

Introduction to accounting and finance

Introduction

In this opening chapter we begin by considering the roles of accounting and finance. As we shall see, both can be valuable tools for decision making. We shall identify those people who are the main users of accounting and financial information and discuss the ways in which this information can improve the quality of decisions that they make. In subsequent chapters, we develop this decision-making theme by considering 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, therefore, 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.
- Explain the purpose of a business and describe how businesses are organised and structured.

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What are accounting and finance?

Let us begin our study of accounting and finance by trying to understand the purpose of each of them. **Accounting** is concerned with collecting, analysing and communicating financial information. This information is useful for those people who need to make decisions and plans about businesses, including those who need to control those businesses. For example, the managers of businesses may need accounting information to decide whether to:

- develop new products or services (such as a computer manufacturer developing a new range of computers);
- increase or decrease the price or quantity of existing products or services (such as a telecommunications business changing its mobile phone call and text charges);
- borrow money to help finance the business (such as a supermarket wishing to increase the number of stores it owns);
- increase or decrease the operating capacity of the business (such as a beef-farming business reviewing the size of its herd); and
- change the methods of purchasing, production or distribution (such as a clothes retailer switching from UK to overseas suppliers).

The information provided should help in identifying and assessing the financial consequences of such decisions.

Though managers working within a business are likely to be significant users of accounting information about that particular business, they are by no means the only users. There are those outside the business (whom we shall identify later) who may need information to decide whether to:

- invest or disinvest in the ownership of the business (for example, buy or sell shares);
- lend money to the business;
- offer credit facilities (for example, a bank to grant an overdraft); and
- enter into contracts for the purchase of products or services.

Sometimes the impression is given that the purpose of accounting is simply to prepare financial reports on a regular basis. While it is true that accountants undertake this kind of work, the preparation of financial reports does not represent an end in itself. The ultimate purpose of the accountant's work is to give people better information on which to base their decisions. This decision-making perspective of accounting dictates 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 a 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 (equipment, premises, inventories and so on) in an attempt to make the business, and its owners, wealthier. It is important that funds are raised in a way that is appropriate to the particular needs of the business, and an understanding of finance should help in identifying:

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

Once the funds are raised, they must be invested in ways that will provide the business with a worthwhile return. An understanding of finance should help in evaluating:

- the returns from an investment; and
- the risks associated with an investment.

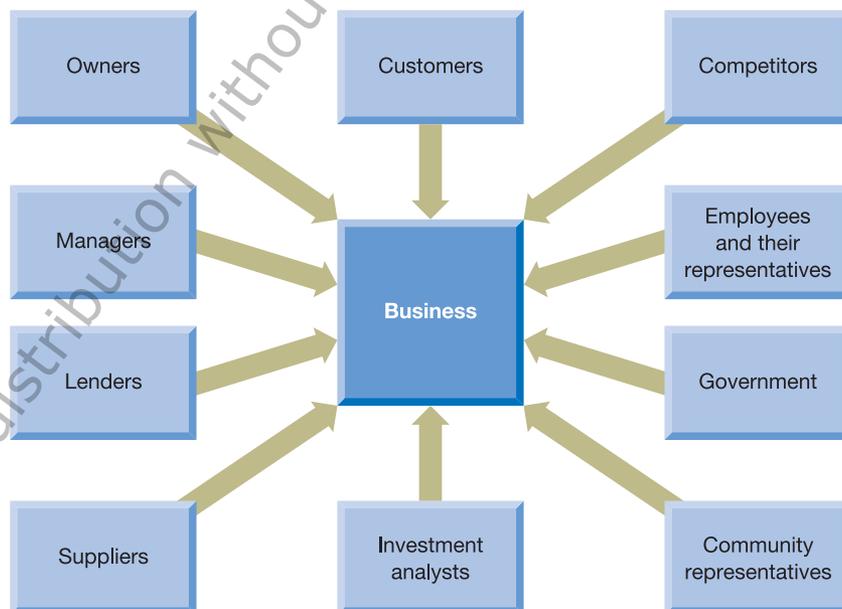
Businesses often raise and invest funds in large amounts for long periods of time. The quality of the financing and investment decisions made can, therefore, have a profound impact on the fortunes of the business.

In this book, we shall not emphasise the distinctions between accounting and finance as there is little point in doing so. We have already seen that both are concerned with the financial aspects of decision making and there are many interconnections. For example, accounting reports are a major source of information for financing and investment decision making.

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:

<i>User group</i>	<i>Decision</i>
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 representatives	Whether to allow PI to expand its premises and/or whether to provide 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 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 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.

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;
- government 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 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.

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;
- radio and TV reports;
- information-gathering agencies (for example, agencies that assess businesses' credit-worthiness 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 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 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 accounting 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 benefits which flow as a result cannot be accurately assessed. 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. This point is considered in the following section.

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 the 'clients', and the accounting information produced can be seen as the service provided. The value of this service to the various 'clients' can be judged according to whether the accounting information meets their needs.

To be useful to users, the information provided must possess certain qualities. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. These two qualities, which are regarded as fundamental qualities, are described below.

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

To be relevant, accounting information must cross a threshold of **materiality**. A key question to be asked is whether its omission or misrepresentation would alter the decisions that users make. If the answer is no, the information is not material. This means that it should not be included within accounting reports as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret them. The threshold of materiality will vary from one business to the next. What is material for one business may not be material to another. To identify the threshold, the nature of the information and the amounts involved must be considered within the context of the accounting reports of the particular business.

- **Faithful representation.** Accounting information should be capable of being relied upon to represent what it is supposed to represent. This means that it should be *complete*, that is it provides all of the information needed to understand what is being portrayed. It should also be *neutral*, which is achieved by selecting and presenting the information provided without bias. Finally, it should be *free from error*, as a result of eliminating errors and omissions in the way in which information has

been selected and described. This last point does not mean that information must always be perfectly accurate; this is not really possible. Estimates may have to be made which eventually turn out to be inaccurate. It does mean, however, that there should be no errors in the way in which these estimates have been prepared and described.

Activity 1.4

Do you think it is really feasible for all accounting information to reflect perfectly these three aspects of faithful representation (complete, neutral and free from error)?

The answer is almost certainly no. Rather, the aim should be to strive, as far as possible, towards these three aspects in the accounting information provided.

Note that 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, but which 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 considered below.

- **Comparability.** This quality helps users to identify similarities and differences between items of information. It may help them, for example, to identify changes in the business over time (such as, the trend in sales revenue over the past five years). It may also help them to evaluate the performance of the business in relation to similar businesses. Comparability is enhanced by treating items that are basically the same in the same manner for accounting purposes. It is also enhanced by making clear the policies that have been adopted in measuring and presenting the information.
- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.
- **Timeliness.** Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later accounting information is produced, the less useful it becomes.
- **Understandability.** Accounting information should be set out as clearly and concisely as possible. It should also 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. 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.

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.

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 a piece of accounting information may have all the qualities described, it does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.6.

Activity 1.6

Suppose an item of accounting information, if produced, would have all the qualities mentioned above. Can you think of a reason why, in practice, you might choose not to produce it?

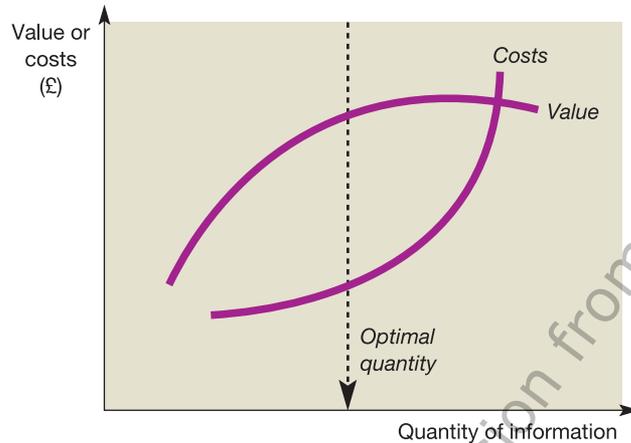
You may decide not to produce, or discover, the information if you judge the cost of doing so to be greater than the potential benefit of having the information. This cost-benefit issue will limit the extent to which accounting information is provided.

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.

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,

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.

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 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 £350 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 £350?

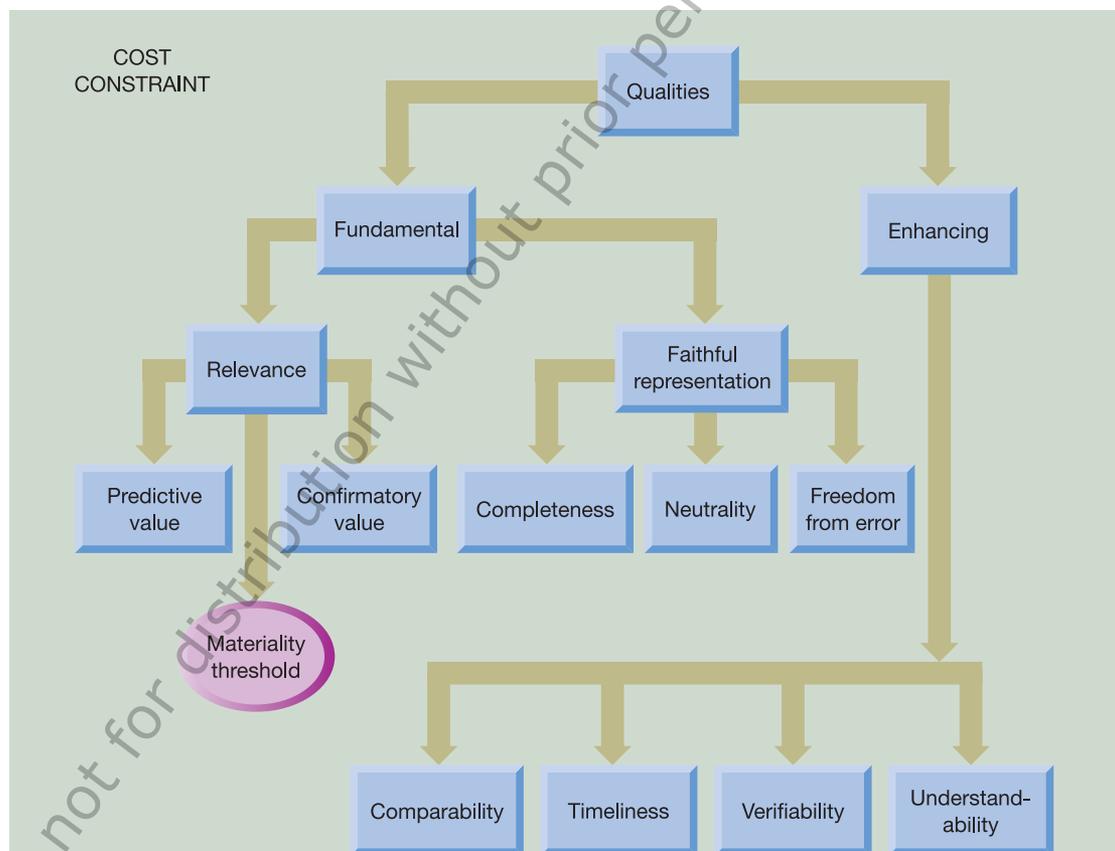
As we can imagine, the answers to these questions may be far from clear – remember that we have only contacted the local garage so far. When assessing the value of accounting information we are confronted with similar problems.

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 the key characteristics should be produced, irrespective of the cost of producing it.

The qualities and constraints discussed in this section and the preceding section 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

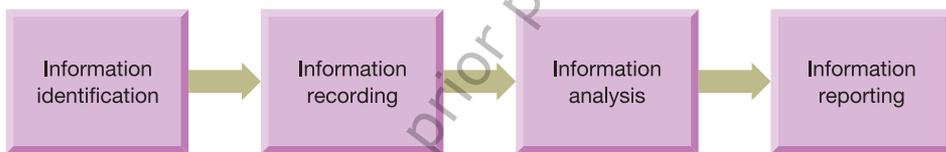
We have already seen that accounting can be seen as the provision of a service to 'clients'. Another way of viewing accounting is as a part of the business's total information system. Users, both inside and outside the business, have to make decisions concerning the allocation of scarce economic resources. 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 1.4.

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 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

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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 £1.3bn – 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.

Financial accounting and management accounting

Accounting is usually seen as having two distinct strands. These are:

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

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.

- 1 *Nature of the reports produced.* Financial accounting reports tend to be general purpose, that is, they contain financial information that will be useful for a broad range of users and decisions rather than being specifically designed for the needs of a particular group or set of decisions. 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.
- 2 *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.
- 3 *Regulations.* Financial accounting reports, for many businesses, are subject to accounting regulations that try to ensure that 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.

- 4 *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).
- 5 *Time orientation.* Financial accounting reports reflect the performance and position of the business for a 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.
- 6 *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.

We can see from this that financial accounting is more constrained than management accounting. Management accounting 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 differences between the two strands of accounting are summarised in Figure 1.5.

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.

Figure 1.5 Management and financial accounting compared

	Management accounting	Financial accounting
<i>Nature of the reports produced</i>	Tend to be specific purpose	Tend to be general purpose
<i>Level of detail</i>	Often very detailed	Usually broad overview
<i>Regulations</i>	Unregulated	Usually subject to accounting regulation
<i>Reporting interval</i>	As short as required by managers	Usually annual or bi-annual
<i>Time horizon</i>	Often based on projected future information as well as past information	Almost always historical
<i>Range and quality of information</i>	Tend to contain financial and non-financial information, often use information that cannot be verified	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 distinction between the two areas of accounting reflects, to some extent, the differences in access to financial 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 financial reporting regulations require must be provided. Though the scope of financial 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 biased in favour of providing information for external users. Financial 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 will 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 1 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 part 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.

Has accounting become too interesting?

Over recent decades, 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? The evidence suggests that the managers of some large businesses have been doing just this.

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 a 25-year prison sentence 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 there had been a combination of weak accounting standards and questionable behaviour by some senior managers. When investors' confidence is high, those who are tempted to take advantage of others are able to do so.

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.

The changing face of accounting

Over the past 30 years, the environment within which businesses operate has become increasingly turbulent and competitive. Various reasons have been identified to explain these changes, including:

- increasingly sophisticated and demanding 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 accounting scandals of recent decades 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 has its base 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.

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. These changes are considered in more detail in Chapter 11.

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; or
- sell particular products.

Such 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 important aspects of accounting and finance. These aspects include:

- how financial reports should be read and interpreted;
- how financial plans are made;

- how investment decisions are made;
- how businesses are financed.

Many, perhaps most, students have a career goal of being a manager within a business – perhaps a personnel 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, it is likely that you will be expected to help in forward planning for the business. This will often involve the preparation of projected financial statements and setting of financial targets. If you do not understand what the financial statements really mean and the extent to which the financial information is reliable, you will find yourself at a distinct disadvantage to others who know their way round the system. Along with other managers, you will also be expected to help decide how the limited resources available to the business should be allocated between competing options. This will require an ability to evaluate the costs and benefits of the different options available. Once again, an understanding of accounting and finance is important to carrying out this management task.

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

Accounting for business

We have seen that the needs of the various user groups will determine the kind of accounting information to be provided; however, the forms of business ownership and the ways in which a business may be organised and structured will help to shape those needs. Thus, in the sections that follow, we consider the business environment within which accounting information is produced. A discussion of these topics 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 2 at the end of the chapter). Drucker defined the purpose of a business in this way in 1967, at a time when most businesses did not adopt this strong customer focus. His view therefore represented a radical challenge to the accepted view of what businesses do. Forty-five 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. Today, 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 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 1.3 discusses how this mantra applies to business schools offering programmes for business executives.

Real World 1.3

The customer is king

FT

For corporations, there is just one message to come out of the recession about business school executive development programmes: it is a buyers' market where the customer is king. And for most business schools, there is also only a single message: rethink your business model if you want to survive.

Customer responsiveness, total quality management and global sensitivity – all topics on which business professors can expound at length – now have to be part of what business schools practise as well as what they preach. Gone are the days when a business school could run a course because it had a professor who understood the subject; customer need has now become paramount.

With both training companies and management consultancies encroaching on the patch of the traditional business education providers, schools have seen two to three years of painful decline in revenues from executive education programmes. Now they hope that business is returning.

Where business is returning, demand has clearly changed. Companies – which pay on average \$1,000 per person per day for business school programmes – are putting themselves squarely in the driving seat in the design and delivery of programmes. They are demanding the kinds of performance measures that inform other aspects of their businesses.

Business schools have talked for years about the best ways of measuring corporate return on investment for short business school programmes, and concluded that it could not really be appraised. Now some companies have decided to impose their own measurement systems, and are withholding payment for programmes until they are convinced that they have been successful.

Corporate clients are also less likely to fly their managers to overseas business schools, now requiring the professors to travel instead. In both open-enrolment and customised programmes, the schools that are proving their worth are those that are prepared to take the programmes to the clients. Even Harvard Business School, the doyen of the industry, now teaches programmes in China and India.

Technology is also much in demand, to save time and money. 'Money is an issue,' says Prof Valor (IESE Business School) 'But time is money, too.' Companies are increasingly replacing elements of classroom programmes with internet-based sessions – web seminars and online study groups or learning tools.

Source: Extracts from 'Business School Strategy: customer becomes king', D. Bradshaw, 9 May 2011, FT.com.

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.

We shall now consider these.

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. 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 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.

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, though many are quite small. 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. Limited companies are considered in more detail in Chapters 4 and 5.

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

Activity 1.9

What are the main advantages of forming a partnership business rather than a limited liability company?

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;
- 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 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 is different in so far as the LLP is responsible for any debts incurred, rather than the individual partners. This type of partnership is often used by accountants and solicitors.

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?

Nearly all 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, 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) 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 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) (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.

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 1.10

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

Three common reasons are:

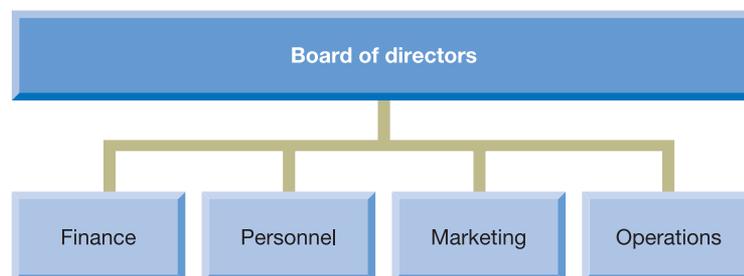
- The sheer volume of activity or number of staff employed makes it impossible for one person to manage them.
- Certain business operations may require specialised knowledge or expertise.
- Geographical remoteness of part of the business operations may make it more practical to manage each location as 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, personnel 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 the figure may be adapted according to the particular needs of the business. Where, for example, a business has few employees, the personnel 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

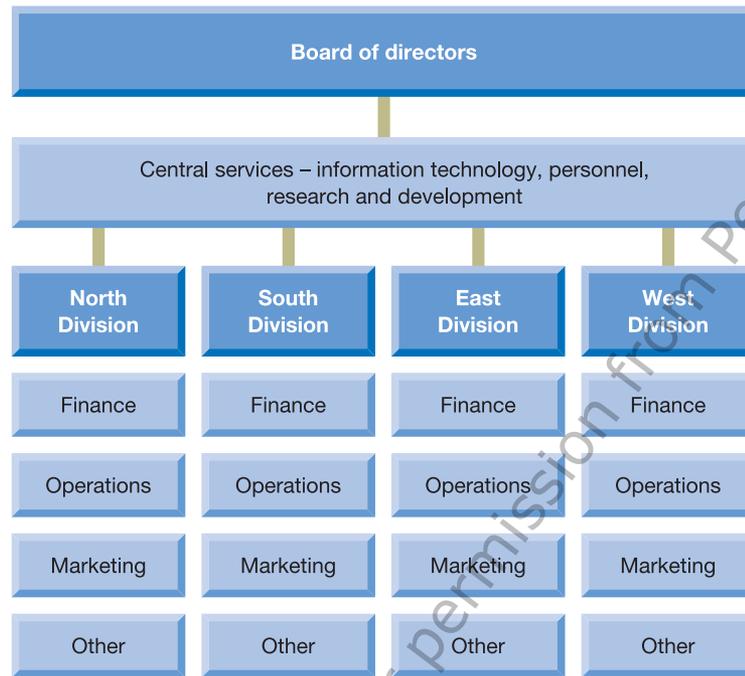
Supercoach Ltd owns a small fleet of coaches that it hires out with drivers for private group travel. The business employs about 50 people. It might be departmentalised as follows:

- *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 personnel 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, borrowing, use of surplus funds, payment of wages and salaries, billing and collecting charges to customers, processing invoices from suppliers and paying 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 personnel, 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.

Once a particular divisional structure has been established, it need not be permanent. Successful businesses are likely to be innovative and looking to improve their operations. This may well extend to revising their divisional structure. Take for example the business whose structure is depicted in Figure 1.7. At some stage, senior management may conclude that the needs of customers and/or operational efficiency would be better served by having a structure that was based on product lines rather than on geography. This might lead to it reorganising into a structure with a separate division for each product, irrespective of where production takes place or where customers are based.

Figure 1.7 A divisional organisational structure

This is a typical organisational structure for a business that has been divided into separate operating divisions.

Real World 1.4 provides an example of a reorganisation at a well-known international financial services provider. In this case, the business moved from a divisional structure based on product lines to one based on geography.

Real World 1.4

Banking on a reorganisation

FT

Citigroup Inc., a financial services organisation (Citibank etc.) based in New York, reorganised its Asia-Pacific operation in an attempt to refocus on providing a better service to its customers. The operation is now managed as four geographical divisions: Japan, North Asia, South Asia and Southeast Asia. The operation had previously been organised along product lines, from New York.

Asia-Pacific accounts for about 20 per cent of Citigroup's income.

Source: Information taken from, 'Pandit shake-up shifts responsibility to regional heads', S. Tucker, *Financial Times*, 19 August 2008.

Both the divisional structure and departmental structure just described appear to be widely used, although other organisational structures may be found in practice.

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 seeks to provide a business with a clear sense of purpose and to ensure that appropriate action is taken to achieve that purpose. The action taken should link the internal resources of the business to the external environment of 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 is an example of a threat. This topic will be considered in more depth in Chapter 12 when we consider business planning and budgeting.

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.

Within a market economy there are strong competitive forces at work to ensure that failure to enhance shareholder wealth will not be tolerated for long. Competition for the funds provided by shareholders and competition for managers' jobs will normally mean that shareholders' interests will prevail. If the managers do not provide the expected increase in shareholder wealth, the shareholders have the power to replace the existing management team with a new team that is more responsive to shareholders' needs. 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 is usually consistent with increasing the wealth of the owners over the longer term. A business with disaffected customers, for example, may find that they turn to another supplier, resulting in a loss of shareholder wealth. **Real World 1.5** reveals how satisfying customer needs in order to increase shareholder wealth is regarded by some businesses as their central purpose.

Real World 1.5

Cleaning up for the shareholders

Reckitt Benckiser Group plc makes a number of household, health and personal care products including Vanish, Dettol, Air Wick and Nurofen. In its 2010 annual report the business stated:

Reckitt Benckiser's vision is to deliver better consumer solutions in household cleaning and health and personal care for the ultimate purpose of creating shareholder value.

On a mission

Elektron Technology plc, which operates in the fast-moving engineered products sector, states:

Our mission is to deliver a highly competitive return to shareholders by using our technologies to create innovative solutions for our customers.

Sources: Reckitt and Benckiser Group plc, Annual Report 2010, p.4, and Elektron Technology plc, www.elektron-technology.com, Accessed 21 August 2011.

A dissatisfied workforce may result in low productivity, strikes and so forth, which will in turn have an adverse effect on shareholders' wealth. Similarly, a business that upsets the local community by polluting the environment may attract bad publicity, resulting in a loss of customers, and heavy fines. **Real World 1.6** provides an example of how two businesses responded to potentially damaging allegations.

Real World 1.6

The price of clothes

FT

US clothing and sportswear manufacturers Gap and Nike have much 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, FT.com, 11 June 2005.

It is important to recognise that generating wealth for the owners is not the same as seeking to maximise the current year's profit. 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 1.7 provides some examples of how emphasis on short-term profit can be damaging.

Real World 1.7

Short-term gains, long-term problems

FT

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 were 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 30 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. Now we are paying the price in trillions of dollars for that imprudent attitude.

One senior investment banker whose business has survived the crisis in good shape recently confirmed this analysis to me. Again and again new product ideas had been put in front of him, without any prior thought about their ethical content.

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.



Real World 1.7 (continued)

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.

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

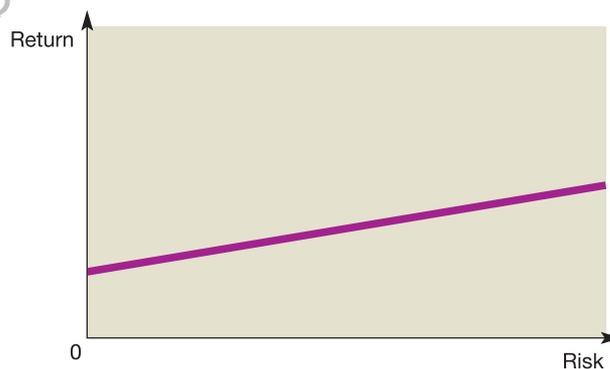
Though enhancing the wealth of the owners may not be a perfect description of what businesses seek to achieve, it is certainly something that businesses cannot ignore for the reasons mentioned. For the remainder of this book enhancement/maximisation of shareholders' (owners') wealth is treated as the key financial objective against which decisions will be assessed. There will usually be other non-financial/non-economic factors that will also tend to bear on decisions. The final decision may well involve some compromise.

Balancing risk and return

All decision making involves the future. We can only make decisions about the future; no matter how much we may regret it, we cannot alter the past. Business decision making is no exception to this general rule. There is only one thing certain about the future, which is that we cannot be sure what is going to happen. Sometimes we may be able to predict with confidence that what actually occurs will be one of a limited range of possibilities. We may even feel able to ascribe statistical probabilities to the likelihood of occurrence of each possible outcome, but we can never be completely certain of the future. Risk is therefore an important factor in all financial decision making. It must be considered explicitly in all cases.

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.

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

The recent turmoil in the banking sector has shown, however, that the right balance is not always struck. Some banks have taken excessive risks in pursuit of higher returns and, as a consequence, have incurred massive losses. They are now being kept afloat with taxpayers' money. **Real World 1.8** discusses the collapse of one leading bank, in which the UK government took a majority stake, and argues that the risk appetite of banks must now change.

Real World 1.8

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?

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 'We own Royal Bank', Robert Peston, 28 November 2008, BBC News, www.bbc.co.uk.

Not-for-profit organisations

Though 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. Examples include:

- charities
- clubs and associations
- universities

- local government authorities
- national government departments
- churches
- trade unions.

Such organisations also need to produce accounting information for decision-making purposes. Various user groups need accounting information about these types of organisation to help them to make decisions. These groups are often the same as, or similar to, those identified for private sector businesses. They may have a stake in the future viability of the organisation and may use accounting information to check that the wealth of the organisation is being properly controlled and used in a way that is consistent with its objectives.

Real World 1.9 provides an example of the importance of accounting to relief agencies, which are, of course, not-for-profit organisations.

Real World 1.9

Accounting for disasters

FT

In the aftermath of the Asian tsunami more than £400 million was raised from charitable donations. It was important that this huge amount of money for aid and reconstruction was used as efficiently and effectively as possible. That did not just mean medical staff and engineers. It also meant accountants.

The charity that exerts financial control over aid donations is Mango: Management Accounting for Non-Governmental Organisations (NGOs). It provides accountants in the field and it provides the back up, such as financial training and all the other services that should result in really robust financial management in a disaster area.

The world of aid has changed completely as a result of the tsunami. According to Mango's director, Alex Jacobs, 'Accounting is just as important as blankets. Agencies have been aware of this for years. But when you move on to a bigger scale there is more pressure to show the donations are being used appropriately.'

More recently, the earthquake in Haiti led to a call from Mango for French-speaking accountants to help support the relief programme and to help in the longer-term rebuilding of Haiti.

Source: Adapted from 'Tsunami: finding the right figures for disaster relief', Robert Bruce, FT.com, 7 March 2005, and 'The work of Mango: Coping with generous donations', Robert Bruce, FT.com, 27 February 2006. 'Accountants needed in Haiti', Paul Grant, *Accountancy Age*, 5 February 2010.

Summary

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

What are accounting and finance?

- Accounting provides financial information for a range of users to help them make better judgements and decisions concerning a business.
- 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, there must be a clear understanding of *for whom* and *for what purpose* the information will be used.
- There may be conflicts of interest between users over the ways in which the wealth of a business is generated or distributed.
- There is evidence to suggest 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 required by the various users.
- To provide a useful service, accounting must possess certain qualities, or characteristics. These are relevance, faithful representation, comparability, verifiability and understandability. In addition, accounting information must be material.
- Providing a service to users can be costly, and financial information should be produced only if the cost of providing the information is less than the benefits gained.

Accounting information

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

Management 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 the other user groups.
- These two strands differ in terms of the types of reports produced, the level of reporting detail, the time horizon, the degree of standardisation and the range and quality of information provided.

Is accounting too interesting?

- In recent years, there has been a wave of accounting scandals in the US and Europe.
- This appears to reflect a particular economic environment, although other factors may also play a part.

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.

Why study accounting?

- Everyone connected with business should be a little 'streetwise' about accounting and finance. Financial information and decisions exert an enormous influence over the ways in which a business operates.

What is the purpose of a business?

- To create and keep a customer.

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.
- 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.

What is the financial objective of a business?

- A business may pursue a variety of objectives but the main objective for virtually all businesses is to enhance the wealth of its owners. This does not mean, however, that the needs of other groups connected with the business, such as employees, should be ignored.
- When setting financial objectives the right balance must be struck between risk and return.

MyAccountingLab

Go to www.myaccountinglab.com to check your understanding of the chapter, create a personalised study plan, and maximise your revision time

Key terms

accounting p. 2	timeliness p. 8
finance p. 2	understandability p. 8
financial management p. 2	accounting information system p. 12
shares p. 6	financial accounting p. 13
relevance p. 7	management accounting p. 13
materiality p. 7	sole proprietorship p. 21
faithful representation p. 7	partnership p. 21
comparability p. 8	limited company p. 22
verifiability p. 8	strategic management p. 27

References

- 1 Dugdale D., Jones C. and Green S., *Contemporary Management Accounting Practices in UK Manufacturing*, CIMA Research Publication, vol. 1, no. 13, 2005.
- 2 Drucker P., *Effective Executive*, Heinemann, 1967.

Further reading

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

- Drury, C., *Management and Cost Accounting*, 8th edn, Cengage Learning, 2012, chapter 1.
- Elliott, B. and Elliott, J., *Financial Accounting and Reporting*, 14th edn, Financial Times Prentice Hall, 2011, chapter 7.
- Horngren, C., Foster, G., Datar, S., Rajan, M. and Ittner, C., *Cost Accounting: A Managerial Emphasis*, 13th edn, Pearson International, 2010, chapter 1.
- McLaney, E., *Business Finance: Theory and Practice*, 9th edn, Financial Times Prentice Hall, 2012, chapters 1 and 2.
- Riahi-Belkaoui, A., *Accounting Theory*, 5th edn, Thomson Learning, 2004, chapters 1, 2 and 6.



Review questions

Solutions to these questions can be found at the back of the book on pages 745–6.

- 1.1** What is the purpose of producing accounting information?
- 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** Management accounting has been described as ‘the eyes and ears of management’. What do you think this expression means?
- 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?

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