give you an opportunity to check and apply your understanding of the core coverage of the chapter. The solution to each of these questions is provided in Appendix C at the end of the book. As with the Activities, it is important that you attempt each question thoroughly before referring to the solution. If you have difficulty with a self-assessment question, you should go over the relevant chapter again.

End-of-chapter assessment material

At the end of each chapter there are four **Critical review questions.** These are short questions requiring a narrative answer or discussion within a tutorial group. They are intended to help you assess how well you can recall and critically evaluate the core terms and concepts covered in each chapter. Answers to these questions are provided in Appendix D at the end of the book. At the end of each chapter, except for Chapter 1, there are seven **Exercises.** These are mostly computational and are designed to reinforce your knowledge and understanding. Exercises are graded as 'basic', 'intermediate' and 'advanced' according to their level of difficulty. The basic and intermediate level exercises are fairly straightforward: the advanced level ones can be quite demanding but are capable of being successfully completed if you have worked conscientiously through the chapter and have attempted the basic exercises. Solutions to four of the exercises in each chapter are provided in Appendix D at the end of the book. A coloured exercise number identifies these four questions. Here, too, a thorough attempt should be made to answer each exercise before referring to the solution. Solutions to the other three exercises and to the review questions in each chapter are provided in a separate Instructors' Manual.

Content and structure

The text comprises 16 chapters organised into three core parts: financial accounting, management accounting and financial management. A brief introductory outline of the coverage of each part and its component chapters is given in the opening pages of each part.

The market research for this text revealed a divergence of opinions, given the target market, on whether or not to include material on double-entry bookkeeping techniques. So as to not interrupt the flow and approach of the financial accounting chapters, Appendix A on recording financial transactions (including Activities and three Exercise questions) has been placed in Part 4.

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CHAPTER 1

Introduction to accounting and finance

Introduction

We begin this opening chapter by considering the roles of accounting and finance. We shall then go on to identify the main users of financial information and discuss their information needs. 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.

Since this book is mainly concerned with accounting and financial decision making for private-sector businesses, we shall devote some time to examining the business environment. We shall consider the purpose of a private-sector business, the main forms of business enterprise and the ways in which a business may be structured. We shall also consider what the key financial objective of a business is likely to be. These are all important considerations as they help to shape the kind of accounting and financial information that is produced.

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;
- identify and discuss the characteristics that make accounting information useful; and
- explain the purpose of a business and describe how businesses are organised and structured.

What are accounting and finance?

Let us start 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 improve the quality of decisions made by users, there is really no point in producing it. We shall see who the main users are, and why they use financial information, 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. As already mentioned, the ultimate aim of the accountant's work is to give users better financial information on which to base their decisions. This decision-making perspective of accounting fits in with the theme of 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.

The way in which funds are raised must fit with the particular needs of the business. An understanding of finance should help in identifying:

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

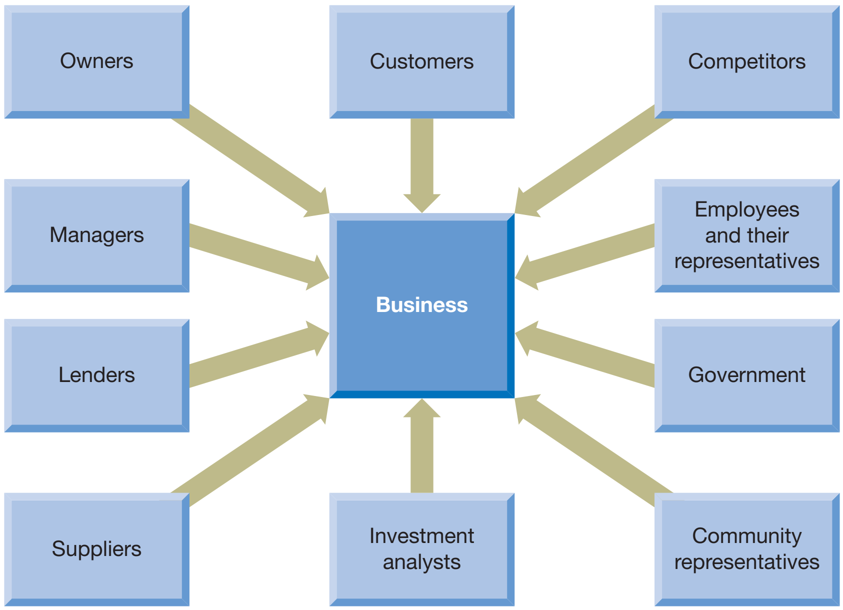
Once funds are raised, they must be invested in a way that will provide the business with a worthwhile return. An understanding of finance should also help in evaluating the risks and returns associated with an investment.

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. For example, accounting reports are a major source of information for 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* the information will be used. There are likely to be various groups of people (known as 'user groups') with an interest in a particular organisation, in the sense of needing to make decisions about it. For the 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**



Several user groups have an interest in accounting information relating to a business. The majority of these are outside the business but, nevertheless, have a stake in it. This is not meant to be an exhaustive list of potential users; however, the groups identified are normally the most important.

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:

User group	*Decision*
Customers	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.
Competitors	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 might involve competitors using PI's performance in various respects as a 'benchmark' when evaluating their own performance. They might also try to assess PI's financial strength and to identify significant changes that may signal PI's future actions (for example, raising funds as a prelude to market expansion).

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Activity 1.1 *continued*

User group	*Decision*
Employees	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.
Government	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.
Community representatives	Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making such decisions, PI's ability to continue to provide employment for the community, its use of community resources, and its likely willingness to fund environmental improvements are likely to be important considerations.
Investment analysts	Whether to advise clients to invest in PI. This would involve an assessment of the likely risks and future returns associated with PI.
Suppliers	Whether to continue to supply PI with goods and services and, if so, whether to supply these on credit. This would require an assessment of PI's ability to pay for any goods and services supplied at the due dates.
Lenders	Whether to lend money to PI and/or whether to require repayment of any existing loans. PI's ability to pay the interest and to repay the principal sum on time would be important factors in such decisions.
Managers	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 the business has the financial flexibility and resources to take on new challenges.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on the rewards offers to senior managers. When doing so, the financial performance of the business would normally be taken into account.

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.

The conflicting interests of users

We have just seen that each user group will have its own particular interests. There is always a risk, however, that the interests of the various user groups will collide. The distribution of a particular business's wealth provides the most likely area for collisions to take place. Take, for example, the position of owners and managers. Although managers are appointed to act in the best interests of the owners, they may not always do so. Instead, they may use the wealth of the business to award themselves large pay rises, to furnish large offices or to buy expensive cars for their own use. Accounting can play an important role in monitoring and reporting how various groups benefit from the business. Owners may, therefore, rely on accounting information to see whether pay and benefits received by managers are appropriate and are in line with agreed policies.

There is also a potential collision of interest between lenders and owners. Funds loaned to a business, for example, may not be used for their intended purpose. They may be withdrawn by the owners for their own use rather than used to expand the business as agreed. Thus, lenders may rely on accounting information to see whether the owners have kept to the terms of the loan agreement.

Activity 1.2

Can you think of other examples where accounting information may be relied on by a user group to see whether the distribution of business wealth is appropriate and/or in line with particular agreements? Try to think of at least one example.

Two possible examples that spring to mind are:

- employees wishing to check that they are receiving a 'fair share' of the wealth created by the business and that managers are complying with agreed profit-sharing schemes; and
- governments wishing to check that the owners of a monopoly do not benefit from excessive profits and that any pricing rules concerning the monopoly's goods or services have not been broken.

You may have thought of other examples.

How useful is accounting information?

No one would seriously claim that accounting information fully meets all of the needs of each of the various user groups. Accounting is still a developing subject and we still have much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained in accounting reports should help users make decisions relating to the business. It should reduce uncertainty about the financial position and performance of the business. It should also help to answer questions concerning the availability of funds to pay owners a return, to repay loans, to reward employees and so on.

Typically, there is no close substitute for the information provided by the financial statements. Thus, if users cannot glean the required information from the financial statements, it is often unavailable to them. Other sources of information concerning the financial health of a business are normally much less useful.

Activity 1.3

What other sources of information might, say, an investment analyst use in an attempt to gain an impression of the financial position and performance of a business? (Try to think of at least four.) What kind of information might be gleaned from these sources?

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Activity 1.3 *continued*

Other sources of information available include:

- meetings with managers of the business;
- public announcements made by the business;
- newspaper and magazine articles;
- websites, including the website of the business;
- radio and TV reports;
- information-gathering agencies (for example, agencies that assess businesses' creditworthiness or credit ratings);
- industry reports; and
- economy-wide reports.

These sources can provide information on various aspects of the business, such as new products or services being offered, management changes, new contracts offered or awarded, the competitive environment within which the business operates, the impact of new technology, changes in legislation, changes in interest rates and future levels of inflation.

The kind of information identified in Activity 1.3 is not really a substitute for accounting information. Rather, it is best used in conjunction with accounting information to provide a clearer picture of the financial health of a business.

Evidence on the usefulness of accounting

There are arguments and convincing evidence that accounting information is at least *perceived* as being useful to users. Numerous research surveys have asked users to rank the importance of accounting reports, in relation to other sources of information, for decision-making purposes. Generally, these studies have found that users rank accounting information very highly. There is also considerable evidence that businesses choose to produce accounting information that exceeds the minimum requirements imposed by accounting regulations. (For example, businesses often produce a considerable amount of accounting information for managers, which is not required by any regulations.) Presumably, the cost of producing this additional accounting information is justified on the grounds that users find it useful. Such arguments and evidence, however, leave unanswered the question of whether the information produced is actually used for decision-making purposes, that is: does it affect people's behaviour?

It is normally very difficult to assess the impact of accounting on decision making. One situation arises, however, where the impact of accounting information can be observed and measured. This is where the **shares** (portions of ownership of a business) are traded on a stock exchange. The evidence shows that, when a business makes an announcement concerning its accounting profits, the prices at which shares are traded and the volume of shares traded often change significantly. This suggests that investors are changing their views about the future prospects of the business as a result of this new information becoming available to them. This, in turn, leads some of them to make a decision either to buy or to sell shares in the business.

While there is evidence that accounting reports are seen as useful and are used for decision-making purposes, it is impossible to measure just how useful they really are to users.

Activity 1.4

Can you figure out why it is impossible to measure this?

Accounting reports will usually represent only one input to a particular decision. The weight attached to them by the decision maker, and the resulting benefits, cannot normally be accurately assessed.

We cannot say with certainty, therefore, whether the cost of producing these reports represents value for money.

It is possible, however, to identify the kinds of qualities which accounting information must possess in order to be useful. Where these qualities are lacking, the usefulness of the information will be diminished. Let us now consider this point in more detail.

Providing a service

One way of viewing accounting is as a form of service. The user groups identified in Figure 1.1 can be seen as 'clients' and the accounting (financial) information produced can be seen as the service provided. The value of this service to these '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 supposed 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 decisions made. To do this, it must help to predict future events (such as predicting the next year's profit), or help to confirm past events (such as establishing the previous year's profit), or do both. By confirming past events, users can check on the accuracy of their earlier predictions. This may, 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 should be considered material, or significant, if its omission or misstatement would change the decisions that users make.

Activity 1.5

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

No. It will often vary from one business to the next. What is material will normally 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. 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 portray what it is supposed to portray. 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 portrayal, the information provided should be complete. In other words, it should incorporate everything needed to understand what is being portrayed. This will normally include 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 information should be presented and selected without bias. No attempt should be made to manipulate the information is 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; this may not be possible. Accounting information often contains estimates, such as future costs and sales, which may turn out to be inaccurate. Nevertheless, estimates can still be faithfully represented providing they are accurately described and properly prepared.

Activity 1.6

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 must contain both fundamental qualities if it is to be useful. There is 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 making choices, users of accounting information often 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. Better comparisons can be made where the accounting system treats items that are alike in the same way. 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 could 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 will undermine the usefulness of the information. Broadly speaking, the later accounting information is produced, the less useful it becomes.
- *Understandability*. Accounting information should be set out 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 1.7

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 though an item of accounting information may have all the qualities described, this does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.8.

Activity 1.8

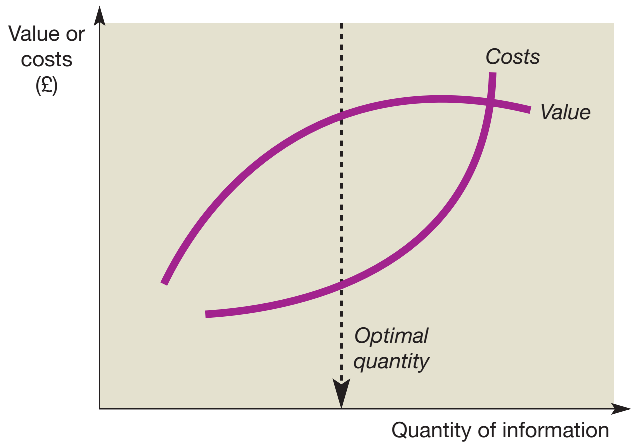
Suppose an item of information is capable of being provided. It is relevant to a particular decision and can be faithfully represented. It is also comparable, verifiable and timely, and can be understood by the decision maker.

Can you think of the reason why, in practice, you might choose not to produce the information?

The reason is that you judge the cost of doing so to be greater than the potential benefit of having the information. This cost–benefit issue will limit the amount of accounting information provided.

In theory, a particular item of accounting information should only be produced if the costs of providing it are less than the benefits, or value, to be derived from its use. Figure 1.2 shows the relationship between the costs and value of providing additional accounting information.

Figure 1.2 Relationship between costs and the value of providing additional accounting information



The benefits of accounting information eventually decline. The cost of providing information, however, will rise with each additional piece of information. The optimal level of information provision is where the gap between the value of the information and the cost of providing it is at its greatest.

The figure shows how the value of information received by the decision maker eventually begins to decline. This is, perhaps, because additional information becomes less relevant, or because of the problems that a decision maker may have in processing the sheer quantity of information provided. The costs of providing the information, however, will increase with each additional piece of information. The broken line indicates the point at which the gap between the value of information and the cost of providing that information is at its greatest. This represents the optimal amount of information that can be provided. This theoretical model, however, poses a number of problems in practice.

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 want to have the dent taken out and the paintwork resprayed 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. 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 local garage so far. When assessing the value of accounting information, we are confronted with similar problems.

Producing accounting information can be very costly. Furthermore, these costs can be 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. These costs are much more difficult to quantify and may well vary between users.

Activity 1.9

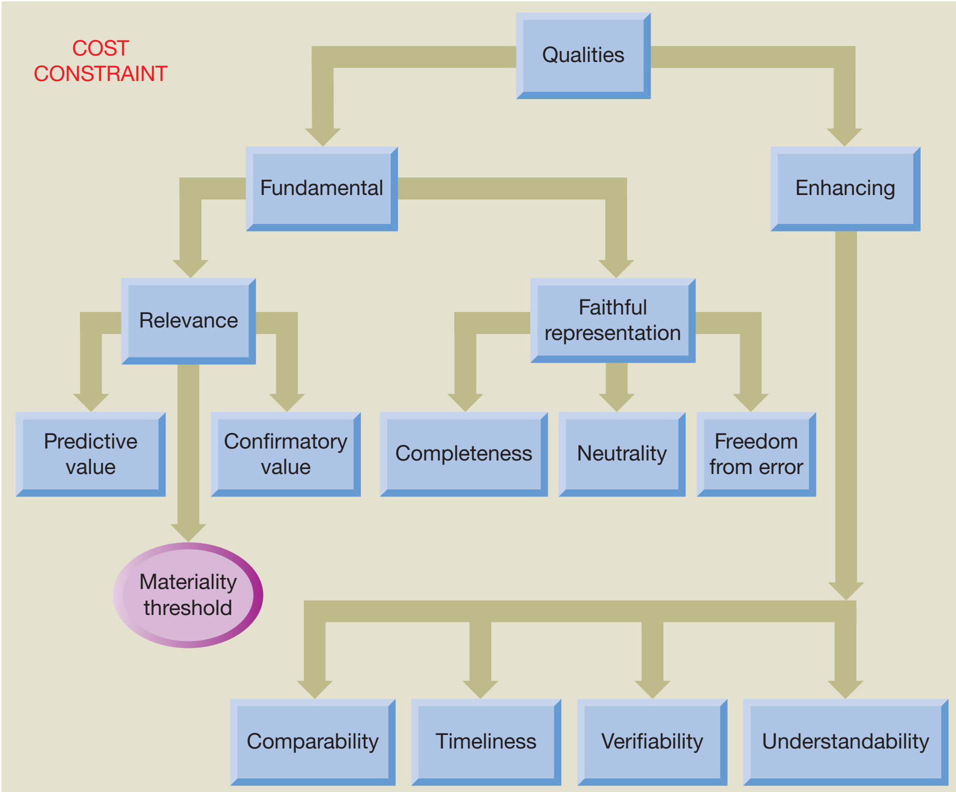
What about the economic benefits of producing accounting information? Do you think it is easier, or harder, to assess the economic benefits of accounting information than to assess the costs of producing it?

It is normally much harder to assess the benefits. We saw earlier that, even if we could accurately measure the economic benefits arising from a particular decision, we must bear in mind that accounting information will be only one factor influencing that decision. Furthermore, the benefits of accounting information, like the associated costs, can vary between users.

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, which we have just discussed, are summarised in Figure 1.3.

Figure 1.3 **The qualities that influence the usefulness of accounting information**



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

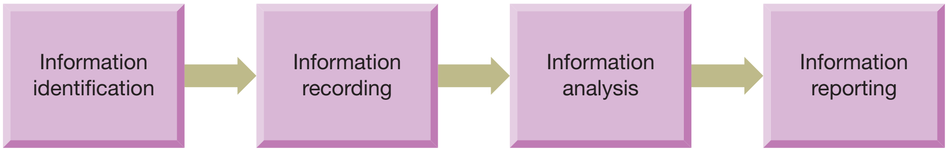
We have already seen that accounting can be seen as the provision of a service to 'clients'. Another way of viewing accounting is as a part of the business's total information system. Users, both inside and outside the business, have to make decisions concerning the allocation of scarce resources. To ensure that these resources are efficiently allocated, users often need financial 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 the needs of users.

The relationship between these features is set out in Figure 1.4.

Figure 1.4 The accounting information system



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 final two elements of the process: the analysis and reporting of financial information. We shall place much more emphasis 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.

Effective 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.

Real World 1.1

Systems error!

Almost one in five large businesses have suffered financial losses as a result of errors in spreadsheets, according to F1F9, which provides financial modelling and business forecasting to large businesses. It warns of looming financial disasters as 71 per cent of large British business always use spreadsheets for key financial decisions.

The company's new white paper entitled *Capitalism's Dirty Secret* showed that the abuse of humble spreadsheet could have far-reaching consequences. Spreadsheets are used in the preparation of British company accounts worth up to £1.9 trillion and the UK manufacturing sector uses spreadsheets to make pricing decisions for up to £170 billion worth of business.

In total, spreadsheet calculations represent up to £38 billion of British private sector investment decisions per year, data harvested through YouGov found. Yet 16 per cent of large companies have admitted finding inaccurate information in spreadsheets more than 10 times in 2014.

Grenville Croll, a spreadsheet risk expert, said of the findings: 'Spreadsheets have been shown to be fallible yet they underpin the operation of the financial system. If the uncontrolled use of spreadsheets continues to occur in highly leveraged markets and companies, it is only a matter of time before another "Black Swan" event occurs causing catastrophic loss.'

The report warns that while 33 per cent of large businesses report poor decision-making as a result of spreadsheet problems, a third of the financial decision-makers using spreadsheets in large UK businesses are still given zero training.

Source: Adapted extract from Burn-Callander, R. (2015) Stupid errors in spreadsheets could lead to Britain's next corporate disaster, www.telegraph.co.uk, 7 April.

Management accounting and financial accounting

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 owners and lenders. It should also, however, be useful to other users that were identified earlier in the chapter (see Figure 1.1).

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

- *Nature of the reports produced.* Financial accounting reports tend to be general purpose. As mentioned above, they are aimed primarily at providers of finance (owners and lenders) but contain financial information that should also be useful for a broad range of external users. Management accounting reports, on the other hand, 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.* Financial accounting reports, for many businesses, are subject to accounting regulations imposed by the law and 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 1.10

Why are financial accounting reports 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 so 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 require 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 reflect the performance and position of the 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 projected information to other users in an

attempt to raise capital or to fight off unwanted takeover bids. Even preparation of the routine financial accounting reports 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 1.5.

Figure 1.5 Management and financial accounting compared

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

Though management and financial accounting are closely linked and have broadly common objectives, they differ in emphasis in various aspects.

The differences between management accounting and financial accounting suggest that there are 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 these needs.

Activity 1.11

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.

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 resulted in other users not receiving the same detailed and wide-ranging information as that available to managers.

In the past, accounting systems were biased in favour of providing information for external users. Financial accounting requirements were the main priority and management accounting suffered as it tended to be an offshoot of financial accounting. Survey evidence suggests, however, that this is no longer the case. Modern management accounting systems usually provide managers with information that is relevant to their needs rather than that determined by external reporting requirements. External reporting cycles, however, retain some influence over management accounting. Managers tend to be aware of external users' expectations. (See Reference 2 at the end of the chapter.)

Scope of this book

This book covers both financial accounting and management accounting topics. The next six chapters (Part 1, Chapters 2 to 7) are broadly concerned with financial accounting, and the following six (Part 2, Chapters 8 to 13) with management accounting. The final chapters of the book (Part 3, Chapters 14 to 16) is concerned with the financial management of the business, that is, with issues relating to the financing and investing activities of the business. As we have seen, accounting information is usually vitally important for financial management decisions.

The changing face of accounting

Over the past fifty years, the environment within which businesses operate has become increasingly turbulent and competitive. Various reasons have been identified to explain these changes, including:

- the increasing sophistication of customers;
- the availability of rapid and sophisticated forms of information and communication (such as the internet);
- 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.

This new, more complex, environment has brought new challenges for managers and other users of accounting information. Their needs have changed and both financial accounting and management accounting have had to respond. To meet the changing needs of users, there has been 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. Work on developing a conceptual framework tries to address such fundamental questions 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 identified and measured?

The internationalisation of businesses has created a need for accounting rules to have an international reach. This has led to an increasing harmonisation of accounting rules across national frontiers. It can no longer be assumed that users of accounting information relating to a particular business are based in the country in which the business operates. Neither can it be assumed that the users are familiar with the accounting rules of that country.

Activity 1.12

How should the harmonisation of accounting rules benefit:

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

To answer this activity, you may have thought of the following:

(a) An international investor should benefit because accounting definitions and policies used in preparing financial accounting reports will not vary between countries. This should make comparisons of performance between businesses operating in different countries much easier.
(b) An international business should benefit because the cost of producing accounting reports 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 transparent and that the financial reports provide a more faithful portrayal of economic reality.

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 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 within a business 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. As we have seen, these decisions may concern whether to:

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

These decisions can have a profound effect on all those connected with the business. It is important, therefore, that *all* those who intend to work in a business should have a fairly clear idea of certain key 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; and
- how businesses are financed.

Many, if not 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 largely on the basis of financial information and reports that your performance as a manager will be judged.

As part of your management role, you will be expected to help in plotting the future path of the business. This can 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 when 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. The aim of the book is to help you to achieve this.

Accounting for business

We have seen that the needs of the various user groups will determine the kind of accounting information to be provided. The forms of business ownership and the ways in which a business is organised and structured, however, will partly shape those needs. In the sections that follow, we consider the business environment within which accounting information is produced. This should help our understanding of points that crop up in later chapters.

What is the purpose of a business?

Peter Drucker, an eminent management thinker, has argued that 'the purpose of business is to create and keep a customer'. (See Reference 3 at the end of the chapter.) Drucker defined the purpose of a business in this way in 1967, at a time when few businesses adopted this strong customer focus. His view, therefore, represented a radical challenge to the accepted view of what businesses should do. More than fifty years on, however, his approach has become part of the conventional wisdom. It is now widely recognised that, in order to succeed, businesses must focus on satisfying the needs of the customer.

Although the customer has always provided the main source of revenue for a business, this has often been taken for granted. In the past, too many businesses have assumed that the customer would readily accept whatever services or products were on offer. When competition was weak and customers were passive, businesses could operate under this assumption and still make a profit. However, the era of weak competition has passed. Now, customers have much greater choice and are much more assertive concerning their needs. They now demand higher quality services and goods at cheaper prices. They also require that services and goods be delivered faster with an increasing emphasis on the product being tailored to their individual needs. If a particular business cannot meet these needs, a competitor often can. Thus, the business mantra for the current era is '*the customer is king*'. Most businesses now recognise this fact and organise themselves accordingly.

Real World 1.2 describes how the internet and social media have given added weight to this mantra. It points out that dissatisfied customers now have a powerful medium for broadcasting their complaints.

Real World 1.2

The customer is king

The mantra that the 'customer is king' has gained even greater significance among businesses in recent years because of the rise of the internet and social media. In the past, a dissatisfied customer might tell only a few friends about a bad buying experience. As a result, the damage to the reputation of the business concerned would normally be fairly limited. However, nowadays, through the magic of the internet, several hundred people, or more, can be very speedily informed of a bad buying experience.

Businesses are understandably concerned about the potential of the internet to damage reputations, but are their concerns justified? Do customer complaints, which wing their way through cyberspace, have any real effect on the businesses concerned? A Harris Poll survey of 2,000 adults in the UK and US suggests they do and so businesses should sit up and take note. It seems that social media can exert a big influence on customer buying decisions.

The Harris Poll survey, which was conducted online, found that around 20 per cent of those surveyed use social media when making buying decisions. For those in the 18 to 34 age range, the figure rises to almost 40 per cent. Furthermore, 60 per cent of those surveyed indicated that they would avoid buying from a business that receives poor customer reviews for its products or services.

The moral of this tale appears to be that, in this internet age, businesses must work even harder to keep their customers happy if they are to survive and prosper.

Source: Based on information in Miesbach, A. (2015) Yes, the customer is still king, www.icmi.com, 30 October.

What kinds of business ownership exist?

The particular form of business ownership has certain implications for financial accounting and so we need to be clear about the main forms of ownership that can arise. There are basically three arrangements for private-sector businesses:

- sole proprietorship;
- partnership; and
- limited company.

Let us now consider these in turn.

Sole proprietorship

Sole proprietorship, as the name suggests, is where an individual is the sole owner of a business. This type of business is often quite small (as measured, for example, by sales revenue generated or number of staff employed); however, the number of such businesses is very large indeed. Examples of sole-proprietor businesses can be found in most business sectors but particularly within the service sector. Hence, services such as electrical repairs, picture framing, photography, driving instruction, retail shops and hotels have a large proportion of sole-proprietor businesses.

The sole-proprietor business is very easy to set up. No formal procedures are required and operations can often commence immediately (unless special permission is required because of the nature of the trade or service, such as running licensed premises (a pub)).

The owner can decide the way in which the business is to be conducted and has the flexibility to restructure or dissolve the business whenever it suits. The law does not recognise the sole-proprietor business as being separate from the owner, so the business will cease on the death of the owner.

Although the owner must produce accounting information about the business to satisfy the taxation authorities, there is no legal requirement to provide it to other user groups. Some user groups, however, may demand accounting information about the business and may be in a position to enforce their demands (for example, a bank requiring accounting information on a regular basis as a condition of a loan). A sole proprietor has unlimited liability which means that no distinction is made between the proprietor's personal wealth and that of the business if there are business debts to be paid.

Partnership

A **partnership** exists where two or more individuals carry on a business together with the intention of making a profit. Partnerships have much in common with sole-proprietor businesses. They are usually quite small in size (although some, such as partnerships of accountants and solicitors, can be very large). They are also easy to set up, as no formal procedures are required (and it is not even necessary to have a written agreement between the partners). The partners can agree whatever arrangements suit them concerning the financial and management aspects of the business. Similarly, the partnership can be restructured or dissolved by agreement between the partners.

Partnerships are not recognised in law as separate entities and so contracts with third parties must be entered into in the name of individual partners. The partners of a business usually have unlimited liability.

Activity 1.13

What are the main advantages and disadvantages that should be considered when deciding between a sole proprietorship and a partnership? Try to think of at least two of each.

The main advantages of a partnership over a sole-proprietor business are:

- sharing the burden of ownership;
- the opportunity to specialise rather than cover the whole range of services (for example, in a solicitors' practice each partner may specialise in a different aspect of the law); and
- the ability to raise capital where this is beyond the capacity of a single individual.

The main disadvantages of a partnership compared with a sole proprietorship are:

- the risks of sharing ownership of a business with unsuitable individuals; and
- the limits placed on individual decision making that a partnership will impose.

Limited company

A **limited company** can range in size from quite small to very large. The number of individuals who subscribe capital and become the owners may be unlimited, which provides the opportunity to create a very large-scale business. The liability of owners, however, is limited (hence 'limited' company), which means that those individuals investing in the company's shares are liable only for debts incurred by the company up to the amount that they have invested or agreed to invest. This cap on the liability of the owners is designed to limit risk and to produce greater confidence to invest. Without such limits on owner liability, it is difficult to see how a modern capitalist economy could operate. In many cases, the owners of a limited company are not involved in the day-to-day running of the business and will, therefore, invest in a business only if there is a clear limit set on the level of investment risk.

Note that this 'limited liability' does not apply to sole proprietors and partners. These people have a legal obligation to meet all of their business debts, if necessary using, what they may have thought of as, private assets (for example, their private houses). This ability of the owners of limited companies to limit their liability can make limited companies a more attractive way of setting up a business, compared with sole proprietorships and partnerships.

The benefit of limited liability, however, imposes certain obligations on such limited companies. To create a limited company, documents of incorporation must be prepared that set out, among other things, the objectives of the business. Furthermore, a framework of regulations exists that places obligations on limited companies concerning the way in which they conduct their affairs. Part of this regulatory framework requires annual financial reports to be made available to owners and lenders and, usually, an annual general meeting of the owners has to be held to approve the reports. In addition, a copy of the annual financial reports must be lodged with the Registrar of Companies for public inspection. In this way, the financial affairs of a limited company enter the public domain.

With the exception of small companies, there is also a requirement for the annual financial reports to be subject to an audit. This involves an independent firm of accountants examining the annual reports and underlying records to see whether the reports provide a true and fair view of the financial health of the company and whether they comply with the relevant accounting rules established by law and by accounting rule makers. Limited companies are considered in more detail later in Chapters 4 and 5.

All of the large household-name UK businesses (Marks and Spencer, Tesco, Shell, Sky, Rolls-Royce, BT, easyJet and so on) are limited companies.

Activity 1.14

What are the main advantages of forming a partnership business rather than a limited liability company? Try to think of at least three.

The main advantages are:

- the ease of setting up the business;
- the degree of flexibility concerning the way in which the business is conducted;
- the degree of flexibility concerning restructuring and dissolution of the business; and
- freedom from administrative burdens imposed by law (for example, the annual general meeting and the need for an independent audit).

As we have just seen, a major disadvantage of a partnership compared with a limited company is that it is not normally possible to limit the liability of all of the partners. There is, however, a hybrid form of business ownership that is referred to as a limited liability partnership (LLP). This has many of the attributes of a normal partnership but differs insofar that the LLP, rather than the individual partners, is responsible for any debts incurred. Accountants and solicitors often use this type of partnership.

This book concentrates on the accounting aspects of limited liability companies because they are, by far, the most important in economic terms. The early chapters will introduce accounting concepts through examples that do not draw a distinction between the different types of business. Once we have dealt with the basic accounting principles, which are the same for all three types of business, we can then go on to see how they are applied to limited companies.

How are businesses organised?

Most businesses that involve more than a few owners and/or employees are set up as limited companies. Finance will come from the owners (shareholders) both in the form of a direct cash investment to buy shares (in the ownership of the business) and through the shareholders allowing past profits, which belong to them, to be reinvested in the business. Finance will also come from lenders (banks, for example), who earn interest on their loans. Further finance will be provided through suppliers of goods and services being prepared to supply on credit.

In larger limited companies, the owners (shareholders) tend not to be involved in the daily running of the business; instead they appoint a board of directors to manage the business on their behalf. The board is charged with three major tasks:

1 setting the overall direction and strategy for the business;
2 monitoring and controlling the activities of the business; and
3 communicating with shareholders and others connected with the business.

Each board has a chair, elected by the directors, who is responsible for running the board in an efficient manner. In addition, each board has a chief executive officer (CEO) who is responsible for running the business on a day-to-day basis. Occasionally, the roles of chair and CEO are combined, although it is usually considered to be a good idea to separate them in order to prevent a single individual having excessive power.

The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager being given responsibility for a particular part of the business's operations.

Activity 1.15

Why are most larger businesses *not* managed as a single unit by just one manager?

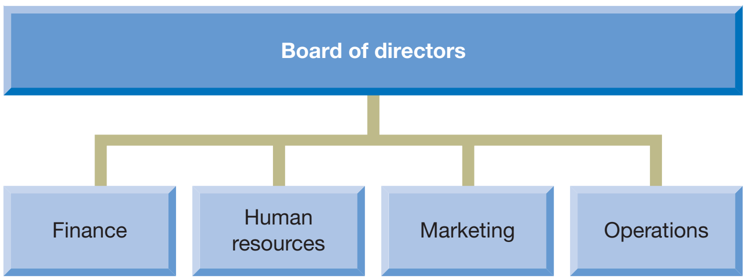
Three common reasons are:

- The sheer volume of activity or number of staff employed makes it impossible for one person to manage them.
- Certain business operations may require specialised knowledge or expertise.
- Geographical remoteness of part of the business operations may make it more practical to manage each location as a separate part, or set of separate parts.

The operations of a business may be divided for management purposes in different ways. For smaller businesses offering a single product or service, separate departments are often created, with each department responsible for a particular function (such as marketing, production, human resources and finance). The managers of each department will then be accountable to the board of directors. In some cases, individual board members may also be departmental managers.

A typical departmental structure, organised along functional lines, is shown in Figure 1.6.

Figure 1.6 A departmental structure organised according to business function



This is a typical departmental structure organised along functional lines.

The structure set out in Figure 1.6 may be adapted according to the particular needs of the business. Where, for example, a business has few employees, the human resources function may not form a separate department but may form part of another department. Where business operations are specialised, separate departments may be formed to deal with each specialist area. Example 1.1 illustrates how Figure 1.6 may be modified to meet the needs of a particular business.

Example 1.1

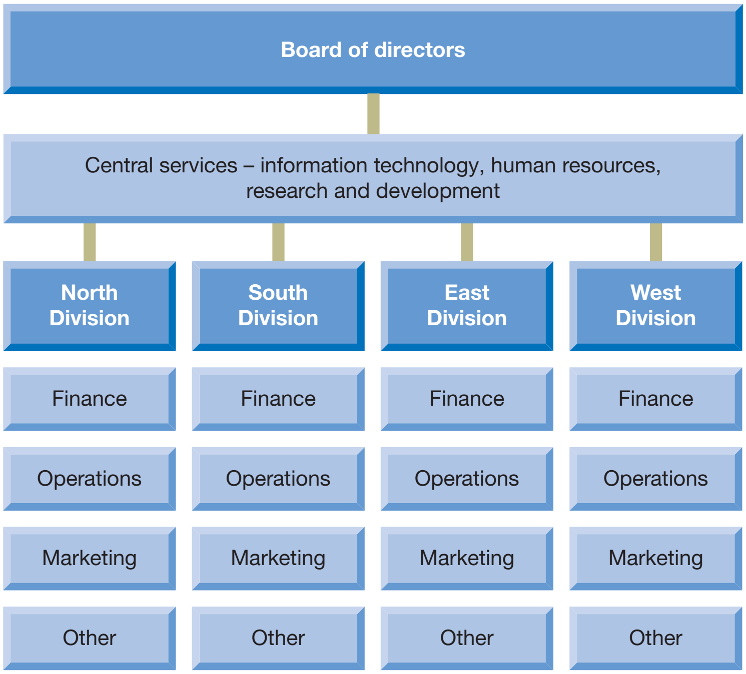
Supercoach Ltd owns a small fleet of coaches that it hires out with drivers for private group travel. The business employs about 50 people. It might be departmentalised as follows:

- *marketing department*, dealing with advertising, dealing with enquiries from potential customers, maintaining good relationships with existing customers and entering into contracts with customers;
- *routing and human resources department*, responsible for the coach drivers' routes, schedules, staff duties and rotas, and problems that arise during a particular job or contract;
- *coach maintenance department*, looking after repair and maintenance of the coaches, buying spares, giving advice on the need to replace old or inefficient coaches;
- *finance department*, responsible for managing the cash flows, costing business activities, pricing new proposals, paying wages and salaries, billing and collecting amounts due from customers, processing and paying invoices from suppliers.

For large businesses that have a diverse geographical spread and/or a wide product range, the simple departmental structure set out in Figure 1.6 will usually have to be adapted. Separate divisions are often created for each geographical area and/or major product group. Each division will be managed separately and will usually enjoy a degree of autonomy. Within each division, however, departments will often be created and organised along functional lines. Some functions providing support across the various divisions, such as human resources, may be undertaken at head office to avoid duplication. The managers of each division will be accountable to the board of directors. In some cases, individual board members may also be divisional managers.

A typical divisional organisational structure is set out in Figure 1.7. Here the main basis of the structure is geographical. North division deals with production and sales in the north and so on.

Figure 1.7 A divisional organisational structure



This is a typical organisational structure for a business that has been divided into separate operating divisions. Head office may provide some services to the divisions. Such services might include information technology, human resources and research and development. Alternatively, the individual divisions may provide themselves with such services.

Once a particular divisional structure has been established, it need not be permanent. Successful businesses constantly strive to improve their operational efficiency. This could well result in revising their divisional structure. **Real World 1.3** comprises extracts from an article that describes how one well-known business has reorganised in order to simplify operations and to reduce costs.

Real World 1.3

Engineering change

The chief executive of Rolls-Royce has shaken up its senior management team and scrapped two divisions as part of his attempt to turnaround the struggling engineer. Warren East . . . will scrap the aerospace and land & sea divisions that split Rolls into two parts . . . .

The move means that Rolls will operate with five smaller businesses all reporting directly to East. The Rolls chief executive plans to bring in a chief operating officer to assist him in running the company.

Rolls said the revamp will 'simplify the organisation, drive operational excellence and reduce cost'.

The Rolls boss is overhauling the company after it issued five profit warnings in less than two years. East wants to cut costs by between £150 million and £200 million a year. The level of concern about the future of Rolls was underlined earlier this week when it emerged the government has drawn up contingency plans to nationalise its nuclear submarine business or force it to merge with defence manufacturer BAE Systems in the event that the company's performance worsens.

East said: 'The changes we are announcing today are the first important steps in driving operational excellence and returning Rolls-Royce to its long-term trend of profitable growth. This is a company with world-class engineering capability, strong market positions and exceptional long-term prospects.'

Under the new structure Rolls will operate with five divisions from 1 January 2016 – civil aerospace, defence aerospace, marine, nuclear, and power systems.

Source: Extracts from Ruddick G. (2016) Rolls-Royce to scrap two divisions amid restructuring, www.theguardian.com, 16 December.

While both divisional and departmental structures are very popular in practice, it should be noted that other organisational structures are found.

How are businesses managed?

We have already seen that the environment in which businesses operate has become increasingly turbulent and competitive. The effect of these environmental changes has been to make the role of managers more complex and demanding. It has meant that managers have had to find new ways to manage their business. This has increasingly led to the introduction of **strategic management**.

Strategic management is concerned with setting the long-term direction of the business. It involves setting long-term goals and then ensuring that they are implemented effectively. To enable the business to develop a competitive edge, strategic management focuses on doing things differently rather than simply doing things better. It should provide a business with a clear sense of purpose, along with a series of steps to achieve that purpose. The steps taken should link the internal resources of the business to the external environment (competitors, suppliers, customers and so on). This should be done in such a way that any business strengths, such as having a skilled workforce, are exploited and any weaknesses, such as being short of investment finance, are not exposed. To achieve this requires the development of strategies and plans that take account of the business's strengths and weaknesses, as well as the opportunities offered and threats posed by the external environment. Access to a new, expanding market is an example of an opportunity; the decision of a major competitor to reduce prices would normally be a threat. This topic will be considered in more depth in Chapter 12 when we consider business planning and budgeting.

Real World 1.4 provides an indication of the extent to which strategic planning is carried out in practice.

Real World 1.4

Strategic planning high on the list

A survey, carried out in 2017, investigated the use of various management tools throughout the world. It found that strategic planning was used by 48 per cent of those businesses that took part. This made it the most popular of the 25 management tools surveyed. The survey, which has been conducted 16 times in the past 25 years, has placed strategic planning consistently among the top ten management tools employed by businesses. As well as being in widespread use, strategic planning scored highly in terms of user satisfaction, with a mean score of 4.03 out of 5.

The results were based on a survey of 1,268 senior executives throughout the world.

Source: Rigby, D. and Bilodeau, B. (2018) *Management Tools and Trends 2017,* Bain and Company.

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 may be pursued that relate to the needs of others with a stake in the business.

Activity 1.16

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 with a view to increasing 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 the business, such as employees, customers, suppliers and the community, 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 1.5** provides examples of businesses that acknowledge the vital link between satisfying customers' needs and creating wealth (value) for their owners (shareholders).

Real World 1.5

Keeping it clean

Unilever plc, a leading provider of household cleaning and food products, states its approach as follows:

> We create value for our shareholders by placing consumers and their interests at the heart of what we do to generate growth that is consistent, competitive, profitable and responsible.

Check this out

J. Sainsbury plc, a supermarket chain, states:

> Since we first opened our doors in 1869 we've helped our customers live well for less. It's the lifeblood of our business. It shapes our strategy, which delivers value to customers and shareholders.

Sources: www.unilever.com, accessed 3 November 2018; www.about.sainsburys.co.uk, accessed 3 November 2018.

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

Real World 1.6 describes how one well-known business came to recognise that future success depended on the continuing support of one important stakeholder group – its customers.

Real World 1.6

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 respond properly. 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.

Sources: Based on information in Nisen, M. (2013) How Nike solved its sweatshop problem, *Business Insider,* 9 May; Allarey, R. (2015) This is how Nike managed to clean up its sweatshop reputation, www.complex.com, 8 June.

It is clear from what we have seen that generating wealth for the owners is not the same as seeking 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 1.7** provides some examples of how emphasis on short-term profit can be very damaging.

Real World 1.7

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.

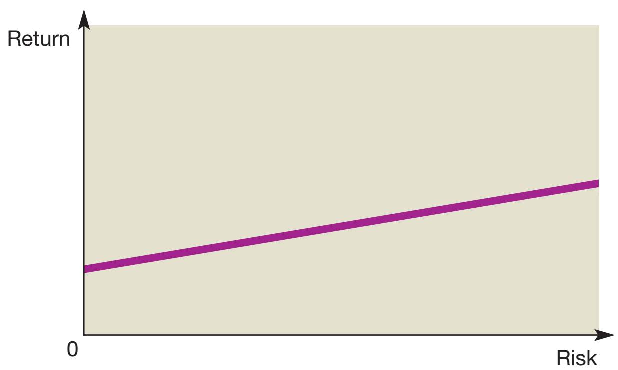
FT *Source*: Extracts from Goyder, M. (2009) How we've poisoned the well of wealth, *Financial Times*, 15 February.

Balancing risk and return

All decision making involves the future. 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 should 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 1.8.

Figure 1.8 Relationship between risk and return



Even at zero risk a certain level of return will be required. This will increase as the level of risk increases.

Activity 1.17

Look at Figure 1.8 and state, in broad terms, where an investment in

(a) a UK government savings account, and
(b) shares in an oil exploration business

should be placed on the risk–return line.

A UK government savings account is normally a very safe investment. Even if the government is 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 exploration business shares, which can be a very risky investment, 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.

Turmoil in the banking sector during the early 2000s showed, however, that the right balance is not always struck. Some banks took on excessive risks in pursuit of higher returns and, as a consequence, incurred massive losses. They are now being kept afloat with taxpayers' money. **Real World 1.8** discusses the collapse of one leading bank, in which the UK government took a majority stake, and points out that the risk appetite of banks had to change.

Real World 1.8

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 from collapse.

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?

Real World 1.8 *continued*

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

Source: Based on information in Peston, R. (2008) We own Royal Bank, *BBC News,* www.bbc.co.uk, 28 November.

Reasons to be ethical

The way in which individual businesses operate in terms of the honesty, fairness and transparency with which they treat their stakeholders (customers, employees, suppliers, the community, the shareholders and so on) has become a key issue. There have been many examples of businesses, some of them very well known, acting in ways that most people would regard as unethical and unacceptable. Examples of such actions include:

- paying bribes to encourage employees of other businesses to reveal information about the employee's business that could be useful;
- oppressive treatment of suppliers, for example making suppliers wait excessive periods before payment; and
- manipulating the financial statements to mislead users of them, for example to overstate profit so that senior managers become eligible for performance bonuses (known as 'creative accounting').

Despite the many examples of unethical acts that have attracted publicity over recent years, it would be very unfair to conclude that most businesses are involved in unethical activities. Nevertheless, revelations of unethical practice can be damaging to the entire business community. Lying, stealing and fraudulent behaviour can lead to a loss of confidence in business and the imposition of tighter regulatory burdens. In response to this threat, businesses often seek to demonstrate their commitment to acting in an honest and ethical way. One way in which this can be done is to produce, and adhere to, a code of ethics concerning business behaviour.

Accountants are likely to find themselves at the forefront with issues relating to business ethics. In the three examples of unethical business activity listed above, an accountant would probably have to be involved either in helping to commit the unethical act or in covering it up. Accountants are, therefore, particularly vulnerable to being put under pressure to engage in unethical acts. Some businesses recognise this risk and produce an ethical code for their accounting staff. **Real World 1.9** provides an example of one such code.

Real World 1.9

The only way is ethics

Vodafone plc, the telecommunications business, has a code of ethics for its chief executive and senior finance and accounting staff. The code states that they have a duty to:

> . . . act with integrity. Integrity requires, among other things, being honest and candid. Deceit, dishonesty and subordination of principle are inconsistent with integrity. Service to the Company should never be subordinated to personal gain and advantage.

The code specifically states that they must:

- act with integrity, including being honest and candid while still maintaining the confidentiality of Company information where required or in the Company's interests;
- observe, fully, applicable governmental laws, rules and regulations;
- comply with the requirements of applicable accounting and auditing standards and Company policies in the maintenance of a high standard of accuracy and completeness in the Company's financial records;
- adhere to a high standard of business ethics and not seek competitive advantage through unlawful or unethical business practices; and
- avoid conflicts of interest wherever possible. Anything that would be a conflict for a Relevant Officer will also be a conflict if it is related to a member of his or her family or a close relative.

Source: Vodafone plc, Code of Ethics, www.vodafone.com, accessed 13 February 2019.

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 1.18

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.

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 properly managed and used in a way consistent with its objectives.

Some not-for-profit organisations, such as charities, however, often suffer from a lack of financial skills among its trustees and managers. **Real World 1.10** 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 1.10

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.

Source: Laville, S. Barr, C. and Slawson, N. (2015) Kids Company trustees accused of ignoring finance warnings, www.theguardian.com, 6 August.

Summary

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 better judgements and decisions.
- Finance also helps users to make better 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.
- Conflicts of interest between users may arise over the ways in which business wealth is generated or distributed.
- The evidence suggests that accounting is both used and useful for decision-making purposes.

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 information must possess certain qualities, or characteristics.
- The fundamental qualities required 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, in theory, 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 the features that are 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, and financial accounting seeks to meet the needs of providers of owners and lenders but will also be of use to other user groups.
- These two strands 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 new methods for managing costs have emerged 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.

What is the purpose of a business?

- According to Drucker, the purpose of a business is to create and keep customers.

What kinds of business ownership exist?

There are three main forms of business unit:

- sole proprietorship – easy to set up and flexible to operate but the owner has unlimited liability;

- partnership – easy to set up and spreads the burdens of ownership, but partners usually have unlimited liability and there are ownership risks if the partners are unsuitable; and
- limited company – limited liability for owners but obligations imposed on the way a company conducts its affairs.

How are businesses organised and managed?

- Most businesses of any size are set up as limited companies.
- A board of directors is appointed by owners (shareholders) to oversee the running of the business.
- Businesses are often divided into departments and organised along functional lines; however, larger businesses may be divisionalised along geographical and/or product lines.
- The move to strategic management has been caused by the changing and more competitive nature of business.

The quest for wealth creation

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

Ethical behaviour

- Accounting staff may be put under pressure to commit unethical acts.
- Businesses may produce a code of ethical conduct to help protect accounting staff from this risk.

Not-for-profit organisations

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

Key terms

For definitions of these terms, see Appendix B.

accounting *p. 2*
finance *p. 2*
shares *p. 6*
relevance *p. 7*
faithful representation *p. 7*
materiality *p. 7*
comparability *p. 8*
verifiability *p. 8*
timeliness *p. 8*
understandability *p. 8*
accounting information system *p. 12*
management accounting *p. 14*
financial accounting *p. 14*
sole proprietorship *p. 20*
partnership *p. 21*
limited company *p. 21*
strategic management *p. 26*

References

1 International Accounting Standards Board (2018) *Conceptual Framework for Financial Reporting,* pages 14 to 20.

2 Dugdale, D., Jones, C. and Green, S. (2006) *Contemporary Management Accounting Practices in UK Manufacturing,* CIMA/Elsevier.

3 Drucker, P. (1967) *The Effective Executive,* Heinemann.

Further reading

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

Drury, C. (2018) *Management and Cost Accounting,* 10th edn, Cengage Learning EMEA, Chapter 1.

Elliott, B. and Elliott, J. (2017) *Financial Accounting and Reporting,* 18th edn, Pearson, Chapters 6 and 7.

McLaney, E. (2017) *Business Finance: Theory and Practice,* 11th edn, Pearson, Chapters 1 and 2.

Scott, W. (2014) *Financial Accounting Theory,* 7th edn, Pearson, Chapters 1 to 3.

Critical review questions

Solutions to these questions can be found at the back of the book on pages 770–771

1.1 What, in economic principle, should determine what accounting information is produced? Should economics be the only issue here? (Consider who the users of accounting information are.)

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 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?

1.4 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?

PART 1

Financial accounting

2 Measuring and reporting financial position
3 Measuring and reporting financial performance
4 Accounting for limited companies (1)
5 Accounting for limited companies (2)
6 Measuring and reporting cash flows
7 Analysing and interpreting financial statements

We saw in Chapter 1 that accounting has two distinct strands: financial accounting and management accounting. Part 1 of this book deals with the former. Here, we introduce the three major financial statements:

- the statement of financial position;
- the income statement; and
- the statement of cash flows.

In Chapter 2, we provide an overview of these three statements and then go on to examine the first of them, the statement of financial position, in some detail. This examination will include an explanation of the main accounting conventions used when preparing the statement. These accounting 'conventions' are generally accepted rules that have evolved to help deal with practical problems experienced by preparers and users of the statement.

In Chapter 3, we examine the second of the major financial statements, the income statement. Here we discuss important issues such as how profit is measured and the point at which it should be recognised. Once again, we consider the main accounting conventions used when preparing this financial statement.

In the UK, the limited company is the most important form of business unit. Chapters 4 and 5 are devoted to an examination of its main features and financing arrangements. From an accounting viewpoint, there is no essential difference between a limited company and any other type of business unit. There are, however, points of detail that must be understood. Chapter 4 examines the nature of limited companies, the way in which they are financed and the accounting issues that relate specifically to this form of business. Chapter 5 considers the duty of directors of a limited company to account to its owners and to others, and the regulatory framework imposed on limited companies. Some additional financial statements, which are prepared by large limited companies, are also considered.

Chapter 6 deals with the last of the three financial statements, the statement of cash flows. This sets out the inflows and outflows of cash during a reporting period. In this chapter, we shall see that making profit is not enough. A business must also be able to generate sufficient cash to pay its obligations when they become due. The statement of cash flows helps users to assess its ability to do this.

When taken together, the three financial statements provide useful information about a business's performance and position for a particular period. We may, however, gain even greater insights by using financial ratios and other techniques based on these financial statements. By combining two figures from the financial statements in the form of a ratio, and then comparing the result with a similar ratio for, say, another business, we have a basis for assessing financial health. In Chapter 7, we consider various financial ratios and other techniques that can be used for assessing financial strengths and weaknesses.

CHAPTER 2

Measuring and reporting financial position

Introduction

We begin this chapter by taking an overview of the three major financial statements that form the core of financial accounting. We shall see how each contributes towards an assessment of the overall financial position and performance of a business. We shall also examine how these three statements are linked.

Following this overview, we shall undertake a more detailed examination of one of these financial statements: the statement of financial position. We shall identify its key elements and consider the interrelationships between them. We also consider the main accounting conventions, or rules, to be 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. Thus, 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 system 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. 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:

Statement of cash flows for Monday

	£
Cash introduced (by Paul)	40
Cash from sales of wrapping paper	45
Cash paid to buy wrapping paper	(40)
Closing balance of cash	45

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

	£
Sales revenue	45
Cost of goods sold ($^3/_4$ of £40)	(30)
Profit	15

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 $^1/_4$ 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

	£
Cash (closing balance)	45
Inventories of goods for resale ($^1/_4$ of £40)	10
Total assets	55
Equity	55

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 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.

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

Example 2.1 ***continued***

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

Statement of cash flows for Tuesday

	£
Opening balance (from Monday evening)	45
Cash from sales of wrapping paper	48
Cash paid to buy wrapping paper	(20)
Closing balance	73

The income statement for Tuesday will be as follows:

Income statement for Tuesday

	£
Sales revenue	48
Cost of goods sold (£20 + £10)	(30)
Profit	18

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

Statement of financial position as at Tuesday evening

	£
Cash (closing balance)	73
Inventories	–
Total assets	73
Equity	73

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 used 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 provides an insight into the total wealth of the business. This wealth can be held in various forms. For Paul's business, wealth is 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.

Statement of cash flows for Wednesday

	£
Opening balance (from the Tuesday evening)	73
Cash from sales of wrapping paper	32
Cash paid to buy wrapping paper	(46)
Closing balance	59

Income statement for Wednesday

	£
Sales revenue	32
Cost of goods sold ($^1/_2$ of £46)	(23)
Profit	9

Statement of financial position as at Wednesday evening

	£
Cash (closing balance)	59
Inventories ($^1/_2$ of £46)	23
Total assets	82
Equity	82

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.

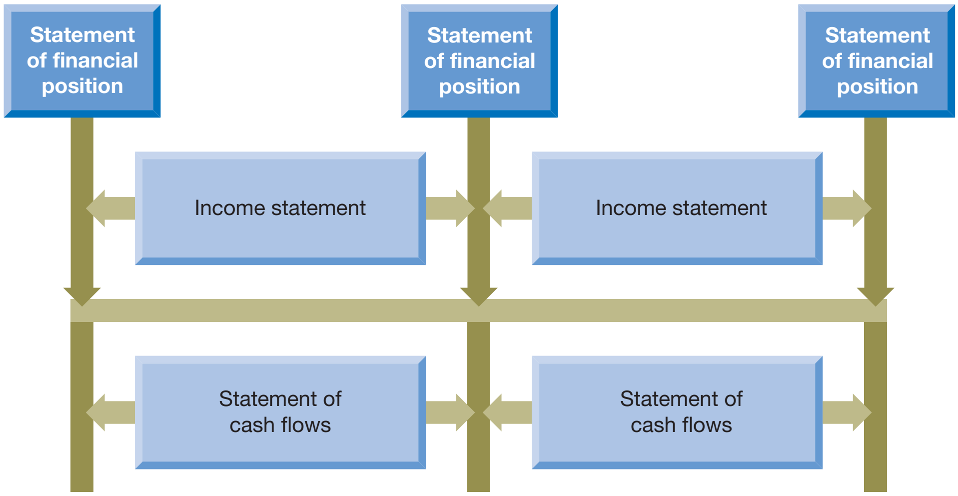
By Wednesday evening, the equity stood at £82. This arose from Paul's initial investment of £40, plus his profits for Monday (£15), Tuesday (£18) and Wednesday (£9). This represents Paul's total investment in his business at that time. The equity of most businesses will similarly arise from injections 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.

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

Figure 2.1 The relationship between the major financial statements



The income statement and statement of cash flows are concerned with measuring flows of wealth and cash (respectively) over time. The statement of financial position, however, is concerned with measuring the amount of wealth at a particular moment in time.

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.

The statement of financial position

We saw a little earlier that this statement shows the forms in which the wealth of a business is held and how much wealth is held in each form. It also shows the sources of funding for that wealth. We can, however, be more specific about the nature of this statement by 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 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 three characteristics:

- *It must be an economic resource.* This type of resource provides the 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, perhaps considerable economic benefits, others can receive the same benefits at no great cost. A public good cannot, therefore, be regarded as an asset of a business.

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

Activity 2.2

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

Benefits flowing from an economic resource may take the following forms:

- cash generated by using it to produce goods or services;
- cash received from the proceeds of its sale;
- 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. These benefits 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).

Activity 2.3

Assume a business owns a 20 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 20 per cent share of the mine that is under its control, rather than the whole of the gold mine.

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 1 at the end of the chapter.)

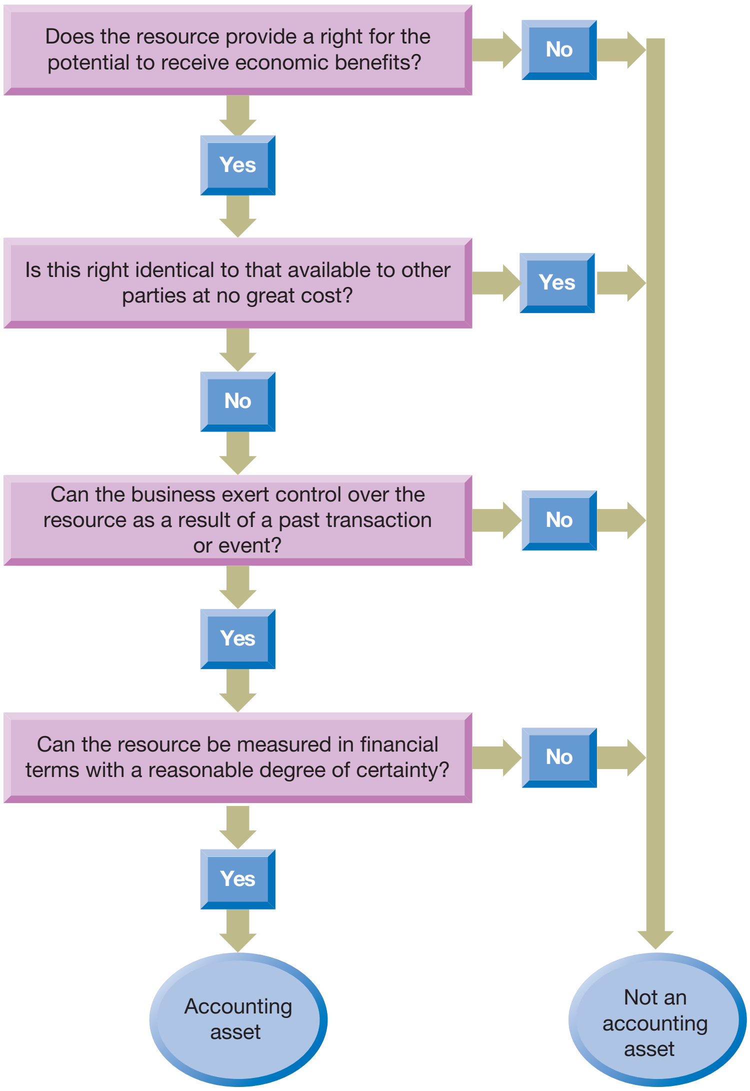
- *The economic resource must be capable of measurement in monetary terms.* Often, an economic resource cannot be measured with a great deal of certainty. Estimates may be used that ultimately prove to be inaccurate. Nevertheless, it can still be reported as an asset for inclusion in the statement of financial position as long as a sufficiently faithful representation of its measurement 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 was 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. 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 assets 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.

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



Only resources that have the characteristics identified may be included in the statement of financial position of a business.

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.

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 'trade debtors'). However, in this particular case, the customer is unable to pay. As a result, this not an economic resource 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 has 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 provide 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 (land and buildings);
- 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, 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. A liability incurred by a business cannot be avoided and so will remain a liability until it is settled.

Most liabilities arise for legal or contractual reasons, such as from acquiring goods or services or from borrowing funds. They can, however, arise from the policies and practices adopted by the business, such as 'no quibble' refunds.

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 them 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:

Jerry and Company
Statement of financial position as at 1 March

	£
ASSETS	
Cash at bank	20,000
Total assets	20,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing	14,000
Total equity and liabilities	20,000

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 a bank transfer.
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

→

Example 2.2 *continued*

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
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing	14,000
Liabilities – trade payable	3,000
Total equity and liabilities	23,000

The effect of buying inventories has been to introduce another new asset (inventories) to the statement of financial position. Furthermore, the fact that the goods have not yet been paid for means that the claims against the business will be increased by the £3,000 owed to the supplier, who is referred to as a **trade payable** (or 'trade creditor') on the statement of financial position.

Activity 2.6

Try drawing up a statement of financial position for Jerry and Company as at 4 March.

The statement of financial position as at 4 March, following the repayment of part of the borrowing, will be:

Jerry and Company
Statement of financial position as at 4 March

	£
ASSETS	
Cash at bank (15,000 − 2,000)	13,000
Motor van	5,000
Inventories	3,000
Total assets	21,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing (14,000 − 2,000)	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	21,000

The repayment of £2,000 of the borrowing will result in a decrease in the balance at the bank of £2,000 and a decrease in the lender's claim against the business by the same amount.

Activity 2.7

Try drawing up a statement of financial position as at 6 March for Jerry and Company.

The statement of financial position as at 6 March, following the introduction of more funds, will be:

Jerry and Company
Statement of financial position as at 6 March

	£
ASSETS	
Cash at bank (13,000 + 4,000)	17,000
Motor van	5,000
Inventories	3,000
Total assets	25,000
EQUITY AND LIABILITIES	
Equity (6,000 + 4,000)	10,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	25,000

The introduction of more funds by the owner will result in an increase in the equity of £4,000 and an increase in the cash at bank by the same amount.

This example (Jerry and Company) illustrates the point that the accounting equation (assets equals equity plus liabilities) will always hold true. It reflects the fact that, if a business wishes to acquire more assets, it must raise funds equal to the cost of those assets. The funds raised must be provided by the owners (equity), or by others (liabilities), or by a combination of the two. This means that the total cost of assets acquired should equal the total equity plus liabilities.

It is worth pointing out that businesses do not normally draw up a statement of financial position after each day, as shown in the example. We have done this to illustrate the effect on the statement of financial position of each transaction separately. In practice, a statement of financial position for a business is usually prepared at the end of a defined period. The period over which businesses measure their financial results is usually known as the **reporting period**, but it is sometimes called the 'accounting period' or 'financial period'.

Determining the length of the reporting period will involve weighing up the costs of producing the information against the perceived benefits of having that information for decision-making purposes. In practice, the reporting period will vary between businesses; it could be monthly, quarterly, half-yearly or annually. For external reporting purposes, an annual reporting period is the norm (although certain businesses, typically larger ones, report more frequently than this). For internal reporting purposes to managers, however, more frequent (perhaps monthly) financial statements are likely to be prepared.

The effect of trading transactions

In the example (Jerry and Company), we showed how various types of transactions affected the statement of financial position. However, one very important type of transaction – trading transactions – has yet to be considered. To show how this type of transaction affects the statement of financial position, let us return to Jerry and Company.

Example 2.2 *continued*

The statement of financial position that we drew up for Jerry and Company as at 6 March was as follows:

Jerry and Company
Statement of financial position as at 6 March

	£
ASSETS	
Cash at bank	17,000
Motor van	5,000
Inventories	3,000
Total assets	25,000
EQUITY AND LIABILITIES	
Equity	10,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	25,000

On 7 March, the business managed to sell all of the inventories for £5,000 and received a cheque immediately from the customer for this amount. The statement of financial position on 7 March, after this transaction has taken place, will be:

Jerry and Company
Statement of financial position as at 7 March

	£
ASSETS	
Cash at bank (17,000 + 5,000)	22,000
Motor van	5,000
Inventories (3,000 − 3000)	–
Total assets	27,000
EQUITY AND LIABILITIES	
Equity (10,000 + (5,000 − 3,000))	12,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	27,000

We can see that the inventories (£3,000) have now disappeared from the statement of financial position, but the cash at bank has increased by the selling price of the inventories (£5,000). The net effect has therefore been to increase assets by £2,000 (that is, £5,000 less £3,000). This increase represents the net increase in wealth (the profit) that has arisen from trading. Also note that the equity of the business has increased by £2,000, in line with the increase in assets. This increase in equity reflects the fact that wealth generated, as a result of trading or other operations, will be to the benefit of the owners and will increase their stake in the business.

Activity 2.8

What would have been the effect on the statement of financial position if the inventories had been sold on 7 March for £1,000 rather than £5,000?

The statement of financial position on 7 March would then have been:

Jerry and Company
Statement of financial position as at 7 March

	£
ASSETS	
Cash at bank (17,000 + 1,000)	18,000
Motor van	5,000
Inventories (3,000 − 3000)	–
Total assets	23,000
EQUITY AND LIABILITIES	
Equity (10,000 + (1,000 − 3,000))	8,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	23,000

As we can see, the inventories (£3,000) will disappear from the statement of financial position but the cash at bank will rise by only £1,000. This will mean a net reduction in assets of £2,000. This reduction represents a loss arising from trading and will be reflected in a reduction in the equity of the owners.

What we have just seen means that the accounting equation can be extended as follows:

Assets (at the end of the period)	**=**	**Equity (amount at the start of the period** **+ Profit (or – Loss) for the period)** **+ Liabilities (at the end of the period)**

(This is assuming that the owner makes no injections or withdrawals of equity during the period.)

Any funds introduced or withdrawn by the owners also affect equity. If the owners withdrew £1,500 for their own use, the equity of the owners would be reduced by £1,500. If these drawings were in cash, the cash balance would decrease by £1,500 in the statement of financial position.

Like all items in the statement of financial position, the amount of equity is cumulative. This means that any profit not taken out as drawings by the owner(s) remains in the business. These retained (or ‘ploughed-back’) earnings have the effect of expanding the business.

Classifying assets

In the statement of financial position, assets and claims are usually grouped into categories. This is designed to help users, as a haphazard listing of these items could be confusing. Assets are usually categorised as being either *current* or *non-current*.

Current assets

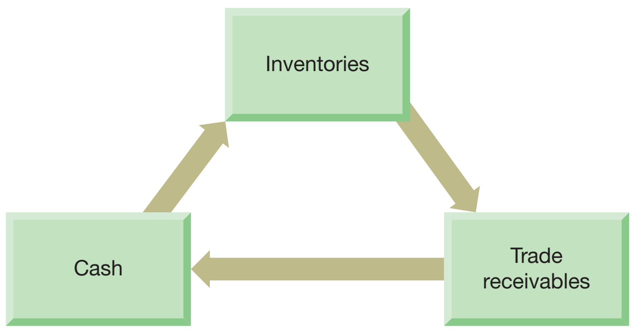
Current assets are basically assets that are held for the short term. To be more precise, they are assets that meet any of the following conditions:

- they are held for sale or consumption during the business's normal operating cycle;
- they are expected to be sold within a year after the date of the relevant statement of financial position;
- they are held principally for trading; and/or
- they are cash, or near cash such as easily marketable, short-term investments.

The operating cycle of a business, mentioned above, is the time between buying and/or creating a product or service and receiving the cash on its sale. For most businesses, this will be less than a year. (It is worth mentioning that sales made by most businesses, retailers being the exception, are made on credit. The customer pays some time after the goods are received or the service is provided.)

The most common current assets are inventories, trade receivables (amounts owed by customers for goods or services supplied on credit) and cash. For businesses that sell goods, rather than provide a service, the current assets of inventories, trade receivables and cash are interrelated. They circulate within a business as shown in Figure 2.3. We can see that cash can be used to buy inventories, which are then sold on credit. When the credit customers (trade receivables) pay, the business receives an injection of cash and so on.

Figure 2.3 The circulating nature of current assets



Inventories may be sold on credit to customers. When the customers pay, the trade receivables will be converted into cash, which can then be used to purchase more inventories. Then the cycle begins again.

For purely service businesses, the situation is similar, except that inventories are not involved.

Non-current assets

Non-current assets (also called *fixed assets*) are simply assets that do not meet the definition of current assets. They tend to be held for long-term operations. Non-current assets may be either tangible or intangible. Tangible non-current assets normally consist of **property, plant and equipment**. We shall refer to them in this way from now on. This is a rather broad term that includes items such as land and buildings, machinery, motor vehicles and fixtures and fittings.

The distinction between those assets continuously circulating (current) and those used for long-term operations (non-current) may help in assessing the mix of assets held. Most businesses need a certain amount of both types of asset to operate effectively.

Activity 2.9

Can you think of two examples of assets that may be classified as non-current assets for an insurance business?

Examples of assets that may be defined as being non-current are:

- property;
- furniture;
- motor vehicles;
- computers;
- computer software; and
- reference books.

This is not an exhaustive list. You may have thought of others.

The way in which a particular asset is classified (that is, between current and non-current) may vary according to the nature of the business. This is because the *purpose* for which the asset is held may vary. For example, a motor van retailer will normally hold inventories of the motor vans for sale; it would, therefore, classify them as part of the current assets. On the other hand, a business that buys one of these vans to use for delivering its goods to customers (that is, as part of its long-term operations) would classify it as a non-current asset.

Activity 2.10

The assets of Kunalun and Co., a large advertising agency, are as follows:

- **cash at bank;**
- **fixtures and fittings;**
- **office equipment;**
- **motor vehicles;**
- **property;**
- **computers; and**
- **work in progress (that is, partly completed work for clients).**

Which of these do you think should be defined as non-current assets and which as current assets?

Your answer should be as follows:

Non-current assets	*Current assets*
Fixtures and fittings	Cash at bank
Office equipment	Work in progress
Motor vehicles	
Property	
Computers	