

# The information of different needs of different user groups

[Business](#), [Management](#)



1 Introduction to accounting Introduction In this opening chapter we begin by considering the role of accounting. We shall see that it can be a valuable tool for decision-making. We shall identify the main users of accounting and financial information and discuss the ways in which this information can improve the quality of decisions that those users make. We shall then go on to consider the particular role of financial accounting and the differences between financial and management accounting.

Since this book is concerned with accounting and financial decision making for private-sector businesses, we shall also examine the main forms of business enterprise and consider what are likely to be the key objectives of a business. | Learning outcomes When you have completed this chapter, you should be able to: ? explain the nature and roles of accounting; ? identify the main users of financial information and discuss their needs; ? distinguish between financial and management accounting; ? explain the purpose of a business and describe how businesses are organised and structured. 2

## CHAPTER 1

INTRODUCTION TO ACCOUNTING What is accounting? ? Accounting is concerned with collecting, analysing and communicating ? nancial information. The purpose is to help people who use this information to make more informed decisions. If the ? nancial information that is communicated is not capable of improving the quality of decisions made, there would be no point in producing it. Sometimes the impression is given that the purpose of accounting is simply to prepare ? nancial reports on a regular basis. While it

is true that accountants undertake this kind of work, it does not represent an end in itself.

The ultimate purpose of the accountant's work is to give people 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. 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. WHO ARE THE USERS OF ACCOUNTING INFORMATION?

Activity 1.1 Parmigan 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 their 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 aspects 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). 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 its profits, sales revenues and financial strength would be made. Community Whether to allow PI to expand its premises and/or whether to provide representative economic support for the business.

PI's ability to continue to provide employment for the community, the extent to which it is likely to use community resources and its likely willingness to help fund environmental improvements are likely to be considered when arriving at such decisions. Investment Whether to advise clients to invest in PI. This would involve an analyst's assessment of the likely risks and future

returns associated with PI. Suppliers Whether to continue to supply PI and, if so, whether to supply on credit. This would involve an assessment of PI's ability to pay for any goods and services supplied.

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 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 decide whether there should be a change in PI's future direction. This would involve looking at PI's ability to perform and at the opportunities available to it.

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 rewarding senior managers. The financial performance of the business would normally be considered when making such a decision. 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.

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INTRODUCTION TO ACCOUNTING The conflicting interests of users

We have seen above that each user group looks at a business from a different perspective and has its own particular interests. This means that there is always the risk that the interests of one group will collide with those of another group. Conflict between user groups is most likely to occur over the way in which the wealth of the business is generated and/or distributed.

A good example is the conflict that may arise between the managers and the owners of the business. Although managers are appointed to act in the best interests of the owners, there is always a danger that they will not do so.

Instead, managers 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 information has an important role to play in reporting the extent to which various groups have benefited from the business. Thus, owners may rely on accounting information to check whether the pay and benefits of managers are in line with agreed policy. A further example is the potential conflict of interest between lenders and owners. There is a risk that the funds loaned to a business will not be used for purposes that have been agreed.

Lenders may, therefore, rely on accounting information to check that the funds have been applied in an appropriate manner and that the terms of the loan agreement are not being broken. Activity 1.2 Can you think of other examples where accounting information may be used to monitor potential conflicts of interest between the various user groups identified? Two possible examples that spring to mind are: ? ? employees (or their representatives) wishing to check that they are receiving a 'fair share' of the wealth created by the business and that agreed profit-sharing schemes are being adhered to; overnment wishing to check that the profits made from a contract that it has given to a business are not excessive. 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.

The information should reduce uncertainty about the financial position and performance of the business. It should 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. HOW USEFUL IS ACCOUNTING INFORMATION? 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? What kind of information might be gleaned from these sources? 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; audio and TV reports; information-gathering agencies (for example, agencies that assess businesses' creditworthiness or credit ratings); industry reports; 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.

However, the various sources of information identified are not really substitutes for accounting reports. Rather, they are best used in conjunction with the reports in order to obtain 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 information, 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 reveals that, when a business makes an announcement concerning its accounting pro? s, the prices at which shares are traded and the volume of shares traded often change signi? cantly. 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 and that this, in turn, leads them to make a decision either to buy or to sell shares in the business. Although there is evidence that accounting reports are perceived as being useful and are used for decision-making purposes, it is impossible to measure just how useful 5 6 CHAPTER 1 INTRODUCTION TO ACCOUNTING ccounting reports are to users. As a result we cannot say with certainty whether the cost of producing those reports represents value for money. Accounting information will usually represent only one input to a particular decision and so the precise weight attached to the accounting information by the decision maker and the bene? ts which ? ow as a result cannot be accurately assessed. We shall now go on to see, however, that it is at least possible 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. Providing a service One way of viewing accounting is as a form of service. Accountants provide economic information to their ' clients', who are the various users identi? ed in Figure 1. 1. The quality of the service provided is determined by the extent to which the needs of the various user groups have been met. To meet these users' needs, it can be argued that accounting information should possess certain key qualities, or

characteristics: relevance, reliability, comparability and understandability. ? ? Relevance. Accounting information must have the ability to influence decisions. Unless this characteristic is present, there is really no point in producing the information. The information may be relevant to the prediction of future events (for example, in predicting how much profit is likely to be earned next year) or relevant in helping to confirm past events (for example, in establishing how much profit was earned last year). The role of accounting in confirming past events is important because users often wish to check the accuracy of earlier predictions that they have made.

The accuracy (or inaccuracy) of earlier predictions may help users to judge the accuracy of current predictions. To influence a decision, the information must, of course, be available when the decision is being made. Thus, relevant information must be timely. ? Reliability. Accounting should be free from significant error or bias. It should be capable of being relied upon by managers to represent what it is supposed to represent. Though both relevance and reliability are very important, the problem that we often face in accounting is that information that is highly relevant may not be very reliable.

Similarly, that which is reliable may not be very relevant. Activity 1.4 To illustrate this last point, let us assume that a manager has to sell a custom-built machine owned by their business and has recently received a bid for it. This machine is very unusual and there is no ready market for it. What information would be relevant to the manager when deciding whether to

accept the bid? How reliable would that information be? The manager would probably like to know the current market value of the machine before deciding whether or not to accept the bid.

The current market value would be highly relevant to the final decision, but it might not be very reliable because the machine is unique and there is likely to be little information concerning market values. BUT ... IS IT MATERIAL?

When seeking to strike the right balance between relevance and reliability, the needs of users should be the overriding consideration. ? ? ?

Comparability. This quality will enable users to identify changes in the business over time (for example, the trend in sales revenue over the past ? ve years).

It will also help them to evaluate the performance of the business in relation to similar businesses. Comparability is achieved by treating items that are basically the same in the same manner for accounting purposes.

Comparability may also be enhanced by making clear the policies that have been adopted in measuring and presenting the information. ?

Understandability. Accounting reports should be expressed as clearly as possible and should be understood by those at whom the information is aimed. Activity 1. 5 Do you think that accounting reports should be understandable to those who have not studied accounting?

It would be very useful if accounting reports could be understood by everyone. This, however, is unrealistic as complex financial events and transactions cannot normally be expressed in simple terms. 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. Generally speaking, accounting reports assume 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.

Despite the answer to Activity 1. 5, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible to non-accountants. But . . . is it material? ? The qualities, or characteristics, that have just been described will help us to decide whether accounting information is potentially useful. If a particular piece of information has these qualities then it may be useful. However, this does not automatically mean that it should be reported to users. We also have to consider whether the information is material, or signi? cant.

This means that we should ask whether its omission or misrepresentation in the accounting reports would really alter the decisions that users make. Thus, in addition to possessing the characteristics mentioned above, accounting information must also cross the threshold of materiality. If the information is not regarded as material, it should not be included within the reports as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret the ? nancial results. The type of information and amounts involved will normally determine whether it is material. 8 CHAPTER 1 INTRODUCTION TO ACCOUNTING Weighing up the costs and benefits Having read the previous sections you may feel that, when considering a piece of accounting information, provided the four main qualities identi? ed are present and it is material it should be gathered and made available to

users. Unfortunately, there is one more hurdle to jump. Something may still exclude a piece of accounting information from the reports even when it is considered to be useful. Consider Activity 1. 6. Activity 1. 6 Suppose an item of information is capable of being provided. It is relevant to a particular decision; it is also reliable, comparable, can be understood by the decision maker concerned and is material. Can you think of a reason why, in practice, you might choose not to produce the information? The reason that you may decide not to produce, or discover, the information 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 extent to which accounting information is 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. WEIGHING UP THE COSTS AND BENEFITS 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. We shall now go on to discuss these. To illustrate the practical problems of establishing the value of information, let us assume that someone has collided with our car in a car park and dented and scraped the paint from one of the doors. We wish to have the dent taken out and the door resprayed at a local garage. We know that the nearest garage would charge £ 250 but 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 petrol 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 petrol 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 ? 250? 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. The provision of accounting information can be very costly; however, the costs are often difficult to quantify.

The direct, out-of-pocket, costs such as salaries of accounting staff are not really a problem to identify, but these are only part of the total costs involved. There are also less direct costs such as the cost of the user's time spent on analysing and interpreting the information contained in reports. The economic benefit of having accounting information is even harder to assess. It is possible to apply some 'science' to the problem of weighing the costs and benefits, but a lot of subjective judgement is likely to be involved. No one would seriously advocate that the typical business should produce no accounting information.

At the same time, no one would advocate that every item of information that could be seen as possessing one or more of the key characteristics should be produced, irrespective of the cost of producing it. The characteristics that influence the usefulness of accounting information and which have been discussed in this section and the preceding section are set out in Figure 1.3.

9 10 CHAPTER 1 INTRODUCTION TO ACCOUNTING Figure 1.3 The characteristics that influence the usefulness of accounting information There are four main qualitative characteristics that influence the usefulness of accounting information.

In addition, however, accounting information should be material and the benefits of providing the information 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 economic resources. To ensure that these resources are efficiently allocated, users need economic information on which to base decisions.

It is the role of the accounting system to provide that information and this will involve information gathering and communication. The accounting information system should have certain features that are common to all valid information systems within a business. These are: identifying and capturing relevant information (in this case financial information); recording the information collected in a systematic manner; analysing and interpreting the information collected; reporting the information in a manner that suits the needs of users. The relationship between these features is set out in Figure 1. . ACCOUNTING AS AN INFORMATION SYSTEM 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 accounting information. We shall consider the way in which information is used by, and is useful to, users rather than the way in



which it is identified and recorded. Efficient accounting systems are an essential ingredient of an efficient business. When the accounting systems fail, the results can be disastrous. Real World 1.1 provides an example of a systems failure when two businesses combined and then attempted to integrate their respective systems. Real World 1.1 Blaming the system FT

When Sir Ken Morrison bought Safeway for £3.35bn in March 2004, he almost doubled the size of his supermarket chain overnight and went from being a regional operator to a national force. His plan was simple enough. He had to sell off some Safeway stores – Morrison has to date sold off 184 stores for an estimated £.3bn – and convert the remaining 230 Safeway stores into Morrison's. Sir Ken has about another 50 to sell. But, nearly fifteen months on, and the integration process is proving harder in practice than it looked on paper. Morrison, once known for its robust performance, has issued four profit warnings in the past ten months. Each time the retailer has blamed Safeway. Last July, it was because of a faster-than-expected sales decline in Safeway stores. In March – there were two warnings that month – it was the fault of Safeway's accounting systems, which left Morrison with lower supplier incomes.

This month's warning was put down to higher-than-expected costs from running parallel store systems. At the time of the first warning last July, Simon Procter, of the stockbrokers Charles Stanley, noted that the news 'has blown all profit forecasts out of the water and visibility is very poor from here on out'. But if it was difficult then to predict where Morrison's profits were heading, it is impossible now. Morrison itself cannot give guidance. 'No one envisaged this,' says Mr Procter. 'When I made that comment about

visibility last July, I was thinking on a twelve-month time frame, not a two-year one. Morrison says the complexity of the Safeway deal has put a 'significant strain' on its ability to cope with managing internal accounts. 'This is impacting the ability of the board to forecast likely trends in profitability and the directors are therefore not currently in a position to provide reliable guidance on the level of profitability as a whole,' admits the retailer. Source: 'Morrison in uphill battle to integrate Safeway', Elizabeth Rigby, Financial Times, 26 May 2005. As a footnote to Real World 1. 1, though Morrison had its problems, these were quickly overcome and the Safeway takeover has proved to be a success. 1 12 CHAPTER 1 INTRODUCTION TO ACCOUNTING 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 accounting needs of all of the other users 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, that is, they contain ? nancial information that will be useful for a broad range of users and decisions rather than being speci? cally designed for the needs of a particular group or set of decisions. Management accounting reports, on the other hand, are often speci? c-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 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 that try to ensure they are produced with standard content and in a standard format. The law and accounting rule makers impose these regulations. As management accounting reports are for internal use only, there are no regulations from external sources concerning the form and content of the reports.

They can be designed to meet the needs of particular managers. 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 may be produced as frequently as required by managers. In many businesses, managers are provided with certain reports on a daily, weekly or monthly basis, which allows them to check progress frequently. In addition, special-purpose reports will be prepared when required (for example, to evaluate a proposal to purchase a piece of 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. 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. 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. SCOPE OF THIS BOOK 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 distinctions between management and financial accounting suggest that there are differences between 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 1.7 Can you think of any

areas of overlap between the information needs of managers and those of other users? We thought of two points: ? ? 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 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. The distinction between the two areas of accounting re? ects, to some extent, the differences in access to ? nancial information. Managers have much more control over the form and content of information they receive. Other users have to rely on what managers are prepared to provide or what the ? nancial reporting regulations require to be provided. Though the scope of ? nancial accounting reports has increased over time, fears concerning loss of competitive advantage and user ignorance concerning the reliability of forecast data have led businesses to resist providing other users with the same detailed and wide-ranging information available to managers. In the past, it has been argued that accounting systems are far too geared to meeting the regulatory requirements of ? nancial accounting to be able to provide the information most helpful to managers. This is to say that ? nancial accounting requirements have been the main priority and management accounting has suffered as a result.

Recent survey evidence suggests, however, that this argument has lost its force. Modern management accounting systems tend to provide managers with information that is relevant to their needs rather than what is

determined by external reporting requirements. Financial reporting cycles, however, retain some influence over management accounting and managers are aware of expectations of external users (see the reference at the end of the chapter). Scope of this book This book is concerned with financial accounting rather than management accounting. In Chapter 2 we begin by introducing the three principal financial statements: the statement of financial position (sometimes known as the balance sheet); the income statement (also called the profit and loss account); and the statement of cash flows.

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These statements are briefly reviewed before we go on to consider the statement of financial position in more detail. We shall see that the statement of financial position provides information concerning the wealth held by a business at a particular point in time and the claims against this wealth. Included in our consideration of the statement of financial position will be an introduction to the conventions of accounting. Conventions are the generally accepted rules that accountants tend to follow when preparing financial statements. Chapter 3 introduces the second of the major financial statements, the income statement. This provides information concerning the wealth created by a business during a period. In this chapter we shall be looking at such issues as how profit is measured, the point in time at which we recognise that a profit has been made and the accounting conventions that apply to this particular statement.

In the UK and throughout much of the industrialised world, the limited company is the major form of business unit. In Chapter 4 we consider the accounting aspects of limited companies. Although there is nothing of

essence that makes the accounting aspects of companies different from other types of private-sector business, there are some points of detail that we need to consider. In Chapter 5 we continue our examination of limited companies and, in particular, consider the framework of rules that must be adhered to when presenting accounting reports to owners and external users.

Chapter 6 deals with the last of the three principal financial statements, the statement of cash flows. This financial statement is important in identifying the financing and investing activities of the business over a period. It sets out how cash was generated and how cash was used during a period. Reading the three statements will provide information about the performance and position of a business. It is possible, however, to gain even more helpful insights about the business by analysing the statements using financial ratios and other techniques. Combining two figures in the financial statements in a ratio and comparing this with a similar ratio for, say, another business, can often tell us much more than just reading the figures themselves. Chapters 7 and 8 are concerned with techniques for analysing financial statements. The typical large business in the UK is a group of companies rather than just a single company. A group of companies will exist where one company controls one or more other companies. In Chapter 9 we shall see why groups exist and consider the accounting issues raised by the combination of companies into groups.

The scope of financial reporting has tended to alter over the years. In Chapter 10 we shall consider where financial reporting has come from and

how it seems to be developing. Finally, in Chapter 11, we shall consider the way in which larger businesses are managed and how directors and other senior managers are accountable to the owners and to other groups with an interest in the business. Has accounting become too interesting? In recent years, accounting has become front-page news and has been a major talking point among those connected with the world of business.

Unfortunately, the attention that accounting has attracted has been for all the wrong reasons. We have seen that investors rely on financial reports to help to keep an eye both on their investment and on the performance of the managers. What, though, if the managers provide misleading financial reports to investors? Recent revelations suggest that the managers of some large businesses have been doing just this. HAS ACCOUNTING BECOME TOO INTERESTING? Two of the most notorious cases have been those of: Enron, an energy-trading business based in Texas, which was accused of entering into complicated financial arrangements in an attempt to obscure losses and to inflate profits; and WorldCom, a major long-distance telephone operator in the US, which was accused of reclassifying \$3.9 billion of expenses so as to falsely inflate the profit figures that the business reported to its owners (shareholders) and to others. In the wake of these scandals, there was much closer scrutiny by investment analysts and investors of the financial reports that businesses produce. This led to further businesses, in both the US and Europe, being accused of using dubious accounting practices to bolster reported profits.



Accounting scandals can have a profound effect on all those connected with the business. The Enron scandal, for example, ultimately led to the collapse of the company, which, in turn, resulted in lost jobs and large financial losses for lenders, suppliers and investors. Confidence in the world of business can be badly shaken by such events and this can pose problems for society as a whole. Not surprisingly, therefore, the relevant authorities tend to be severe on those who perpetrate such scandals. In the US, Bernie Ebbers, the former chief executive of WorldCom, received 25 years in prison for his part in the fraud.

Various reasons have been put forward to explain this spate of scandals. Some may have been caused by the pressures on managers to meet unrealistic expectations of investors for continually rising profits, others by the greed of unscrupulous executives whose pay is linked to financial performance. However, they may all reflect a particular economic environment. Real World 1.2 gives some comments suggesting that when all appears to be going well with a business, people can be quite gullible and over-trusting. Real World 1.2 The thoughts of Warren Buffett

Warren Buffett is one of the world's shrewdest and most successful investors. He believes that the accounting scandals mentioned above were perpetrated during the 'new economy boom' of the late 1990s when confidence was high and exaggerated predictions were being made concerning the future. He states that during that period You had an erosion of accounting standards. You had an erosion, to some extent, of executive

behaviour. But during a period when everybody 'believes', people who are inclined to take advantage of other people can get away with a lot.

He believes that the worst is now over and that the 'dirty laundry' created during this heady period is being washed away and that the washing machine is now in the 'rinse cycle'. Source: The Times, Business Section, 26 September 2002, p. 25. nisyndication.com. Whatever the causes, the result of these accounting scandals has been to undermine the credibility of financial statements and to introduce much stricter regulations concerning the quality of financial information. We shall return to this issue in later chapters when we consider the financial statements. 15 16 CHAPTER 1

INTRODUCTION TO ACCOUNTING The changing face of accounting Over the past 25 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 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; 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 framework and principles upon which to base financial accounting reports. Various attempts have been made to clarify the purpose of financial accounting reports and to provide a more solid foundation for the development of accounting rules. The frameworks and principles that have been developed try to address fundamental questions such as: Who are the users of financial accounting information? What kinds of financial accounting reports should be prepared and what should they contain? How should items (such as profit and asset values) be measured? In response to criticisms that the financial reports of some businesses are not clear enough to users, accounting rule makers have tried to improve reporting rules to ensure that the accounting policies of businesses are more comparable and more transparent, and that they portray economic reality more faithfully. While this has had a generally beneficial effect, the recent accounting scandals have highlighted the limitations of accounting rules in protecting investors and others. The internationalisation of businesses has created a need for accounting rules to have an international reach. It can no longer be assumed that users of accounting information relating to a particular business are based in the country in which the business operates or are familiar with the accounting rules of that country.

Thus, there has been increasing harmonisation of accounting rules across national frontiers. A more detailed review of these developments is included in Chapter 5. 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 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. WHAT KINDS OF BUSINESS OWNERSHIP EXIST? 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. What kinds of business ownership exist? The particular form of business ownership has important implications for accounting purposes and so it is useful to be clear about the main forms of ownership that can arise. There are basically three arrangements: sole proprietorship; partnership; and limited company. Each of these is considered below. 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 in terms of size (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 industrial 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 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). 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 to satisfy the taxation authorities, there is no legal requirement to produce accounting information relating to the business for other user groups. However, some user groups may demand accounting information about the business and may be in a position to have their demands met (for example, a bank requiring accounting information on a regular basis as a condition of a loan). The sole proprietor will have unlimited liability which means that no distinction will be made between the proprietor's personal wealth and that of the business if there are business debts that must be paid.

Partnership ? A partnership exists where at least two 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 large). Partnerships 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. 17 18 CHAPTER 1 INTRODUCTION TO ACCOUNTING

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. 8 What

are the main advantages and disadvantages that should be considered when deciding between a sole proprietorship and a partnership? 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); 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; the

limits placed on individual decision making that a partnership will impose.

Limited company ? Limited companies 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 subscribing capital to the company are liable only for debts incurred by the company up to the amount that they have 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. The benefit of limited liability, however, imposes certain obligations on such companies. To start up 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. All of the large household-name UK businesses (Marks and Spencer, Tesco, Shell, BSkyB, BA, BT, easyJet and so on) are limited companies. Limited companies are considered in more detail in Chapters 4 and 5. HOW ARE BUSINESSES ORGANISED? Activity 1. 9 What are the main advantages and disadvantages that should be considered when deciding between a partnership business and a limited liability company?

The main advantages of a partnership over a limited company 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; freedom from administrative burdens imposed by law (for example, the annual general meeting and the need for an independent audit). The main disadvantage of a partnership compared with a limited company is the fact that it is not possible to limit the liability of all of the partners.

This book concentrates on the accounting aspects of limited liability companies because this type of business is 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. It must be emphasised that there are



no differences in the way that these three forms of business keep their day-to-day accounting records.

In preparing their periodic financial statements, there are certain differences that need to be considered. These differences are not ones of principle, however, but of detail. How are businesses organised? As we have just seen, nearly all businesses that involve more than a few owners and/or employees are set up as limited companies. This means that the 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 owners 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 and from suppliers of goods and services being prepared to supply on credit, with payment occurring a month or so after the date of supply, usually on an interest-free basis. In larger limited companies, the owners (shareholders) are not 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: setting the overall direction and strategy for the business; monitoring and controlling its activities; and communicating with owners and others connected with the business. Each board has a chairman, 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), or managing director, who is responsible for running the business on a day-to-day basis. Occasionally, the roles of chairman 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. We shall come back to consider the relationship between directors and shareholders in more detail in Chapter 4. 19 20 CHAPTER 1 INTRODUCTION TO ACCOUNTING The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager given responsibility for a particular part of the business's operations. What is the financial objective of a business? A business is created 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 there are other objectives that a business may pursue that are related to the needs of others associated with the business. For example, a business may seek to provide good working conditions for its employees, or it may seek to conserve the environment for the local community. While a business may pursue these objectives, it is normally set up 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.

Real World 1. 3 reveals how one well-known business has changed its focus in order to improve profitability. Real World 1. 3 Profiting from change It speaks volumes for the work done by Kate Swann in turning around W H Smith that when she became chief executive five years ago, the company was being spoken of in similar terms to Woolworths. Comments such as ' You wouldn't invent it if you were starting out today' and ' What is it actually for these days? ' were typical among analysts, as they were with Woolies.

Indeed, many thought that W H Smith was beyond help and argued that the supermarkets were eating away at sales. Ms Swann has defied the sceptics, achieving an impressive turnaround. The company's magazine and newspaper distribution division was hived off as a separate entity and new outlets were opened at airports and railway stations – so much so that sales by W H Smith's travel unit now threaten to overtake those of its traditional high street stores. Lower-[profit-]margin lines, such as CDs and DVDs, have been cleared from the shelves to make way for higher-margin items, such as stationery.

The last plank of the strategy was in evidence again in yesterday's update, in which Ms Swann reported that sales in the nine weeks to January 17 were down by 7 per cent in the high street stores and by 2 per cent in the travel stores, partly because W H Smith is continuing to reduce its exposure to the entertainment category. That was the bad news. The good news was that, although sales overall were down, the reduced focus on entertainment was good for profits. W H Smith made an extra 2p of profit in every ? 1 of sales, compared with the same period a year earlier, a stunning achievement given the deflation hitting the high street.

Source: ' Business big shot', Ian King, The Times, 27 January 2009, p. 39. nisyndication. com. 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. WHAT IS THE FINANCIAL OBJECTIVE OF A BUSINESS?

Does this mean that the needs of other groups associated with the business (employees, customers, suppliers, the community and so on) are not really important? The answer to this question is certainly no, if the business wishes to survive and prosper over the longer term. Satisfying the needs of other groups will normally be consistent with increasing the wealth of the owners over the longer term. The importance of customers to a business cannot be overstated. Dissatisfied customers will take their business to another supplier and this will, in turn, lead to a loss of wealth for the owners of the business losing the customers.

Real World 1. 4 provides an illustration of the way in which one business acknowledges the link between customer satisfaction and creating wealth for its owners. Real World 1. 4 Checking out Sainsbury's objectives J Sainsbury plc is a leading food retailer that recognises the importance of customers to increasing the wealth of the owners (shareholders) as follows: Our objective is to serve customers well and thereby provide shareholders with good, sustainable financial returns. Source: Investor FAQs, [www. j-sainsbury. co. uk](http://www.j-sainsbury.co.uk), 8 January 2009, p. 1. A dissatisfied workforce may result in low productivity, strikes and so forth, which will in turn have an adverse effect on owners' wealth. Similarly, a business that upsets the local community by unacceptable behaviour, such as polluting the environment, may attract bad publicity, resulting in a loss of customers and heavy ? nes. Real World 1. 5

provides an example of how two businesses responded to potentially damaging allegations. Real World 1. 5 The price of clothes FT US clothing and sportswear manufacturers Gap and Nike have many of their clothes produced in Asia where labour tends to be cheap.

However, some of the contractors that produce clothes on behalf of the two companies have been accused of unacceptable practices. Campaigners visited the factories and came up with damaging allegations. The factories were employing minors, they said, and managers were harassing female employees. Nike and Gap reacted by allowing independent inspectors into the factories. They promised to ensure their contractors obeyed minimum standards of employment. Earlier this year, Nike took the extraordinary step of publishing the names and addresses of all its contractors' factories on the internet.

The company said it could not be sure all the abuse had stopped. It said that if campaigners visited its contractors' factories and found examples of continued malpractice, it would take action. Nike and Gap said the approach made business sense. They needed society's approval if they were to prosper. Nike said it was concerned about the reaction of potential US recruits to the campaigners' allegations. They would not want to work for a company that was constantly in the news because of the allegedly cruel treatment of those who made its products. Source: ' Fair shares? ', Michael Skapinker, Financial Times, 11 June 2005. 21 22 CHAPTER 1 INTRODUCTION TO ACCOUNTING It is important to recognise that generating wealth for the owners is not the same as seeking to maximise the current year's pro? t.

Wealth creation is a longer-term concept, which 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 1.6 gives some examples of how emphasis on short-term profit can be damaging. Real World 1.6 Short-term gains, long-term problems

FT Human beings are bad at learning and changing. It takes a good crisis to drive home what may have been staring us in the face. So what in particular are the lessons for all those concerned with saving, investment, borrowing and lending? 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 b