CHAPTER 1

Introduction to accounting and finance

Introduction

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

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

Learning outcomes

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

- explain the nature and roles of accounting and finance;
- identify the main users of financial information and discuss their needs;
- identify and discuss the characteristics that make accounting information useful; and
- explain the purpose of a business and describe how businesses are organised and structured.

What are accounting and finance?

Let us start by trying to understand the purpose of each. **Accounting** is concerned with *collecting, analysing* and *communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. If the financial information that is communicated were not capable of improving the quality of decisions made, there would be no point in producing it. We shall see who uses financial information, and for what kind of decisions it is useful, a little later in this chapter.

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

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

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

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

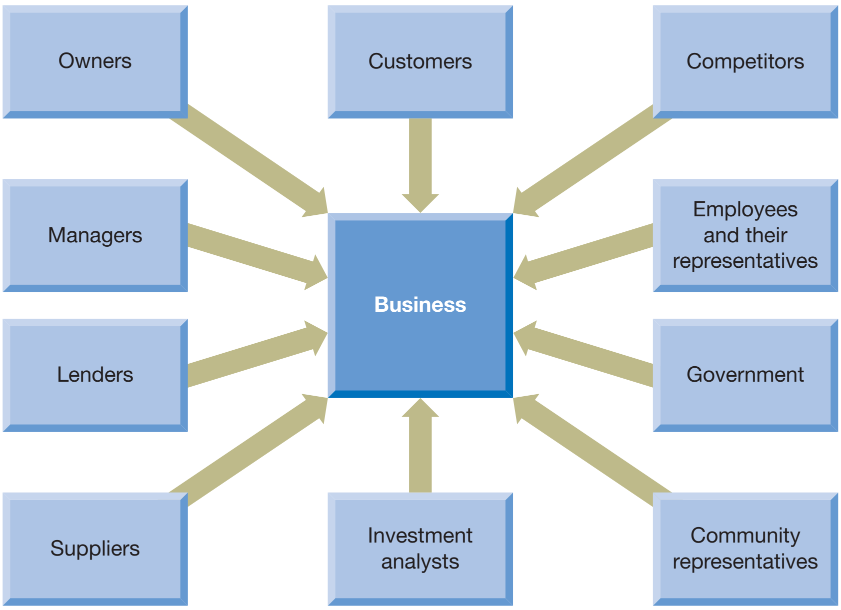
Once the funds are raised, they must be invested in a way that will provide the business with a worthwhile return. An understanding of finance should also help in evaluating the risks and returns associated with an investment.

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

Who are the users of accounting information?

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

Figure 1.1 Main users of financial information relating to a business



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

Activity 1.1

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

Your answer may be along the following lines:

User group	*Decision*
Customers	Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet customers' needs, particularly in respect of any insurance claims made.
Competitors	How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This might involve competitors using PI's performance in various respects as a 'benchmark' when evaluating their own performance. They might also try to assess PI's financial strength and to identify significant changes that may signal PI's future actions (for example, raising funds as a prelude to market expansion).

Activity 1.1 *continued*

User group	*Decision*
Employees	Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions.
Government	Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions an assessment of PI's profits, sales revenues and financial strength would be made.
Community representatives	Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making such decisions, PI's ability to continue to provide employment for the community, the extent to which it is likely to use community resources, and its likely willingness to fund environmental improvements are likely to be important considerations.
Investment analysts	Whether to advise clients to invest in PI. This would involve an assessment of the likely risks and future returns associated with PI.
Suppliers	Whether to continue to supply PI 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 consider a change in PI's future direction. This may involve determining whether the business has the flexibility and resources to take on new challenges.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on rewarding senior managers. When making such a decision, the financial performance of the business would normally be considered.

Although this answer covers many of the key points, you may have identified other decisions and/or other factors to be taken into account by each group.

The conflicting interests of users

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

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

Activity 1.2

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

Two possible examples that spring to mind are:

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

You may have thought of other examples.

How useful is accounting information?

No one would seriously claim that accounting information fully meets all of the needs of each of the various user groups. Accounting is still a developing subject and we still have much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained in accounting reports should help users make decisions relating to the business. 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? (Try to think of at least four.) 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; and
- economy-wide reports.

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

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

Evidence on the usefulness of accounting

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

It is normally very difficult to assess the impact of accounting on decision making. One situation arises, however, where the impact of accounting information can be observed and measured. This is where the **shares** (portions of ownership of a business) are traded on a stock exchange. The evidence 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 some of them to make a decision either to buy or to sell shares in the business.

While there is evidence that accounting reports are seen as useful and are used for decision-making purposes, it is impossible to measure just how useful they really are to users. We cannot say with certainty whether the cost of producing these reports represents value for money. Accounting reports will usually represent only one input to a particular decision. The weight attached to them by the decision maker, and the resulting benefits, cannot 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. We shall now consider this point in more detail.

Providing a service

One way of viewing accounting is as a form of service. The user groups identified in Figure 1.1 can be seen as 'clients' and the accounting (financial) information produced can be seen as the service provided. The value of this service can be judged according to whether the users' information needs have been met.

To be useful, the information provided should possess certain qualities, or characteristics. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. These two qualities, **relevance** and **faithful representation,** are regarded as fundamental qualities and are now explained in more detail.

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

  We should bear in mind that accounting information often relies on the use of estimates. These can cover a wide range and may, for example, include estimates of future sales, costs and cash flows. By their very nature, however, estimates contain a degree of uncertainty.

Activity 1.4

Do you think that the use of estimates will weaken the relevance of accounting information provided to users?

Estimates will vary in the degree of uncertainty that they contain. The higher the degree of uncertainty, the less relevant estimates are likely to be.

The point raised by Activity 1.4 does not imply, however, that estimates with a high degree of uncertainty should not be reported. There may be situations where they still provide users with the most relevant information available.

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

Activity 1.5

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

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

Ultimately, what is considered material is a matter of judgement. In making this judgement consideration should be given as to how this information is likely to be used. Where a piece of information is not material, it should not be included within the accounting reports. It will merely clutter them up and, perhaps, interfere with the users' ability to interpret them.

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

  To provide a perfectly faithful representation, the information provided should be *complete.* In other words, it should incorporate everything needed for users to understand what is being portrayed. It should also be *neutral,* which means that the information should be presented and selected without bias. No attempt should be made to manipulate the information is such a way as to influence user attitudes and behaviour. Finally, it should be *free from error.* This is not the same as saying that information must be perfectly accurate; this may not be possible. We saw earlier that accounting information often contains estimates and these may turn out to be inaccurate. Nevertheless, estimates can still be faithfully represented providing they are properly described and prepared. In practice, accounting information may be unable to reflect perfectly these three aspects of faithful representation. It should aim to do so, however, insofar as possible.

Accounting information must contain *both* fundamental qualities if it is to be useful. There is little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, even if it is faithfully represented.

Further qualities

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

- *Comparability*. Users of accounting information often want to make comparisons. They may want to compare performance of the business over time (for example, profit this year compared to last year). They may also want to compare certain *aspects* of business performance to those of similar businesses (such as the level of sales achieved during the year). Better comparisons can be made where the accounting system treats items that are basically the same in the same way and where policies for measuring and presenting accounting information are made clear.
- *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 could reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence, such as an invoice stating the cost of some item of inventories.
- *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 so as to help those users at whom the information is aimed.

Activity 1.6

Do you think that accounting reports should be understandable to those who have not studied accounting?

It would be very helpful if everyone could understand accounting reports. This, however, is unrealistic, as it is not normally possible to express complex financial events and transactions in simple, non-technical terms. Any attempts to do so are likely to provide a distorted picture of reality.

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

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

Weighing up the costs and benefits

Even though a piece of accounting information may have all the qualities described, this does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.7.

Activity 1.7

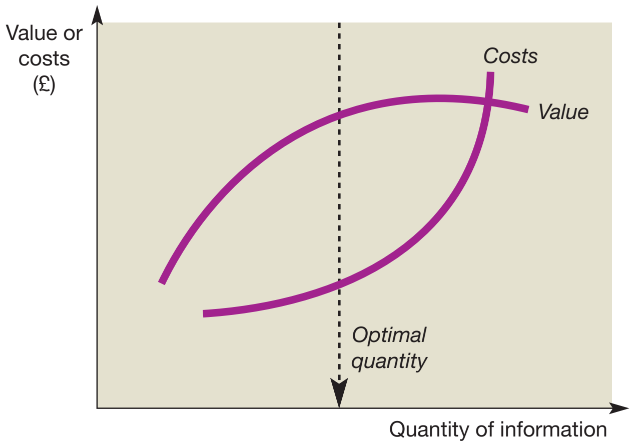
Suppose an item of information is capable of being provided. It is relevant to a particular decision and can be faithfully represented. It is also comparable, verifiable and timely, and can be understood by the decision maker.

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

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

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

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



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

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

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

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

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

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

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

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

Producing accounting information can be very costly. The costs, however, are often difficult to quantify. Direct, out-of-pocket costs, such as salaries of accounting staff, are not usually a problem, but these are only part of the total costs involved. There are other costs such as the cost of users' time spent on analysing and interpreting the information provided.

Activity 1.8

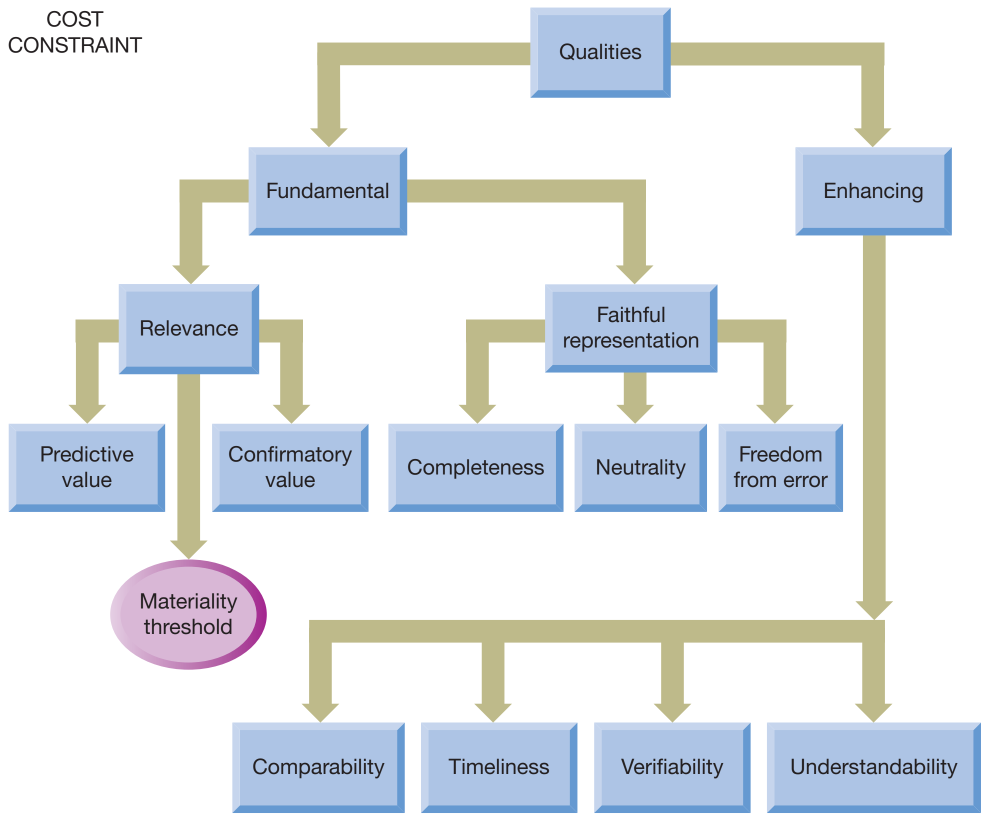
What about the economic benefits of producing accounting information? Do you think it is easier, or harder, to assess the economic benefits of accounting information than to assess the costs of producing it?

It is normally much harder to assess the benefits. We saw earlier that, even if we could accurately measure the economic benefits arising from a particular decision, we must bear in mind that accounting information will be only one factor influencing that decision. Other factors will also be taken into account.

There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some 'science' to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, which we have just discussed, are summarised in Figure 1.3.

Figure 1.3 The qualities that influence the usefulness of accounting information



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

Accounting as an information system

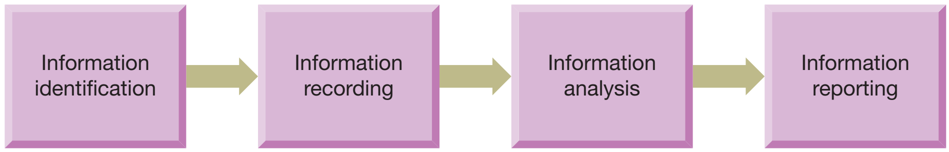
We have already seen that accounting can be seen as the provision of a service to 'clients'. Another way of viewing accounting is as a part of the business's total information system. Users, both inside and outside the business, have to make decisions concerning the allocation of scarce resources. To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

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

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

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

Figure 1.4 The accounting information system



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

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

Efficient accounting information systems are an essential ingredient of an efficient business. When they fail, the results can be disastrous. **Real World 1.1** describes how spreadsheets, which are widely used to prepare accounting and financial information, may introduce errors that can lead to poor financial decisions.

Real World 1.1

Systems error!

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

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

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

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

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

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

Management accounting and financial accounting

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

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

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

- *Nature of the reports produced.* Financial accounting reports tend to be general-purpose. Although they are aimed primarily at providers of finance such as owners and lenders, they contain financial information that will be useful for a broad range of users and decisions. Management accounting reports, on the other hand, are often specific-purpose reports. They are designed with a particular decision in mind and/or for a particular manager.
- *Level of detail.* Financial accounting reports provide users with a broad overview of the performance and position of the business for a period. As a result, information is aggregated (that is, added together) and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular operational decision.
- *Regulations.* Financial accounting reports, for many businesses and virtually all larger businesses, are subject to accounting regulations imposed by the law and accounting rule makers. These regulations often require a standard content and, perhaps, a standard format to be adopted. As management accounting reports are for internal use only, there are no regulations from external sources concerning the form and content of the reports. They can be designed to meet the needs of particular managers.
- *Reporting interval.* For most businesses, financial accounting reports are produced on an annual basis, though some large businesses produce half-yearly reports and a few produce quarterly ones. Management accounting reports will be produced as frequently as needed by managers. A sales manager, for example, may require routine sales reports on a daily, weekly or monthly basis, so as to monitor performance closely. Special-purpose reports can also be prepared when the occasion demands: for example, where an evaluation is required of a proposed investment in new equipment.
- *Time orientation.* Financial accounting reports reflect the performance and position of the business for the past period. In essence, they are backward-looking. Management accounting reports, on the other hand, often provide information concerning future performance as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release projected information to other users in an attempt to raise capital or to fight off unwanted takeover bids. Even preparation of the routine financial accounting reports typically requires making some judgements about the future (as we shall see in Chapter 3).
- *Range and quality of information.* 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 management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of reliability. The only real test to be applied when assessing the value of the information produced for managers is whether or not it improves the quality of the decisions made.

The main differences between financial accounting and management accounting are summarised in Figure 1.5.

Figure 1.5 Management and financial accounting compared

	Management accounting	*Financial accounting*
Nature of the reports produced	Tend to be specific purpose	Tend to be general purpose
Level of detail	Often very detailed	Usually broad overview
Regulations	Unregulated	Usually subject to accounting regulation
Reporting interval	As short as required by managers	Usually annual or bi-annual
Time orientation	Often based on projected future information as well as past information	Almost always historical
Range and quality of information	Tend to contain financial and non-financial information, often use 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 differences between management accounting and financial accounting suggest that there are differences in the information needs of managers and those of other users. While differences undoubtedly exist, there is also a good deal of overlap between these needs.

Activity 1.9

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

Two points that spring to mind are:

- Managers will, at times, be interested in receiving a historical overview of business operations of the sort provided to other users.
- Other users would be interested in receiving detailed information relating to the future, such as the planned level of profits, and non-financial information, such as the state of the sales order book and the extent of product innovations.

To some extent, differences between the two strands of accounting reflect differences in access to financial information. Managers have much more control over the form and content of the information that they receive. Other users have to rely on what managers are prepared to provide or what financial reporting regulations insist must be provided. Although the scope of financial accounting reports has increased over time, fears concerning loss of competitive advantage and user ignorance about the reliability of forecast data have resulted in other users not receiving the same detailed and wide-ranging information as that available to managers.

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

The changing face of accounting

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

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

This new, more complex, environment has brought new challenges for managers and other users of accounting information. Their needs have changed and both financial accounting and management accounting have had to respond. To meet the changing needs of users, there has been a radical review of the kind of information to be reported.

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

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

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

Activity 1.10

How should the harmonisation of accounting rules benefit:

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

(a) An international investor should benefit because accounting definitions and policies that are used in preparing financial accounting reports will not vary across countries. This should make the comparison of performance between businesses operating in different countries much easier.
(b) An international business should benefit because the cost of producing accounting reports in order to comply with the rules of different countries can be expensive. Harmonisation can, therefore, lead to significant cost savings. It may also broaden the appeal of the business among international investors. Where there are common accounting rules, they may have greater confidence to invest.

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

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

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

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

Why do I need to know anything about accounting and finance?

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

- continue with certain business operations;
- invest in particular projects; 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; and
- how businesses are financed.

Many, perhaps most, students have a career goal of being a manager within a business – perhaps a human resources manager, production manager, marketing manager or IT manager. If you are one of these students, an understanding of accounting and finance is very important. When you become a manager, even a junior one, it is almost certain that you will have to use financial reports to help you to carry out your role. It is equally certain that it is 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 forward-looking financial statements and setting 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 those who do. Along with other managers, you will also be expected to help decide how the limited resources available to the business should be allocated between competing options. This will require an ability to evaluate the costs and benefits of the different options available. Once again, an understanding of accounting and finance is important to carrying out this management task.

This is not to say that you cannot be an effective and successful human resources, production, marketing or IT manager unless you are also a qualified accountant. It does mean, however, that you need to become a bit 'streetwise' in accounting and finance if you are to succeed. This book 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. The forms of business ownership and the ways in which a business may be organised and structured, however, will partly shape these needs. In the sections that follow, we consider the business environment within which accounting information is produced. This should help our understanding of points that crop up in later chapters.

What is the purpose of a business?

Peter Drucker, an eminent management thinker, has argued that 'the purpose of business is to create and keep a customer'. (See reference 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. Fifty years on, however, his approach has become part of the conventional wisdom. It is now widely recognised that, in order to succeed, businesses must focus on satisfying the needs of the customer.

Although the customer has always provided the main source of revenue for a business, this has often been taken for granted. In the past, too many businesses have assumed that the customer would readily accept whatever services or products were on offer. When competition was weak and customers were passive, businesses could operate under this assumption and still make a profit. However, the era of weak competition has passed. Nowadays, 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 1.2 describes how the internet and social media have given added weight to this mantra. It points out that dissatisfied customers now have a powerful medium for broadcasting their complaints.

Real World 1.2

The customer is king

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

Businesses are understandably concerned about the potential of the internet to damage reputations, but are their concerns justified? Do customer complaints, which wing their way through cyberspace, have any real effect on the businesses concerned? A Harris Poll

Real World 1.2 *continued*

survey of 2,000 adults in the UK and US suggests they do and so businesses should be concerned. It seems that social media can exert a big influence on customer buying decisions.

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

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

Source: Based on information in Miesbach, A.(2015) *Yes, the Customer is Still King* 30 October www.icmi.com

What kinds of business ownership exist?

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

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

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 very easy to set up. No formal procedures are required and operations can often commence immediately (unless special permission is required because of the nature of the trade or service, such as running licensed premises (a pub)). The owner can decide the way in which the business is to be conducted and has the flexibility to restructure or dissolve the business whenever it suits. The law does not recognise the sole-proprietor business as being separate from the owner, so the business will cease on the death of the owner.

Although the owner must produce accounting information 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). They are also easy to set up, as no formal procedures are required (and it is not even necessary to have a written agreement between the partners). The partners can agree whatever arrangements suit them concerning the financial and management aspects of the business. Similarly, the partnership can be restructured or dissolved by agreement between the partners.

Activity 1.11

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); and
- the ability to raise capital where this is beyond the capacity of a single individual.

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

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

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.

Limited company

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

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

The benefit of limited liability, however, imposes certain obligations on such limited companies. To 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 later 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 1.12

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; and
- freedom from administrative burdens imposed by law (for example, the annual general meeting and the need for an independent audit).

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

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

How are businesses organised?

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

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

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

Each board has a 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) 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 1.13

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

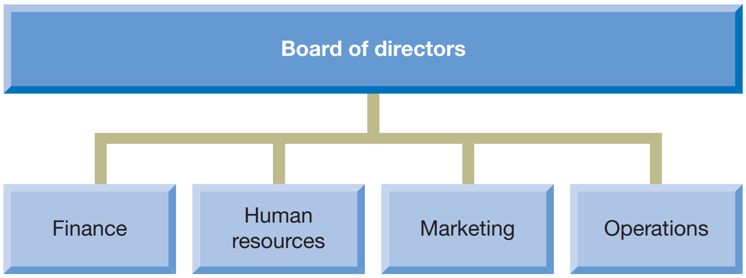
Three common reasons are:

- 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, human resources and finance). The managers of each department will then be accountable to the board of directors. In some cases, individual board members may also be departmental managers.

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

Figure 1.6 A departmental structure organised according to business function



This is a typical departmental structure organised along functional lines.

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

Example 1.1

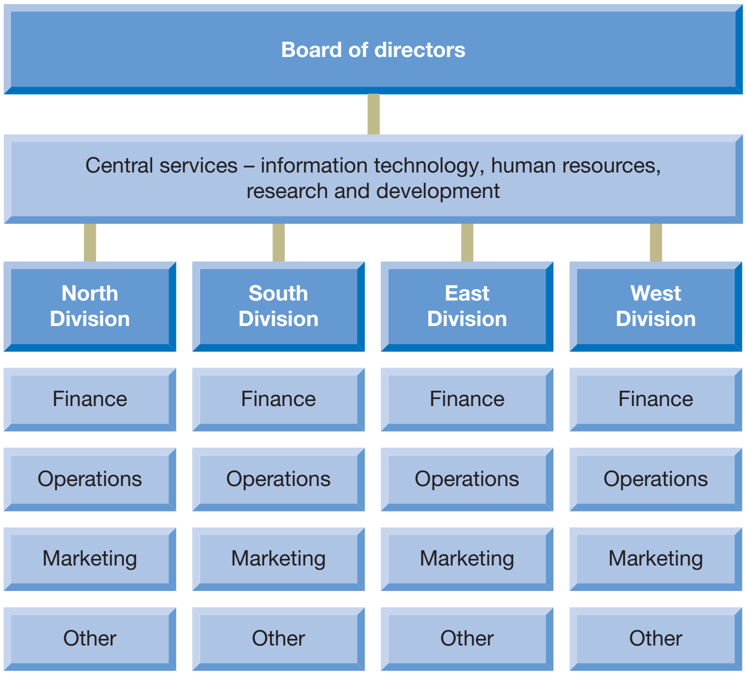
Supercoach Ltd owns a small fleet of coaches that it hires out with drivers for private group travel. The business employs about 50 people. It might be departmentalised as follows:

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

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

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

Figure 1.7 A divisional organisational structure



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

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

Real World 1.3

Engineering change

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

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

→

Real World 1.3 *continued*

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

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

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

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

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

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

How are businesses managed?

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

Strategic management is concerned with setting the long-term direction of the business. It involves setting long-term goals and then ensuring that they are implemented effectively. To enable the business to develop a competitive edge, strategic management focuses on doing things differently rather than simply doing things better. It should provide a business with a clear sense of purpose, along with a series of steps to achieve that purpose. The steps taken should link the internal resources of the business to the external environment 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.

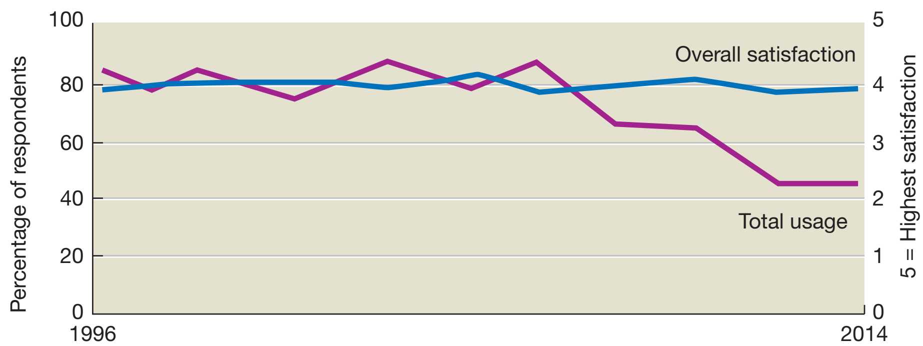
Real World 1.4 provides an indication of the extent to which strategic planning is carried out in practice.

Real World 1.4

Strategic planning high on the list

A recent survey investigated the use of various management tools throughout the world. It found that strategic planning is used by more than 40 per cent of those businesses that took part. This made it the fourth most popular management tool. The survey, which is conducted annually, has placed strategic planning in first position for three of the last five years and in second position for one of those years. Figure 1.8 indicates the level of usage and satisfaction concerning this technique.

Figure 1.8 Usage and effectiveness of strategic planning



Despite a high level of satisfaction with this technique, it has become less widely used in recent years.

The results were based on a survey of 1,067 senior executives throughout the world.

Source: Rigby, D. and Bilodeau, B. (2015) *Management Tools and Trends 2015,* Bain and Company.

The quest for wealth creation

A business is normally 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 with a stake in the business. A business may, for example, 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 primarily with a view to increasing the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

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

Meeting the needs of other stakeholders

These points do not mean that the needs of other groups with a stake in the business, such as employees, customers, suppliers and the community, are unimportant. In fact, the opposite is true if the business wishes to survive and prosper over the longer term. For example, a business with disaffected customers may well find that they turn to another supplier, resulting in a loss of shareholder wealth. The point that modern businesses must be responsive to customer needs was discussed earlier.

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

Real World 1.5 describes how one well-known business came to recognise that future success depended on the support of key stakeholder groups.

Real World 1.5

The price of clothes

Nike is king. From its dominance in the athletic world, its popularity amongst consumers and being one of the most globally recognised brands, Nike is riding a wave of success that shows no signs of slowing down. But it wasn't always like that.

In the late '90s, Nike was embroiled in controversy over its reported use of sweatshops, an issue that threatened to derail Nike's popularity and undoubtedly hurt its company image. In a recent report by *Business Insider,* we're able to read just some of the things Nike has done to improve and change the way people perceive the brand. "The sweatshop perception was one of the biggest challenges Nike has faced," University of Southern California professor Jeetendr Sehdev said. "It seemed impossible they could ever shake the perception."

Nike used sweatshops. There's no denying that. BI's report mentions the 14 cents an hour earned by Indonesian workers, while also referencing a *New York Times* article from 1997 that documented abuse of workers by a Vietnamese sub-contractor. It's a part of Nike's history that the brand isn't proud of. But since then, it has doing its part in the upgrade its overseas conditions and to help make sure that the abuses of the past never occur again.

In 1998, Nike's Phil Knight helped lead the change in the company. Knight vowed Nike would be more upfront with the issues, promising to be more transparent in overseas dealings and becoming more committed to addressing and improving the issues and abuses it was confronted with and accused of. "The Nike product has become synonymous with slave wages, forced overtime, and arbitrary abuse," Knight said. "I truly believe the American consumer doesn't want to buy products made under abusive conditions."

Since then, Nike has done just that having raised minimum wage rates, improving factory conditions, and ensuring the factories have clean air. Also, Nike also publishes public reports documenting its general responsibility and factory conditions following through on the promise of being more transparent.

Source: Allarey, R (2015) *This Is How Nike Managed to Clean Up Its Sweatshop Reputation,* www.complex.com, 8 June.

It is clear from what we have seen that generating wealth for the owners is not the same as seeking to maximise the current year's profit. Wealth creation is concerned with the longer term. It relates not only to this year's profit but to that of future years as well. In the short term, corners can be cut and risks taken that improve current profit at the expense of future profit. **Real World 1.6** provides some examples of how emphasis on short-term profit can be very damaging.

Real World 1.6

Short-term gains, long-term problems

For many years, under the guise of defending capitalism, we have been allowing ourselves to degrade it. We have been poisoning the well from which we have drawn wealth. We have misunderstood the importance of values to capitalism. We have surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made.

Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them was not their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

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

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

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

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

FT

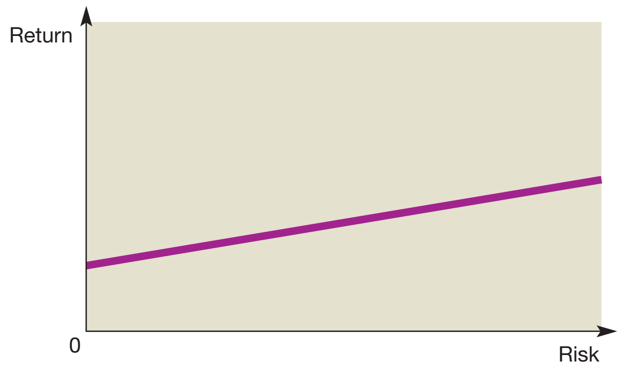
Source: Extracts from Goyder, M. (2009) How we've poisoned the well of wealth, *Financial Times,* 15 February. © The Financial Times Limited 2012. All Rights Reserved.

Balancing risk and return

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

As in other aspects of life, risk and return tend to be related. Evidence shows that returns relate to risk in something like the way shown in Figure 1.9.

Figure 1.9 Relationship between risk and return



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

Activity 1.14

Look at Figure 1.9 and state, in broad terms, where an investment in

(a) a UK government savings account, and
(b) a lottery ticket

should be placed on the risk–return line.

A UK government savings account is normally a very safe investment. Even if the government is in financial difficulties, it may well be able to print more money to repay investors. Returns from this form of investment, however, are normally very low. Investing in a lottery ticket runs a very high risk of losing the whole amount invested. This is because the probability of winning is normally very low. However, a winning ticket can produce enormous returns.

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

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

The 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 1.7** 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 1.7

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

Reasons to be ethical

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

- paying bribes to encourage employees of other businesses to reveal information about the employee's business that could be useful;
- oppressive treatment of suppliers, for example making suppliers wait excessive periods before payment; and

- manipulating the financial statements to mislead users of them, for example to overstate profit so that senior managers become eligible for performance bonuses (known as 'creative accounting').

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

Accountants are likely to find themselves at the forefront with issues relating to business ethics. In the three examples of unethical business activity listed above, an accountant would probably have to be involved either in helping to commit the unethical act or in covering it up. Accountants are, therefore, particularly vulnerable to being put under pressure to engage in unethical acts. Some businesses recognise this risk and produce an ethical code for their accounting staff. **Real World 1.8** provides an example of one such code.

Real World 1.8

The only way is ethics

BT plc, the telecommunications business, has a code of ethics for its senior finance and accounting staff which states that they must:

- Act with honesty and integrity, including ethically handling actual or apparent conflicts of interest between their personal relationships or financial or commercial interests and their responsibilities to BT;
- Promote full, fair, accurate, timely and understandable disclosure in all reports and documents that BT files with, or submits to, the US Securities and Exchange Commission or otherwise makes public;
- Comply with all laws, rules and regulations applicable to BT and to its relationship with its shareholders;
- Report known or suspected violations of this code of ethics promptly to the chairman of the Nominating & Governance Committee; and
- Ensure that their actions comply not only with the letter but the spirit of this code of ethics and foster a culture in which BT operates in compliance with the law and BT's policies.

Source: BT plc, *Our business practice and code of ethics,* www.BT.com, accessed 8 November 2016.

Not-for-profit organisations

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

Activity 1.15

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

We thought of the following:

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

All of these organisations need to produce accounting information for decision-making purposes. Once again, various user groups need this information to help them to make decisions. These user 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

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.

FT

Sources: Adapted from Bruce, R. (2005) Tsunami: finding the right figures for disaster relief, ft. com, 7 March; Bruce, R. (2006) The work of Mango: coping with generous donations, ft.com, 27 February; Grant, P. (2010) Accountants needed in Haiti, *Accountancy Age,* 5 February. © The Financial Times Limited 2012. All Rights Reserved.

Summary

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

What are accounting and finance?

- Accounting provides financial information to help various user groups make better judgements and decisions.
- Finance also helps users to make better decisions and is concerned with the financing and investing activities of the business.

Accounting and user needs

- For accounting to be useful, it must be clear *for whom* and *for what purpose* the information will be used.
- Owners, managers and lenders are important user groups but there are several others.
- Conflicts of interest between users may arise over the ways in which business wealth is generated or distributed.
- The evidence suggests that accounting is both used and useful for decision-making purposes.

Providing a service

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

Accounting information

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

Management accounting and financial accounting

- Accounting has two main strands – management accounting and financial accounting.
- Management accounting seeks to meet the needs of the business's managers, and financial accounting seeks to meet the needs of providers of finance but will also be of use to other user groups.
- These two strands differ in terms of the types of reports produced, the level of reporting detail, the time orientation, the degree of regulation and the range and quality of information provided.

The changing face of accounting

- Changes in the economic environment have led to changes in the nature and scope of accounting.

- Financial accounting has improved its framework of rules and there has been greater international harmonisation of accounting rules.
- Management accounting has become more outward looking, and new methods for managing costs have emerged.

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?

- The purpose of a business is to create and keep customers.

What kinds of business ownership exist?

There are three main forms of business unit:

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

How are businesses organised and managed?

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

The quest for wealth creation

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

Ethical behaviour

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

Not-for-profit organisations

- These produce accounting information for decision-making purposes.
- They have user groups that are similar to, or the same as, those of private-sector businesses.

Key terms

For definitions of these terms, see Appendix B.

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

References

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

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

Further reading

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

Drury, C. (2015) *Management and Cost Accounting,* 9th edn, Cengage Learning, Chapter 1.

Elliot, B. and Elliot, J. (2015) *Financial Accounting and Reporting,* 17th edn, Pearson, Chapter 11.

McLaney, E. (2018) *Business Finance: Theory and Practice,* 11th edn, Pearson, Chapters 1 and 2.

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

Review questions

Solutions to these questions can be found at the back of the book on pp. 786–787.

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

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

1.3 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?