TENTH EDITION

ACCOUNTING AND FINANCE FOR NON-SPECIALISTS

Peter Atrill
Eddie McLaney

Pearson

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FOR NON-SPECIALISTS

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Brief contents

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Lecturer Resources

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ON THE WEBSITE

Preface

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

- Students who are not majoring in accounting or finance but who are, nevertheless, studying introductory-level accounting and finance as part of their course. The course may be in business, economics, hospitality management, tourism, engineering, or some other area. For these students, the book provides an overview of the role and usefulness of accounting and finance within a business.
- Students who are majoring in either accounting or finance. These students should find the book a helpful introduction to the main principles, which can serve as a foundation for further study.

The book does not focus on the technical aspects, but rather considers principles and underlying concepts. It also examines the ways in which financial statements and other financial information may improve the quality of decision making. To reinforce the practical emphasis of the book, there are illustrative extracts from company reports, survey data and other sources throughout.

In this tenth edition, we have made improvements suggested by students and lecturers who used the previous edition. We have also increased the number of diagrams in order to aid learning. Examples from real life have been updated and their number has been increased. Finally, we have improved the range and quality of self-assessment material.

The book is written in an 'open-learning' style. This means that there are numerous integrated activities, worked examples and questions throughout the book to help you to understand the subject fully. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you are using the book as part of a taught course or for personal study, we have found that this approach is more 'user-friendly' and makes it easier for you to learn.

We recognise that most of you will not have studied accounting or finance before, and we have therefore tried to write in a concise and accessible style, minimising the use of technical jargon. We have also tried to introduce topics gradually, explaining everything as we go. Where technical terminology is unavoidable we try to provide clear explanations. You will find all of the key terms highlighted in the book, and then listed at the end of each chapter with a page reference. All of these key terms are also listed alphabetically, with a concise definition, in the glossary towards the end of the book. This should provide a convenient point of reference from which to revise.

A further important consideration in helping you to understand and absorb the topics covered is the design of the book itself. The page layout and colour scheme have been carefully considered to allow for the easy navigation and digestion of material. The layout features a large page format, an open design, and clear signposting of the various features and assessment material.

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

Peter Atrill
Eddie McLaney

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Figures

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Chapter 1

INTRODUCTION TO ACCOUNTING AND FINANCE

INTRODUCTION

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

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

Learning outcomes

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

- explain the nature and roles of accounting and finance;
- identify the main users of financial information and discuss their needs;
- distinguish between financial accounting and management accounting;
- explain why an understanding of accounting and finance is likely to be relevant to your needs.

WHAT ARE ACCOUNTING AND FINANCE?

Let us begin by trying to understand the purpose of each. **Accounting** is concerned with *collecting, analysing* and *communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. Unless the financial information being communicated can lead to better decisions being made, there really is no point in producing it.

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 financial information to improve the quality of their decisions. This decision-making perspective of accounting provides the theme for this book and shapes the way in which we deal with each topic.

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

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

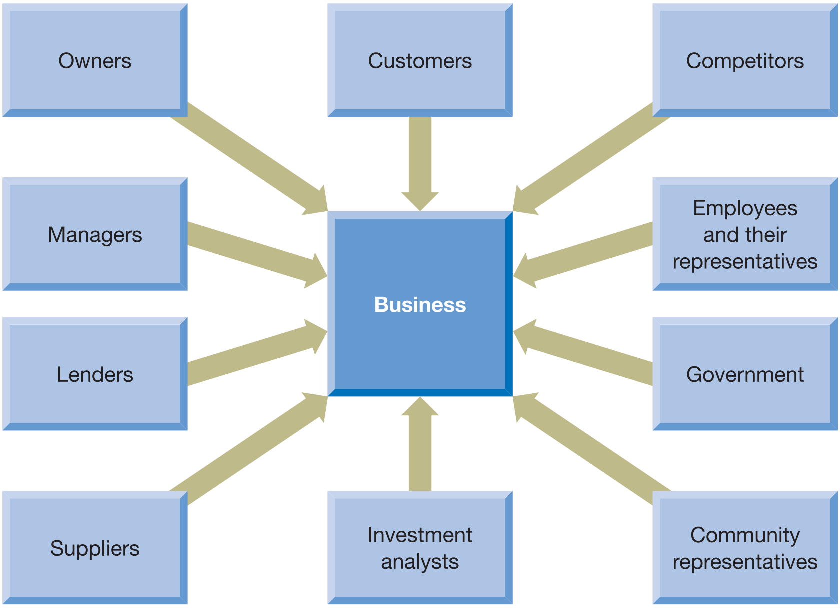
- the main forms of finance available;
- the costs and benefits of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

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

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

WHO ARE THE USERS OF ACCOUNTING INFORMATION?

For accounting information to be useful, the accountant must be clear *for whom* the information is being prepared and *for what purpose* it will be used. There are likely to be various groups of people (usually known as 'user groups') with an interest in a particular organisation, in the sense of needing to make decisions about it. For 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.



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 an exhaustive list of potential users; however, those groups identified are normally the most important.

Figure 1.1 Main users of financial information relating to a business

Activity 1.1

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

Your answer may be along the following lines:

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 may involve competitors using various aspects of PI's performance as a 'benchmark' when evaluating their own performance. They may also try to assess PI's financial strength and to identify changes that may signal PI's future intentions (for example, raising funds as a prelude to market expansion).

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 these decisions, PI's ability to provide employment for the community, its use of community resources and its willingness to fund environmental improvements are likely to be important considerations.
Investment analysts	Whether to advise clients to invest in PI. This would involve an evaluation 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 require an assessment of PI's ability to pay for goods and services supplied at the due dates.
Lenders	Whether to lend money to PI and/or whether to demand repayment of any existing loans. PI's ability to pay the interest due and to repay the principal sum on time would be important factors in such decisions.
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 it has the financial flexibility and resources to take on new challenges.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. As with investment analysts (see above) this would involve an evaluation of the likely risks and returns associated with PI. Owners may also have to decide on the rewards offered to senior managers. When doing so, the financial performance and position of the business would normally be considered.

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.

PROVIDING A SERVICE

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

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

- **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 next year's profit), or help to *confirm past events* (such as establishing last year's profit), or do both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

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

Activity 1.2

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

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

Ultimately, what is considered material is a matter of judgement. In making this judgement, managers should consider how the information is likely to be used by the various user groups.

Where a piece of information is not considered to be 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 this, the information should be *complete.* In other words, it should reflect all of the information needed to understand what is being portrayed. It should also be *neutral,* which means that the information should be presented and selected without bias. Finally, it should be *free from error.* This is not the same as saying that it must always be perfectly accurate; this is not really possible. Estimates may have to be made that eventually turn out to be inaccurate. It does mean, however, that there should be no errors in the way in which the estimates are prepared and described.

Activity 1.3

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

Probably not – however, each piece of information should aim to do so insofar as possible.

Accounting information must contain both of these fundamental qualities if it is to be useful. There is little point in producing information that is relevant but 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 (such as profit this year compared with last year). They may also want to compare certain aspects of business performance with 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 would be able to agree that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.
- **Timeliness**. Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later accounting information is produced, the less useful it becomes.
- **Understandability**. Accounting information should be set out as clearly and concisely as possible. It should also be understood by those for whom the information is provided.

Activity 1.4

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

Although it would be very useful if everyone could understand accounting reports, it is unrealistic to assume that this will ever be possible. Financial events and transactions are often complex and incapable of being expressed in simple terms.

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

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

WEIGHING UP THE COSTS AND BENEFITS

Even when a piece of accounting information may have all the qualities described, it does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.5.

Activity 1.5

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, timely and could be understood by the decision maker.

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

You may 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 be produced only if the costs of providing it are less than the benefits, or value, to be derived from its use. In practice, however, these costs and benefits are difficult to assess.

To illustrate the practical problems of establishing the value of information, let us assume that we accidentally reversed our car into a wall in a car park. This resulted in a dented boot and scraped paintwork. We would like the dent taken out and the paintwork re-sprayed at a local garage. We know that the nearest garage would charge £350 but we believe that other local garages may offer to do the job for a lower price. The only way of finding out the prices at other garages is to visit them, so that they can see the extent of the damage. Visiting the garages will involve using some fuel and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local garages? The answer, as we have seen, is that if the cost of discovering the price is less than the potential benefit, it is worth having that information.

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

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

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

- What is the cheapest price that we might be quoted for the job?
- How likely is it that we shall be quoted a price cheaper than £350?

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

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

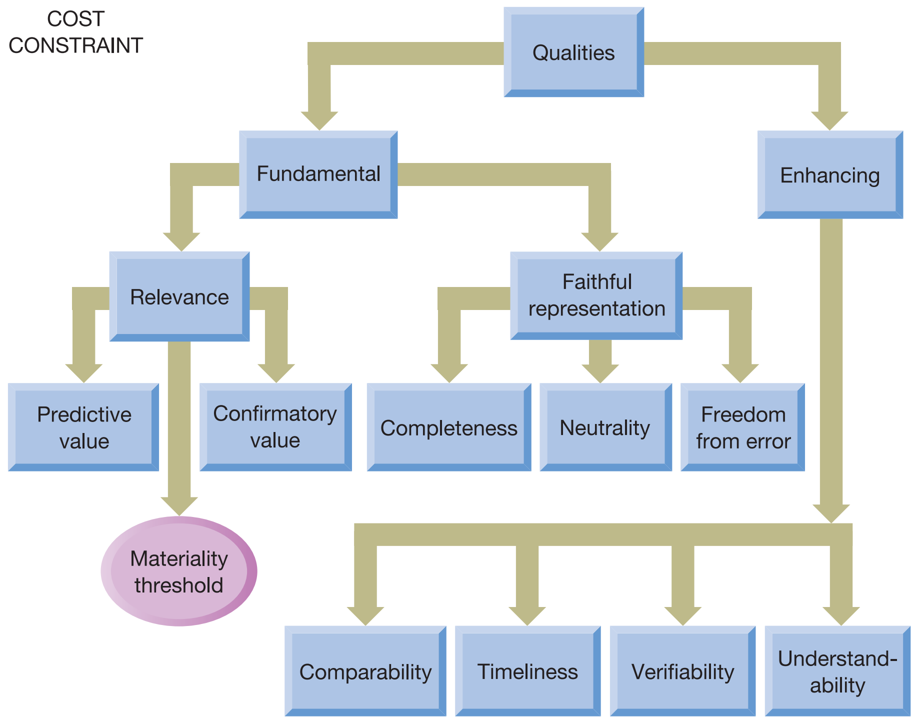
Activity 1.6

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

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

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

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



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.

Figure 1.2 The qualities that influence the usefulness of accounting information

ACCOUNTING AS AN INFORMATION SYSTEM

We have already seen that accounting can be viewed 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, make decisions concerning the allocation of scarce resources. For these resources to be efficiently allocated, they often need financial (accounting) information on which to base decisions. It is the role of the accounting system to provide this information.

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

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

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