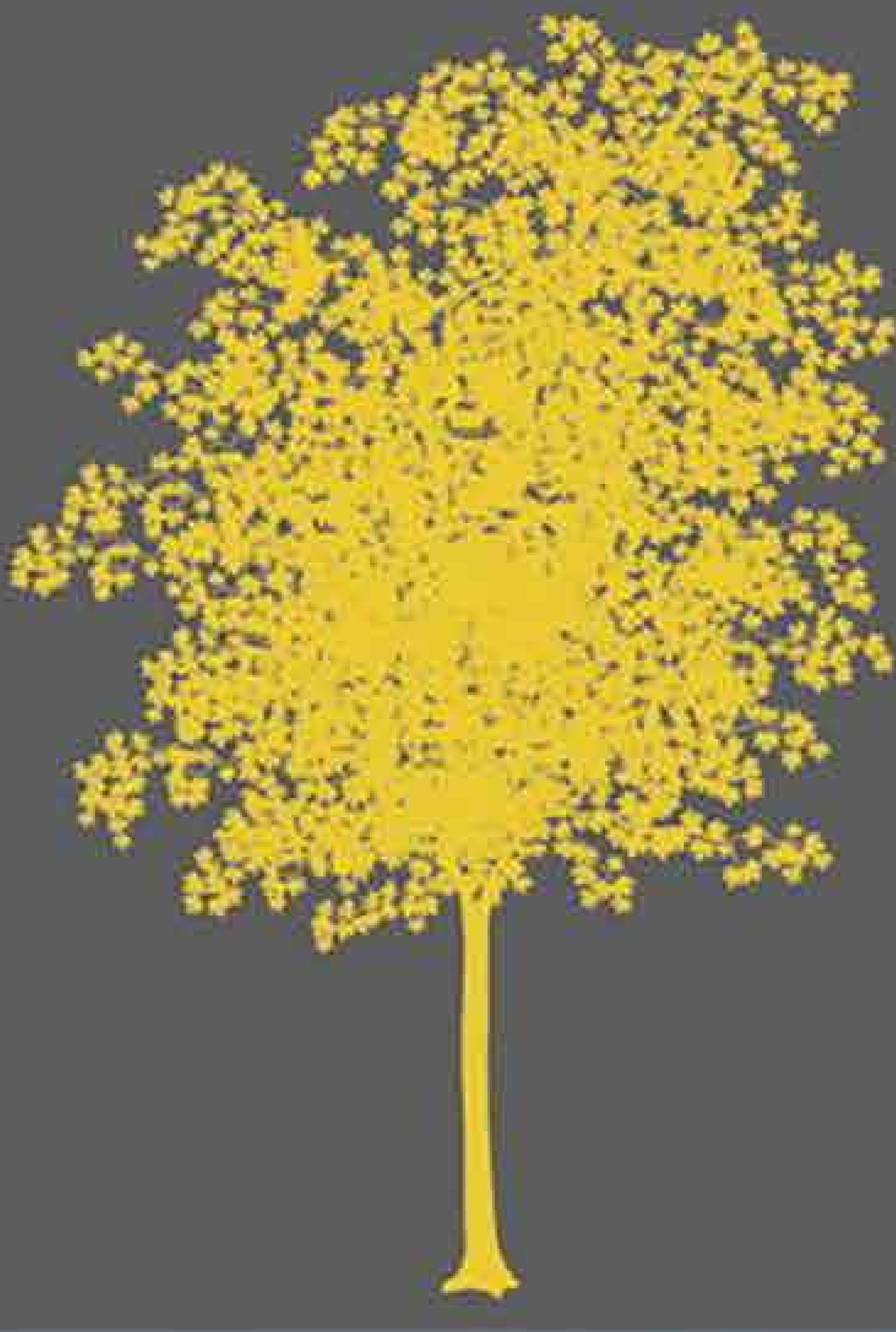
NINTH EDITION

ACCOUNTING AND FINANCE FOR NON-SPECIALISTS

Peter Atrill
Eddie McLaney



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ACCOUNTING AND FINANCE

FOR NON-SPECIALISTS

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Lecturer Resources

ON THE WEBSITE

For password-protected online resources tailored to support the use of this textbook in teaching, please visit **www.pearsoned.co.uk/atrillmclaney**

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 ninth 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.

Some new topics can be found in this ninth edition. A short section on Islamic finance has been added, which reflects the growing importance of this topic. Also, some additional sources of finance have been included.

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. In addition, you will find all 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 an open design and clear signposting of the various features and assessment material. More detail about the nature and use of these features, together with example pages, is given in the Guided tour on pp. xviii.

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

Peter Atrill
Eddie McLaney

Guided tour

Chapter 2

MEASURING AND REPORTING FINANCIAL POSITION

INTRODUCTION

We saw in Chapter 1 that accounting has two distinct strands: financial accounting and management accounting. This chapter, along with Chapters 3, 4 and 5, examines the three major financial statements that form the core of financial accounting. We start by taking an overview of these statements to see how each one contributes towards an assessment of the overall financial position and performance of a business.

Following this overview, we begin a more detailed examination by turning our attention towards one of these financial statements: the statement of financial position. We shall see how it is prepared and examine the principles underpinning it. We shall also consider its value for decision-making purposes.

Learning outcomes

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

- explain the nature and purpose of the three major financial statements;
- prepare a simple statement of financial position and interpret the information that it contains;
- discuss the accounting conventions and other principles underpinning the statement of financial position;
- discuss the uses and limitations of the statement of financial position for decision-making purposes.

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

Learning outcomes Bullet 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.

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.

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 selling 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 trade receivables and in the amount of bad debts. Example 12.3 shows how this may be done.

Example 12.3

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 accept this facility but that the remaining customers, who tend to be slow payers, will not pay 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.

Should Williams Wholesalers Ltd offer the new credit terms to customers?

Solution

The first step 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	(602,740)
Reduction in trade receivables		164,383

The costs and benefits of offering the discount can be set out as follows:

Cost and benefits of policy		
Cost of discount (£2m × 2%)		40,000
Less		
Interest saved on the reduction in trade receivables (£164,383* × 13%)	21,370	
Administration cost saving	6,000	
Cost of bad debts saved (20,000 – 10,000)	10,000	(37,370)
Net cost of policy		2,630

* It could be argued that the interest should be based on the amount expected to be received; that is the value of the trade receivables *after* taking account of the discount. Basing it on the expected receipt figure would not, however, alter the conclusion that the business should not offer the new credit terms.

These calculations show that the business will be worse off by offering the new credit terms.

MANAGING TRADE RECEIVABLES 467

If we look back to Real World 7.2 (page 249) we can see that Ryanair typically had a much larger margin of safety than BA.

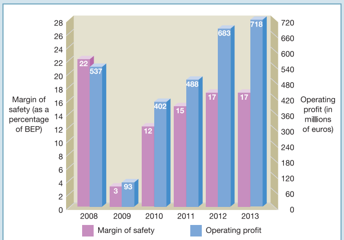
Real World 7.4 goes into more detail on Ryanair's margin of safety and operating profit, over recent years.

REAL WORLD 7.4

Ryanair's margin of safety

As we saw in Real World 7.2, commercial airlines pay a lot of attention to BEPs. They are also interested in their margin of safety (the difference between load factor and BEP).

Figure 7.9 shows Ryanair's margin of safety and its operating profit over a six-year period. Note that in 2009, Ryanair had a load factor that was only just above its break-even point and this led to an unusually small operating profit. In the other years, the load factors were comfortably greater than the BEP. This led to larger operating profits in those years.



The margin of safety is expressed as the difference between the load factor and the BEP (for each year), expressed as a percentage of the BEP. Generally, the higher the margin of safety, the higher the operating profit.

Source: Derived from information contained in Ryanair Holdings plc 2013 Annual Report.

Figure 7.9 Ryanair's margin of safety

MARGIN OF SAFETY 255

'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.

THE DIRECTORS' DUTY TO ACCOUNT

With many companies, there is a separation of ownership from day-to-day control. This creates the need for directors to be accountable for their stewardship (management) of the company's assets. Thus, the law requires that directors:

- maintain appropriate accounting records;
- prepare annual financial statements and a directors' report and make these available to shareholders and lenders.

The financial statements must also be made available to the public by submitting a copy to the Registrar of Companies who allows any interested person to inspect them. In addition, Stock Exchange listed companies must publish their financial statements on their website.

Activity 4.15

What are the possible consequences of failing to make financial statements available to shareholders, lenders and suppliers on the ability of the business to operate?

If shareholders do not receive information about the performance and position of their investment, they will have problems in appraising their investment. Under these circumstances, they would probably be reluctant to invest. Furthermore, individuals and organisations would be reluctant to engage in commercial relationships, such as supplying goods or lending money, where a company does not provide information about its financial health.

THE NEED FOR ACCOUNTING RULES

If we accept the need for directors to prepare and publish financial statements, we should also accept the need for rules about how they are prepared and presented. Without rules, there is a much greater risk that unscrupulous directors will adopt accounting policies and practices that portray an unrealistic view of financial health. There is also a much greater risk that the financial statements will not be comparable over time or with those of other businesses. Accounting rules can narrow areas of differences and reduce the variety of accounting methods. This should help ensure that similar transactions are treated in a similar way.

Although accounting rules should help to provide confidence in the integrity of financial statements, users must be realistic about what can be achieved. Problems of manipulation and of concealment can still occur even within a highly regulated environment. The scale of these problems, however, should be reduced where there is a practical set of rules. Problems of comparability can also still occur as judgements and estimates must be made when preparing financial statements. There is also the problem that no two companies are identical and so accounting policies may vary between companies for entirely valid reasons.

THE NEED FOR ACCOUNTING RULES 139

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.

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 B.

SELF-ASSESSMENT QUESTION 8.1

Psilis Ltd makes a product in two qualities, called 'Basic' and 'Super'. The business is able to sell these products at a price that gives a standard profit mark-up of 25 per cent of full cost. Full cost is derived using a traditional batch costing approach.

Management is concerned by the lack of profit.

To derive the full cost for each product, overheads are absorbed on the basis of direct labour hours. The costs are as follows:

	Basic	*Super*
	£	£
Direct labour (all £10 an hour)	40	60
Direct material	15	20

The total annual overheads are £1,000,000.

Based on experience over recent years, in the forthcoming year the business expects to make and sell 40,000 Basics and 10,000 Supers.

Recently, the business's management accountant has undertaken an exercise to try to identify activities and cost drivers in an attempt to be able to deal with the overheads on a more precise basis than had been possible before. This exercise has revealed the following analysis of the annual overheads:

Activity (and cost driver)	*Cost*	*Annual number of activities*		
	£000	*Total*	*Basic*	*Super*
Number of machine set-ups	280	100	20	80
Number of quality-control inspections	220	2,000	500	1,500
Number of sales orders processed	240	5,000	1,500	3,500
General production (machine hours)	260	500,000	350,000	150,000
Total	1,000			

The management accountant explained the analysis of the £1,000,000 overheads as follows:

- The two products are made in relatively small batches, so that the amount of the finished product held in inventories is negligible. The Supers are made in particularly small batches because the market demand for this product is relatively low. Each time a new batch is produced, the machines have to be reset by skilled staff. Resetting for Basic production occurs about 20 times a year and for Supers about 80 times: about 100 times in total. The cost of employing the machine-setting staff is about £280,000 a year. It is clear that the more set-ups that occur, the higher the total set-up costs; in other words, the number of set-ups is the factor that drives set-up costs.
- All production has to be inspected for quality and this costs about £220,000 a year. The higher specifications of the Supers mean that there is more chance that there will be quality problems. Thus the Supers are inspected in total 1,500 times annually, whereas the Basics only need about 500 inspections. The number of inspections is the factor that drives these costs.

→

USING FULL (ABSORPTION) COST INFORMATION 309

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.

SUMMARY

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

Sources of finance

- Long-term finance is for at least one year whereas short-term finance is for a shorter period.
- External sources of finance require the agreement of outside parties, whereas internal sources do not.
- The higher the risk associated with a source of finance, the higher the expected return from investors.

Internal sources of finance

- Retained earnings are by far the most important source of new long-term finance (internal or external) for UK businesses.
- Retained earnings are not a free source of finance, as investors will require returns similar to those from ordinary shares.
- Internal sources of short-term finance include tighter control of trade receivables, reducing inventories levels and delaying payments to trade payables.

External sources of finance

- External sources of long-term finance include ordinary shares, preference shares, borrowings, leases and securitisation.
- From an investor's perspective, ordinary shares are normally the most risky form of investment and provide the highest expected returns to investors. Borrowings (loans) are normally the least risky and provide the lowest expected returns to investors.
- Loans are relatively low risk because lenders usually have security for their loan. Loan covenants can further protect lenders.
- Types of loans include term loans, convertible loan notes, mortgages and eurobonds.
- Convertible loan notes offer the right of conversion to ordinary shares at a specified date and a specified price.
- Interest rates may be floating or fixed.
- A finance lease is really a form of lending that gives the lessee the use of an asset over most of its useful life in return for regular payments.
- A sale and leaseback arrangement involves the sale of an asset to a financial institution accompanied by an agreement to lease the asset back to the business.
- Securitisation involves bundling together similar, illiquid assets to provide backing for the issue of bonds.
- External sources of short-term finance include bank overdrafts, debt factoring and invoice discounting.
- Bank overdrafts are flexible and cheap but are repayable on demand.

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KEY TERMS

profit p. 68
revenue p. 68
expense p. 69
reporting period p. 69
gross profit p. 71
operating profit p. 71
profit for the period p. 72
cost of sales p. 73
matching convention p. 80
accrued expenses p. 81
prepaid expenses p. 83
materiality convention p. 84
accruals convention p. 84
accruals accounting p. 85
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carrying amount p. 88
written-down value p. 88
net book value p. 88
reducing-balance method p. 89
first in, first out (FIFO) p. 94
last in, first out (LIFO) p. 94
weighted average cost (AVCO) p. 94
consistency convention p. 98
bad debt p. 99

FURTHER READING

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

Alexander, D. and Nobes, C., *Financial Accounting: An International Introduction*, 5th edn, Pearson, 2013, Chapters 8, 9 and 10.

Elliott, B. and Elliott, J., *Financial Accounting and Reporting*, 16th edn, Pearson, 2013, Chapters 2, 8, 20 and 21.

Ernst and Young, *International GAAP 2013 Generally Accepted Accounting Principles*, Wiley, 2013, Chapters 24, 25 and 30.

International Accounting Standards Board, *2013 International Financial Reporting Standards IFRS 2013 IAS2 Inventories*, *IAS18 Revenue*.

104 CHAPTER 3 MEASURING AND REPORTING FINANCIAL PERFORMANCE

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.

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.

FURTHER READING

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

Atkinson, A., Kaplan, R., Matsumura, E. and Young, S. M., *Management Accounting*, 6th edn, Pearson, 2011, Chapter 11.

Atrill, P. and McLaney, E., *Management Accounting for Decision Makers*, 7th edn, FT/Prentice Hall, 2012, Chapters 6 and 7.

Drury, C., *Management and Cost Accounting*, 8th edn, Cengage Learning EMEA, 2012, Chapter 15.

Horngren, C., Datar, S. and Rajan, M., *Cost Accounting: A managerial emphasis*, 14th edn, Prentice Hall International, 2011, Chapter 6.

? REVIEW QUESTIONS

Answers to these questions can be found at the back of the book, starting on p. 526.

9.1 Define a budget. How is a budget different from a forecast?

9.2 What were the five uses of budgets that were identified in the chapter?

9.3 What is meant by a *variance*? What is the point in analysing variances?

9.4 What is the point in flexing the budget in the context of variance analysis? Does flexing imply that differences between budget and actual in the volume of output are ignored in variance analysis?

EXERCISES

Exercise 9.1 is basic level, 9.2 and 9.3 are intermediate level and 9.4 and 9.5 are advanced level. Those with ***coloured numbers*** *have answers at the back of the book, starting on page 547.*

9.1 You have overheard the following statements:

(a) 'A budget is a forecast of what is expected to happen in a business during the next year.'
(b) 'Monthly budgets must be prepared with a column for each month so that you can see the whole year at a glance, month by month.'
(c) 'Budgets are OK but they stifle all initiative. No manager worth employing would work for a business that seeks to control through budgets.'
(d) 'Any sensible person would start with the sales budget and build up the other budgets from there.'

Required:
Critically discuss these statements, explaining any technical terms.

350 CHAPTER 9 BUDGETING

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 C.

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 D, 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/atrillmclaney**.

Acknowledgements

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Figures

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Text

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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. If the financial information being communicated cannot 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 book strongly reflects the decision-making perspective of accounting. That perspective also 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:

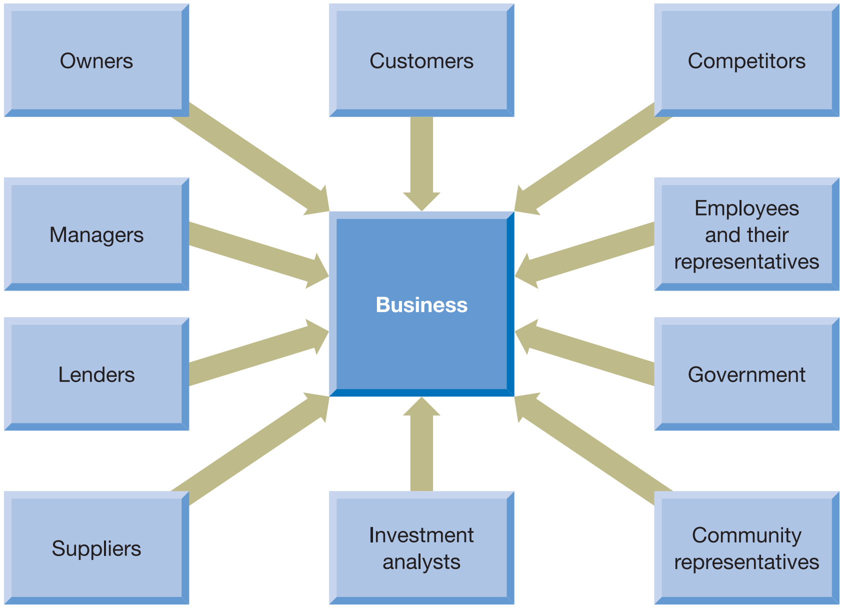
- the main forms of finance available;
- the costs, benefits and risks of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

Once 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 meant to be an exhaustive list of potential users; however, the 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 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).

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 and its willingness to use community resources and 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 any goods and services supplied.
Lenders	Whether to lend money to PI and/or whether to demand 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 both PI's ability to perform and the opportunities available.
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 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.

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, 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 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.

  If 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 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. In practice, a piece of accounting information may not reflect perfectly these three aspects of faithful representation. It should aim to do so, however, 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. Also, those at whom the information is aimed should understand it.

Activity 1.3

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

It would be helpful if everyone could understand accounting reports. This is unrealistic, however, as complex financial events and transactions cannot normally be expressed 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 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, it does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.4.

Activity 1.4

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 when parking our car, we dented one of the doors and scraped the paintwork. We want to have the dent taken out and the door resprayed 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 petrol and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local garages? The answer, as we have seen, is that if the cost of discovering the price is less than the potential benefit, it is worth having that information.

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

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

The economic benefit of having the information on the price of the job is probably even harder to assess 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 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.

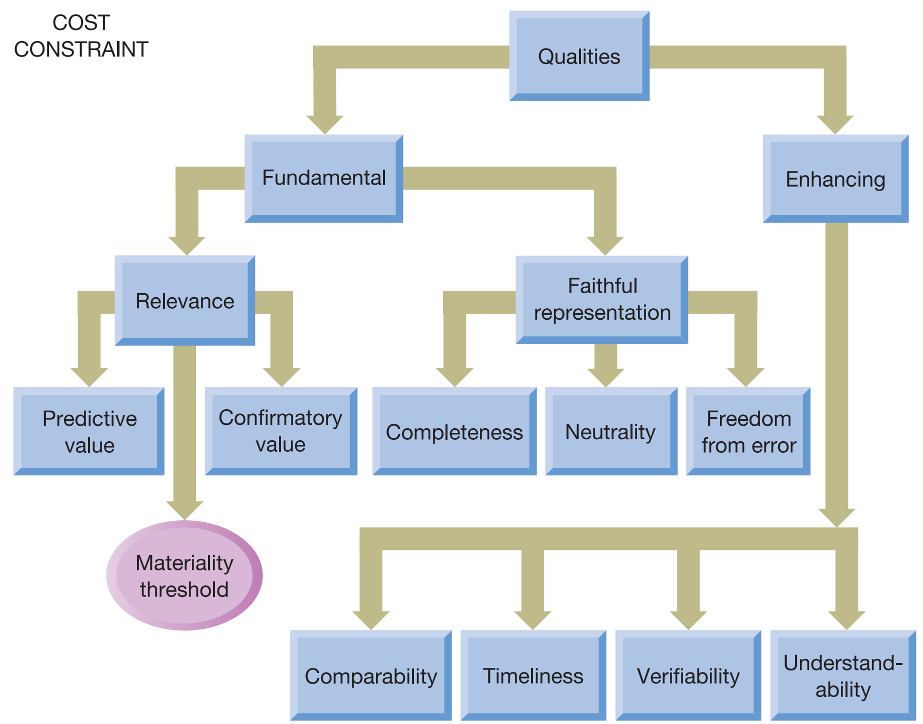
Activity 1.5

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. Furthermore, the precise weight attached to the accounting information by the decision maker 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, which have been 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

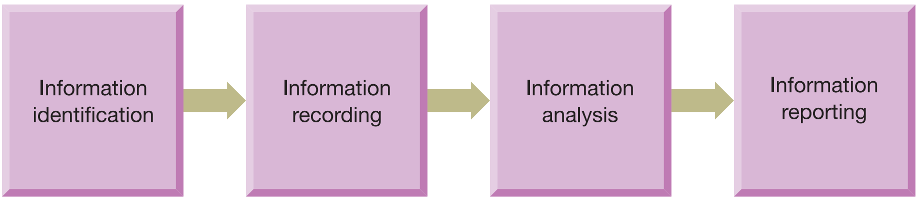
ACCOUNTING AS AN INFORMATION SYSTEM

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, have to make decisions concerning the allocation of scarce resources. To ensure that these resources are efficiently allocated, users 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.



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.

Figure 1.3 The accounting information system

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 consider the way in which information is used by, and is useful to, users rather than the way in which it is identified and recorded.

Efficient accounting systems are an essential ingredient of an efficient business. When the accounting systems fail, the results can be disastrous. **Real World 1.1** provides an example of a systems failure. It arose from the failure to integrate two separate accounting systems following the merger of two businesses.