

SEVENTH EDITION

Eddie McLaney
Peter Atrill

ACCOUNTING
AND FINANCE
AN INTRODUCTION



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Accounting and Finance

An Introduction

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Preface

This text provides a comprehensive introduction to financial accounting, management accounting and core elements of financial management. It is aimed both at students who are not majoring in accounting or finance and those who are. Those studying introductory-level accounting and/or financial management as part of their course in business, economics, hospitality management, tourism, engineering or some other area should find that the book provides complete coverage of the material at the level required. Students who are majoring in either accounting or finance should find the book useful as an introduction to the main principles, which can serve as a foundation for further study. The text does not focus on technical issues, but rather examines basic principles and underlying concepts. The primary concern throughout is the ways in which financial statements and information can be used to improve the quality of the decisions made by those who use them. To reinforce this practical emphasis, there are numerous illustrative extracts throughout the text, with commentary from real life including company reports, survey data and other sources.

The text is written in an ‘open-learning’ style. This means that there are numerous integrated activities, worked examples and questions in all the chapters 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 readers will not have studied accounting or finance before, and we have therefore tried to write in a concise and accessible style, minimising the use of technical jargon. We have also tried to introduce topics gradually, explaining everything as we go. Where technical terminology is unavoidable we try to provide clear explanations. In addition, you will find all of the key terms highlighted in the text. These are then listed at the end of each chapter with a page reference. They are also listed alphabetically, with a concise definition, in the glossary given in Appendix B towards the end of the book. This should provide a convenient point of reference from which to revise.

A further important consideration in helping you to understand and absorb the topics covered is the design of the text 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.

In this seventh edition, we have taken the opportunity to make improvements that have been suggested by students and lecturers who used the previous edition. We have also brought up to date and expanded the number of examples from real life. We have continued to reflect the latest developments in the international rules relating to their main financial statements. We have also made reference to changes in financing methods. We have also expanded the number of student progress questions (Activities) and increased the quantity of explanatory diagrams.

More detail about the nature and use of these features is given in the ‘How to use this book’ section which follows; and the main points are also summarised, using example pages from the text, in the guided tour on pages xxiv to xxv.

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

*Eddie McLaney
Peter Atrill*

How to use this book

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

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

Integrated assessment material

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

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

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

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

End-of-chapter assessment material

At the end of each chapter there are four **Review questions**. These are short questions requiring a narrative answer or discussion within a tutorial group. They are intended to help you assess how well you can recall and critically evaluate the core terms and concepts covered in each chapter. Answers to these questions are provided in the MyAccountingLab as well as Appendix D at the end of the book. At the end of each

chapter, except for Chapter 1, there are eight **Exercises**. These are mostly computational and are designed to reinforce your knowledge and understanding. Exercises are graded as 'basic' and 'more advanced', according to their level of difficulty. The basic-level questions are fairly straightforward; the more advanced ones can be quite demanding but are capable of being successfully completed if you have worked conscientiously through the chapter and have attempted the basic exercises. Solutions to five of the exercises in each chapter are provided in Appendix D at the end of the book. A coloured exercise number identifies these five questions. Here, too, a thorough attempt should be made to answer each exercise before referring to the solution. Solutions to the other three exercises and to the review questions in each chapter are provided in a separate Instructors' Manual.

To familiarise yourself with the main features and how they will benefit your study from this text, an illustrated Guided tour is provided on pages xxiv–xxvii.

Content and structure

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

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

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Guided tour of the book

CHAPTER 1

Introduction to accounting

Introduction

In this opening chapter, we begin by considering the roles of accounting and finance. We 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. 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. There are all important considerations as they help to shape the kind of accounting and financial information that is produced.

Learning outcomes

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

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

662 CHAPTER 16 MANAGING WORKING CAPITAL

An alternative approach to evaluating the credit decision

It is possible to view the credit decision as a capital investment decision. Granting trade credit involves an opportunity outlay of resources in the form of cash (which has been temporarily forgone) in the expectation that future cash flows will be increased (through higher sales) as a result. A business will usually have choices concerning the level of investment to be made in credit sales and the period over which credit is granted. These choices will result in different returns and different levels of risk. There is no reason in principle why the NPV investment appraisal method, which we considered in Chapter 14, should not be used to evaluate these choices. The NPV method takes into account both the time value of money and the level of risk involved.

Approaching the problem as an NPV assessment is not different in principle from the way that we dealt with the decision in Example 16.2. In both approaches the time value of money is taken into consideration, but in Example 16.2 this was done by charging a financing cost on the outstanding trade receivables.

Cash discounts

To encourage prompt payment from its credit customers, a business may offer a **cash discount** (or discount for prompt payment). The size of any discount will be an important influence on whether a customer decides to pay promptly. From the business's viewpoint, the cost of offering discounts must be weighed against the likely benefits in the form of a reduction both in the cost of financing receivables and in the amount of bad debts. Example 16.3 shows how this may be done.

Example 16.3

Williams Wholesalers Ltd currently asks its credit customers to pay by the end of the month after the month of delivery. In practice, customers take rather longer to pay – on average 70 days. Sales revenue amounts to £4 million a year and bad debts to £20,000 a year.

It is planned to offer customers a cash discount of 2 per cent for payment within 30 days. Williams estimates that 50 per cent of customers will take up this facility but that the remaining customers, who tend to be slow payers, will not until 80 days after the sale. At present the business has an overdraft facility at an interest rate of 13 per cent a year. If the plan goes ahead, bad debts will be reduced to £10,000 a year and there will be savings in credit administration expenses of £6,000 a year.

The first step in deciding whether Williams Wholesalers Ltd should offer the new credit terms to customers is to determine the reduction in trade receivables arising from the new policy.

	£	£	
Existing level of trade receivables	(£4m × 70/365)		767,123
New level of trade receivables:			
£2m × 80/365	438,356		
£2m × 30/365	164,384		
Reduction in trade receivables			(602,743)
			164,383

Key terms The key concepts and techniques in each chapter are highlighted in colour where they are first introduced.

Examples At frequent intervals throughout most chapters, there are numerical examples that give you step-by-step workings to follow through to the solution.

Introductions A brief introduction, detailing the topics covered in the chapter, and also showing how chapters are linked together.

Learning outcomes Bulleted points at the start of each chapter show what you can expect to learn from the chapter, and provide a brief checklist of the core issues.

26 CHAPTER 1 INTRODUCTION TO ACCOUNTING

Real World 1.4

Standard practice

Standard Life, a leading long-term savings and investment business, states its purpose as follows:

We will continue to drive shareholder value through being a leading, customer-centric business, focused on long-term savings and investment propositions. This means finding, acquiring and retaining valuable customers for mutual and sustained financial benefit.

On a mission

Electron Technology plc, which operates in the fast-moving engineered products sector, states: Our mission is to deliver a highly competitive return to shareholders by using its technologies to create innovative solutions for its customers.

Source: Standard Life plc, www.standardlife.com, accessed 17 December 2012; Electron Technology plc, Health Report 2011/12, p. 4.

A disaffected workforce may result in low productivity, strikes and so forth, which will in turn have an adverse effect on owners' wealth. Similarly, a business that upsets the local community by unacceptable behaviour, such as polluting the environment, may attract bad publicity, resulting in a loss of customers and heavy fines. Real World 1.5 provides an example of how two businesses responded to potentially damaging allegations.

Real World 1.5

The price of clothes

US clothing and sportswear manufacturers Gap and Nike have many of their clothes produced in Asia where labour tends to be cheap. However, some of the contractors that produce clothes on behalf of the two companies have been accused of unacceptable practices. Campaigners visited the factories and came up with damaging allegations. The factories were employing minors, they said, and managers were harassing female employees.

Nike and Gap reacted by allowing independent inspectors into the factories. They promised to ensure their contractors obeyed minimum standards of employment. Earlier this year, Nike took the extraordinary step of publishing the names and addresses of all its contractors' factories on the internet. The company said it could not be sure all the abuse had stopped. It said that if campaigners visited its contractors' factories and found examples of continued malpractice, it would take action.

Nike and Gap said the approach made business sense. They needed society's approval if they were to prosper. Nike said it was concerned about the reaction of potential US recruits to the campaigners' allegations. They would not want to work for a company that was constantly in the news because of the allegedly cruel treatment of those who made its products.

FT Source: Sharelink M. (2005) Fair share's Financial Times, 11 June. © The Financial Times Limited 2012. All Rights Reserved.

We should be clear 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, owners 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 damaging.

256 CHAPTER 7 ANALYSING AND INTERPRETING FINANCIAL STATEMENTS

Activity 7.21

Calculate the interest cover ratio of Alexis plc for the year ended 31 March 2013.

The ratio for the year ended 31 March 2013 is:

Interest cover ratio = $\frac{47}{32} = 1.5$ times

Alexis plc's gearing ratios are:

	2012	2013
Gearing ratio	26.2%	36.0%
Interest cover ratio	13.5 times	1.5 times

Activity 7.22

What do you deduce from a comparison of Alexis plc's gearing ratios over the two years?

The gearing ratio has changed significantly. This is mainly due to the substantial increase in the contribution of long-term lenders to financing the business. The gearing ratio at 31 March 2013 would not be considered very high for a business that is trading successfully. It is the low profitability that is the problem. The interest cover ratio has declined dramatically from 13.5 times in 2012 to 1.5 times in 2013. This was partly caused by the increase in borrowings in 2013, but mainly caused by the dramatic decline in profitability in that year. The situation in 2013 looks hazardous. Only a small decline in future operating profits would result in the profit being unable to cover interest payments.

Without knowledge of the planned ratios, it is not possible to reach a valid conclusion on Alexis plc's gearing.

Real World 7.6 contains extracts from an article that discusses the likely lowering of gearing levels as a result of the poor economic climate. It explains that many businesses are likely to issue additional ordinary shares (equity) to reduce borrowing as a means of reducing gearing. Note that the gearing ratio mentioned in the article differs slightly from the one discussed above.

Real World 7.6

Changing gear

With a wave of rights issues and other equity issuance now expected from the UK's non-financial companies – and with funds from these being used to pay down debt – the pendulum is rapidly swinging back in favour of more conservative balance sheet (statement of financial position) management. Gearing levels are set to fall dramatically, analysts say. There is going to be an appreciable and material drop in gearing, by about a quarter or a third over the next three years, predicts Stuart Siddall, chief executive of the Association of Corporate Treasurers.

Activities These short questions, integrated throughout each chapter, allow you to check your understanding as you progress through the text. They comprise either a narrative question requiring you to review or critically consider topics, or a numerical problem requiring you to deduce a solution. A suggested answer is given immediately after each activity.

'Real World' illustrations Integrated throughout the text, these illustrative examples highlight the practical application of accounting concepts and techniques by real businesses, including extracts from company reports and financial statements, survey data and other insights from business.

Self-assessment questions Towards the end of most chapters you will encounter one of these questions, allowing you to attempt a comprehensive question before tackling the end-of-chapter assessment material. To check your understanding and progress, solutions are provided in Appendix C.

LIMITATIONS OF RATIO ANALYSIS 275

Self-assessment question 7.1

Both All plc and Bhaskar plc operate wholesale electrical stores throughout the UK. The financial statements of each business for the year ended 30 June 2013 are as follows:

Statements of financial position as at 30 June 2013

	All plc £m	Bhaskar plc £m
ASSETS		
Non-current assets		
Property, plant and equipment (cost less depreciation)	360.0	510.0
Land and buildings	87.0	91.2
Furniture and fittings	447.0	401.2
Current assets		
Inventories	592.0	403.0
Trade receivables	176.4	321.9
Cash at bank	84.6	91.8
	653.0	816.5
Total assets	1,900.0	1,417.7
EQUITY AND LIABILITIES		
Equity		
£1 ordinary shares	300.0	250.0
Retained earnings	387.6	624.6
	687.6	874.6
Non-current liabilities		
Borrowings – loan notes	190.0	250.0
Current liabilities		
Trade payables	406.4	275.7
Taxation	16.0	17.4
	422.4	293.1
Total equity and liabilities	1,200.0	1,417.7

Income statements for the year ended 30 June 2013

	All plc £m	Bhaskar plc £m
Revenue	1,478.1	1,790.4
Cost of sales	(1,015.3)	(1,214.8)
Gross profit	462.8	575.6
Operating expenses	(308.9)	(408.6)
Operating profit	153.9	167.0
Interest payable	(18.9)	(27.3)
Profit before taxation	135.0	139.7
Taxation	(32.0)	(24.8)
Profit for the year	99.9	104.6

All purchases and sales were on credit. The market values of a share in All plc and Bhaskar plc at the end of the year were £6.50 and £8.20 respectively.

276 CHAPTER 7 ANALYSING AND INTERPRETING FINANCIAL STATEMENTS

Self-assessment question 7.1 continued

Required:

(a) For each business, calculate two ratios that are concerned with each of the following aspects:

- profitability
- efficiency
- liquidity
- gearing
- investment

(ten ratios in total)

What can you conclude from the ratios that you have calculated?

(b) Calculate the Z-scores for each business using the Altman model.

(c) Comment on the Z-scores for each business and on the validity of applying the Altman model to these particular businesses.

The solution to this question can be found in Appendix C.

Summary

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

Ratio analysis

- Compares two related figures, usually both from the same set of financial statements.
- Is an aid to understanding what the financial statements really mean.
- Is an inexact science so results must be interpreted cautiously.
- Past periods, the performance of similar businesses and planned performance are often used to provide benchmark ratios.
- A brief overview of the financial statements can often provide insights that may not be revealed by ratios and/or may help in the interpretation of them.

Profitability ratios

- Profitability ratios are concerned with effectiveness at generating profit.
- The profitability ratios covered are the return on ordinary shareholders' funds (ROSF), return on capital employed (ROCE), operating profit margin and gross profit margin.

Efficiency ratios

- Efficiency ratios are concerned with efficiency of using assets/resources.
- The efficiency ratios covered are the average inventories turnover period, average settlement period for trade receivables, average settlement period for trade payables, sales revenue to capital employed and sales revenue per employee.

Liquidity ratios

- Liquidity ratios are concerned with the ability to meet short-term obligations.
- The liquidity ratios covered are the current ratio, the acid test ratio and the cash generated to maturing obligations ratio.

Bullet point chapter summary Each chapter ends with a bullet point summary, highlighting the material covered in the chapter and serving as a quick reminder of the key issues.

Key terms summary At the end of each chapter, there is a list (with page references) of all the key terms introduced in that chapter, allowing you to refer back easily to the essential points.

634 CHAPTER 15 FINANCING A BUSINESS

Key terms

security p. 594	hire purchase p. 605
fixed charge p. 594	securitisation p. 606
floating charge p. 594	bank overdraft p. 608
loan covenants p. 595	debt factoring p. 608
subordinated loans p. 596	invoice discounting p. 610
term loan p. 597	asset-based finance p. 612
bonds p. 598	rights issue p. 618
eurobonds p. 599	offer for sale p. 621
deep discount bonds p. 599	public issue p. 621
convertible loan notes p. 600	tender issue p. 621
financial derivative p. 601	private placing p. 621
mortgage p. 601	efficient capital market p. 623
floating interest rate p. 601	Alternative Investment Market (AIM) p. 627
fixed interest rate p. 601	venture capital p. 628
finance lease p. 602	business angels p. 629
operating lease p. 602	
sale and leaseback p. 604	

References

- 1 Dimson, E., Marsh, P. and Staunton, M., *Credit Suisse Global Investments Returns Sourcebook*, 2012.
- 2 London Stock Exchange, *Market Statistics*, December 2012, Table 1.
- 3 Armitage, S., 'The direct costs of UK rights issues and open offers', *European Financial Management*, March 2000.
- 4 London Stock Exchange, *The Cost of Capital: An International Comparison*, 2006.

Further reading

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

Arnold, G., *Corporate Financial Management*, 5th edn, Pearson, 2012, Chapters 11 and 12.

Brealey, R., Myers, S. and Allen, F., *Corporate Finance*, 10th edn, McGraw-Hill International, 2010, Chapters 14, 25 and 26.

Hilber, D., Ross, S., Westerfeld, R., Jaffe, J. and Jordan, B., *Corporate Finance*, European edn, McGraw-Hill Higher Education, 2010, Chapters 19–21.

McLaney, E., *Business Finance: Theory and Practice*, 9th edn, Financial Times Prentice Hall, 2011, Chapters 9, 11 and 12.

Pike, R., Neale, B. and Lindsay, P., *Corporate Finance and Investment*, 7th edn, Pearson, 2012, Chapters 15 and 16.

References Full details of the sources of information referred to in the chapter.

Further reading This section provides a list of relevant chapters in other textbooks that you might wish to refer to in order to pursue a topic in more depth or access an alternative perspective.

112 CHAPTER 3 MEASURING AND REPORTING FINANCIAL PERFORMANCE

Review questions

Solutions to these questions can be found in Appendix D.

- 3.1 'Although the income statement is a record of past achievement, the calculations required for certain expenses involve estimates of the future.' What does this statement mean? Can you think of examples where estimates of the future are used?
- 3.2 'Depreciation is a process of allocation and not valuation.' What do you think is meant by this statement?
- 3.3 What is the convention of consistency? Does this convention help users in making a more valid comparison between businesses?
- 3.4 'An asset is similar to an expense.' In what ways is this true or untrue?

Exercises

Exercises 3.1 to 3.3 are basic level, 3.4 and 3.5 are intermediate level and 3.6 and 3.7 are advanced level. Solutions to exercises with coloured numbers can be found in Appendix E.

If you wish to try more exercises, visit the students' side of the Companion Website and MyAccountingLab.

- 3.1 You have heard the following statements made. Comment critically on them.
 - (a) 'Equity only increases or decreases as a result of the owners putting more cash into the business or taking some out.'
 - (b) 'An accrued expense is one that relates to next year.'
 - (c) 'Unless we depreciate this asset we shall be unable to provide for its replacement.'
 - (d) 'There is no point in depreciating the factory building. It is appreciating in value each year.'
- 3.2 Singh Enterprises, which started business on 1 January 2010, has a reporting period to 31 December and uses the straight-line method of depreciation. On 1 January 2010 the business bought a machine for £10,000. The machine had an expected useful life of four years and an estimated residual value of £2,000. On 1 January 2011 the business bought another machine for £15,000. This machine had an expected useful life of five years and an estimated residual value of £2,500. On 31 December 2012 the business sold the first machine bought for £3,000.

Required:

Show the relevant income statement extracts and statement of financial position extracts for the years 2010, 2011 and 2012.

Review questions These short questions encourage you to review and/or critically discuss your understanding of the main topics covered in each chapter, either individually or in a group. Solutions to these questions can be found in Appendix D.

Exercises There are eight of these comprehensive questions at the end of most chapters. The more advanced questions are separately identified. Solutions to five questions (those with coloured numbers) are provided in Appendix E, enabling you to assess your progress. Solutions to the remaining questions are available for lecturers only. An additional exercise for each chapter can be found on the Companion Website at www.pearsoned.co.uk/mclaney.

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The screenshot displays the MyAccountingLab interface for the course 'Atrill/McLaney: Accounting and Finance: An Introduction 7e'. The interface is divided into several sections:

- Navigation Menu (Left):** Includes options for STUDENT (Course Home, Calendar, Do Homework, Take a Test/Quiz, Results, Study Plan, Chapter Resources) and INSTRUCTOR (Course Manager, Home Page Manager, Assignment Manager, Study Plan Manager, Gradebook, Instructor Resources).
- Calendar (Top):** Shows a calendar for November with dates 24, 25, 26, 27, 28, 29, and 30. The 27th is highlighted.
- My Upcoming Assignments:** A section with a 'View All Assignments' link. Below it, it states 'There are currently no upcoming assignments' and a 'View Course Documents' link.
- Announcements:** A section with a 'View All Announcements' link. It contains a 'Welcome to MyAccountingLab' message and two bullet points: 'Before you start, run the [Browser Check](#) to confirm that you have the plug-ins and players you need to view questions and multimedia content in your course.' and 'Learn [How to Enter Answers](#) for homework, tests, quizzes, or self-study, whether you're starting out or just need a refresher.'
- My Results:** A section with an 'Overall Score' of 0% (No Results Yet) and a 'Course Timeline' showing 0% completion. It includes a 'Date Submitted' of 12/4/13 and a 'Study Plan' of 0/74.
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How do I use MyAccountingLab?

Study Plan Contents	Mastery Points		
	Earned	Possible	Time Spent
Ch. 1: Introduction to accounting and finance	0	6	
Ch. 2: Measuring and reporting financial position	0	5	
Ch. 3: Measuring and reporting financial performance	0	6	
Ch. 4: Accounting for limited companies (1)	0	3	
Ch. 5: Accounting for limited companies (2)	0	6	
Ch. 6: Measuring and reporting cash flows	0	3	
Ch. 7: Analysing and interpreting financial statements	0	8	
Ch. 8: Relevant costs for decision making	0	2	
Ch. 9: Cost-volume-profit analysis	0	5	
Ch. 10: Full costing	0	4	
Ch. 11: Costing and performance evaluation in a competitive environment	0	5	
Ch. 12: Budgeting			
Ch. 13: Accounting for control			
Ch. 14: Making capital investment decisions			
Ch. 15: Financing a business			
Ch. 16: Managing a working capital			
Ch. 17: Supplementary appendix			

Practice tests for each chapter of the textbook enable you to check your understanding and identify the areas in which you need to do further work.

Based on your test results, we create a personalised Study Plan. This highlights areas where you still need to revise, allowing you to focus on weaker areas and study more efficiently. It also links to the eText, so you can re-read sections in topics you have not yet mastered.

We also provide step-by-step solutions to exercises, so you can see how to get the right answer.

Book Contents for All Topics	Correct	Worked	Questions	Time Spent
Ch. 1: Introduction to accounting and finance			57	
Ch. 2: Measuring and reporting financial position			60	
Ch. 3: Measuring and reporting financial performance			72	
Ch. 4: Accounting for limited companies (1)			0	
Ch. 5: Accounting for limited companies (2)			0	
Ch. 6: Measuring and reporting cash flows			0	
Ch. 7: Analysing and interpreting financial statements			0	
Ch. 8: Relevant costs for decision making			0	
Ch. 9: Cost-volume-profit analysis			0	
Ch. 10: Full costing			0	
Ch. 11: Costing and performance evaluation in a competitive environment			0	
Ch. 12: Budgeting			0	
Ch. 13: Accounting for control			0	
Ch. 14: Making capital investment decisions			0	
Ch. 15: Financing a business			0	
Ch. 16: Managing a working capital			0	
Ch. 17: Supplementary appendix: Recording financial transactions			0	
Total: All Chapters	0	0	189	

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Text

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Introduction to accounting

Introduction

In this opening chapter, we begin by considering the roles of accounting and finance. We 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.

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;
- 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 is 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, in the following section.

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

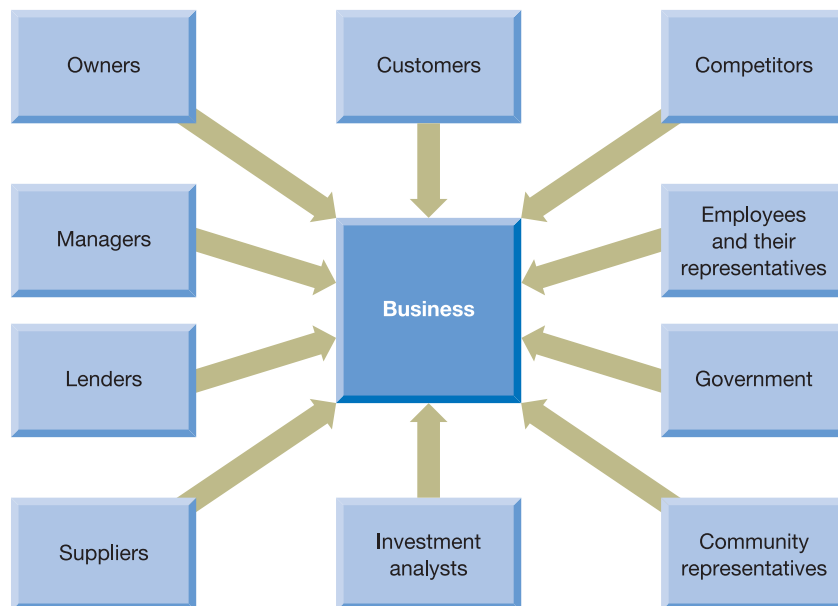
- the main forms of finance available;
- the costs, benefits and risks of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

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:

<i>User group</i>	<i>Decision</i>
Customers	Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet 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).
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.



Activity 1.1 continued

<i>User group</i>	<i>Decision</i>
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 would involve looking at PI's ability to perform and at the opportunities available to it.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on rewarding senior managers. 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 seen above that each user group will have its own particular interests. There is always a risk 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 agreed 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;
- 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? 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;



Activity 1.3 *continued*

- websites, including the website of the business;
- radio and TV reports;
- information-gathering agencies (for example, agencies that assess businesses' credit-worthiness or credit ratings);
- industry reports;
- economy-wide reports.

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

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

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

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 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, which are regarded as fundamental qualities, are therefore:

- **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. With confirmation of 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 is considered material, or significant, if its omission or misstatement would alter the decisions that users make. If the 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.

Activity 1.4

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.

- **Faithful representation.** Accounting information should represent what it is supposed to represent. This means that it should be *complete*, by providing 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 which eventually turn out to be inaccurate. It does mean, however, that there should be no errors in the way in which these estimates have been prepared and described. In practice, a piece of accounting information may not reflect perfectly these three aspects of faithful representation. It should try to do so, however, insofar as is 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 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 (such as the level of sales achieved during the year) to those of similar businesses. Better comparisons can be made where the accounting system treats items that are 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 at whom the information is aimed.

Activity 1.5

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

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

It is probably best that we regard accounting reports in the same way that we regard a report written in a foreign language. To understand either of these, we need to have had some preparation. When producing accounting reports, it is normally assumed that the user not only has a reasonable knowledge of business and accounting but is also prepared to invest some time in studying the reports. 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 1.6.