

accounting

AN INTRODUCTION

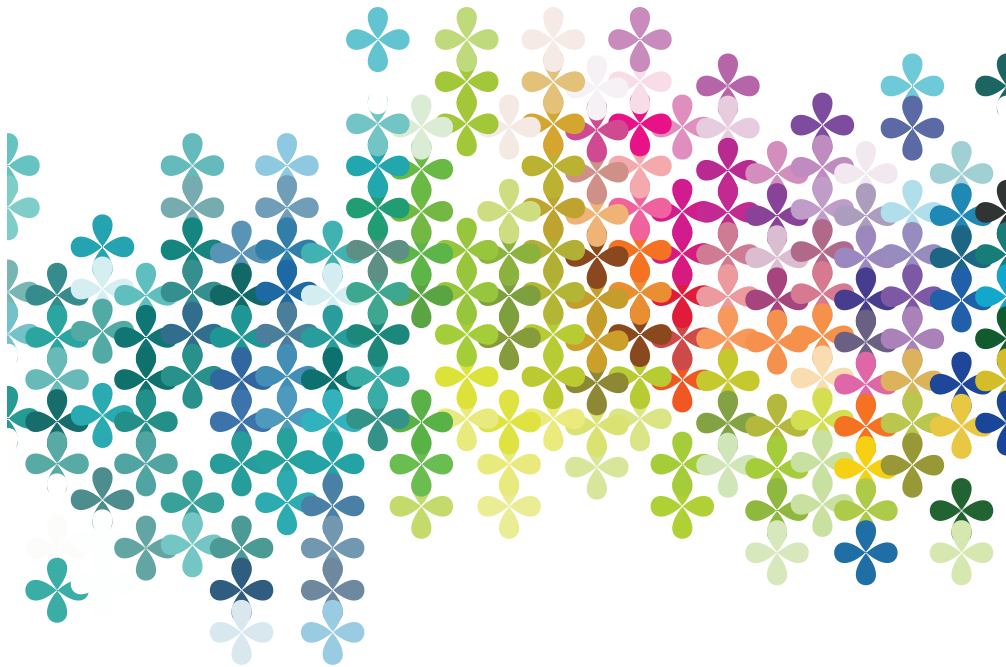
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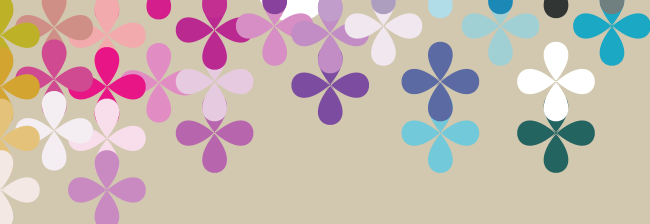
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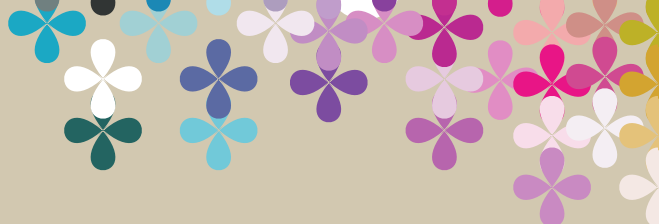
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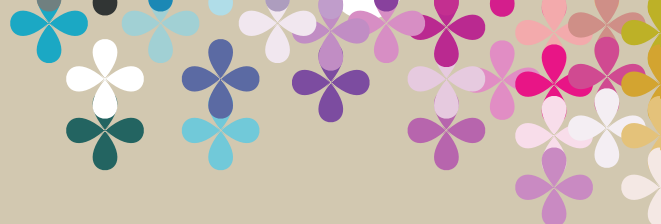
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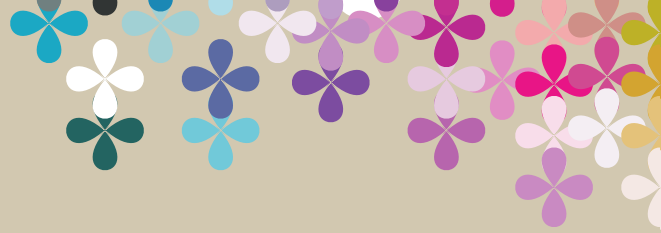
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about the Australian author



Emeritus Professor David Harvey



After qualifying as an accountant in the United Kingdom, David began lecturing in 1971 at Portsmouth Polytechnic (now Portsmouth University) with a subsequent move to Plymouth Polytechnic (now the University of Plymouth) in 1977. During his time in the United Kingdom he developed a keen interest in curriculum development and teaching methods and was involved with the writing of several books with an open learning style, many of these in collaboration with Peter Atrill and Eddie McLaney. During this time he also completed a Masters degree in Managerial Financial Controls and a PhD in the areas of investment and financing decisions. This research work covered both traditional investment appraisal and corporate strategy.

In 1991 he moved to Australia to take up the position of Professor of Accounting and Head of the Centre for Accounting and Finance at the University of New England (Northern Rivers), which subsequently became Southern Cross University. In 1992 he became the Dean of the Faculty of Business and Computing, a position he held until 1996, before reverting to his Professorship. In 2000 he took up the position of the Dean of the Faculty of Commerce at the University of Southern Queensland. In 2001 the Faculty of Commerce was merged with the Faculty of Business and David became Dean of the enlarged Faculty of Business. David has had extensive experience in developing and teaching programs internationally. His most recent position was as Pro Vice-Chancellor (International Quality), a position he held from 2004 until his retirement in 2005.



preface



This text is the sixth Australian edition of a UK book. It provides a broad-based introduction to accounting and finance for those who wish, or need, to acquire an understanding of the main concepts and their practical application in decision-making, but who do not require in-depth theoretical or technical detail. It is aimed primarily at students who are studying a single unit in accounting and finance as part of a university or MBA course, including courses in business studies, economics, engineering and a range of other non-specialist accounting courses. Given the content and style of the text it is suitable for students studying at a distance, and for those who are studying independently, perhaps with no formal qualification in mind.

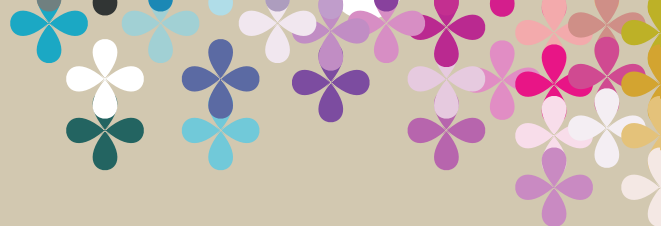
In writing the text we have been particularly mindful that most of its readers will not have studied accounting and finance before. We have, therefore, tried to write in an accessible style, avoiding technical jargon. Throughout, we have tried to ensure that basic concepts are thoroughly explained. Underpinning the text's coverage is an 'open learning' approach – that is to say, it involves the reader in a way that is not traditionally found in textbooks, delivering topics much as a good lecturer would do and encouraging readers to interact with the text. This approach distinguishes itself through a variety of integrated and end-of-chapter assessment material, which has been largely updated for this edition, including the following.

- ❖ Interspersed throughout each chapter are numerous activities, with one for every learning objective. These are relatively short 'quick fire' questions of a type a lecturer might pose to students during a lecture or tutorial, and are intended to serve two purposes: to give readers the opportunity to check that they have understood the preceding section; and to encourage them to think beyond the immediate topic and make linkages to topics either previously covered or covered in the next section. An answer to each activity is provided at the end of the chapter, to which readers should refer only after they have attempted the activity.
- ❖ Towards the end of chapters, but also at an appropriate point in some chapters, there is a self-assessment question or questions. These are much more demanding and comprehensive than the activities, in terms both of the breadth and depth

of the material they cover. As with the activities, it is important to make a thorough attempt at each question before referring to the solution.

- ❖ Discussion questions occur at the end of each chapter. These are relatively short, typically require a descriptive or analytical answer, and are intended to enable readers to assess their recollection and critical evaluation of the main principles in each chapter. They might be used as the basis for tutorial discussion.
- ❖ Application exercises are also positioned at the end of most chapters and these have been categorised as easy, intermediate or challenging. These are typically of a numerical type, and are designed to enable readers to further apply and consolidate their understanding of topics. The discussion questions and application exercises are generally, though not exclusively, at the easy end of the spectrum, in line with suggestions from reviewers and users.
- ❖ A single case study can also be found at the end of each chapter. Some of these are simply more complicated problems, but in the main they are questions based on contemporary news media articles. Their aim is to get students to think in a broader manner than usual, and to develop a wider approach to dealing with issues that are real and current.
- ❖ This edition continues to include what we have called Real World examples (typically two or three per chapter), which aim to provide a link between theory and current practice. These are updated to reflect what has occurred since the last edition of the book.
- ❖ This edition also continues with a feature introduced in the fifth edition. Each chapter has an Accounting and You section, which aims to relate the content of the chapter to the individual student reader. All too often students feel that the content is big-business oriented and has nothing really to do with them and their everyday lives. This section illustrates that what they are learning has real relevance to their everyday lives.

Throughout the text we have been conscious of the need to develop generic skills where possible, as well as the more



traditional accounting skills. Generic skills targeted include, communication, teamwork, critical thinking, problem-based learning, ethics, self-management, planning and organisation. It is impossible to do this in a single book, but we believe that this book should facilitate a curriculum-wide approach to development of these kinds of skills.

Specific areas to note include the following:

- ❖ The opportunity to use the discussion questions and cases to develop oral and presentational skills and to develop teamwork.
- ❖ The whole book is problem-based, so problem-solving skills should be enhanced.
- ❖ Self-management and organisation skills development should be facilitated by the open learning approach and use of activities.
- ❖ Reference to ethics and governance, particularly in Chapters 5 and 7, provide a focus for ethics and 'green' issues.
- ❖ Critical thinking is enhanced by the use of appropriate cases and questions, together with current Real World examples and the sections on Accounting and You. By way of illustration, Chapters 5 and 7, in particular, raise major issues relating to governance and sustainability that need to be approached critically.

It is perhaps worth noting that all three authors are qualified accountants. However, their career paths and interests are rather different. The main areas of interest include financial accounting, management accounting, finance and corporate strategy. Specific areas of expertise include behavioural aspects of accounting, and the links between finance theory and corporate strategy. All have experience of curriculum development ranging from thorough to comprehensive. One has extensive experience internationally. The net result is a writing team of considerable diversity of experience which is aware of the need to try to balance the accounting skills requirement with the need to develop more broadly based skills.

Coverage and structure

Although the topics included are, to some extent, relatively conventional, the coverage and treatment of material is

designed to meet the needs of non-specialists; therefore, the emphasis is on the application and interpretation of information for decision-making, and the underlying concepts, rather than on the collection of data and the preparation of statements and reports.

In making changes we have incorporated many of the suggestions made by reviewers. Generally the sixth edition is not quite as detailed as the fifth edition, reflecting a clearer focus on the non-specialist market. Three chapters have been deleted (forecast financial statements, share and business valuations and the chapter on trends and issues in accounting) although the most critical areas of these old chapters have been incorporated in the remaining chapters in recognition that they are now mainstream. Corporate governance is now covered in reasonable detail in Chapter 5 and corporate social responsibility and sustainability accounting is in Chapter 7. Chapter 6 includes some reference to the use of the main financial statements for planning and budgeting.

Having said this the main structural differences between the fifth and sixth editions are to be found in the first five chapters. The more we examined the order and level of content the more we realised that as business and accounting become more complicated so it was becoming more difficult to cover these issues in a reasonably straightforward way, using the structure of earlier editions. So in the sixth edition we have introduced (in Chapters 2 and 3) two of the major accounting statements in the context of relatively simple business organisations, mainly sole proprietorships and partnerships, or very simple companies. This has enabled us to cover the basic accounting statements without adding the complications of a complex corporate regulatory framework. Once the underlying principles and nature of the statement of financial position (the balance sheet) and the statement of financial performance (the income statement) have been understood, we can then complicate it by adding (Chapters 4 and 5) companies and their regulatory framework. The first five chapters seem to us to be more bite sized than the old chapters in the fifth edition.

We have ordered the chapters and their component topics to reflect what we consider to be a logical sequence. For this reason, we advise readers to work through the text in the order presented, particularly since we have been careful to ensure that earlier chapters do not refer to concepts or terms that are not covered until a later chapter.

Chapters 1-8 can be said to be broadly financial accounting oriented, Chapters 9-11 focus on what are clearly management accounting areas, and Chapters 12-14 focus on what is generally regarded as financial management. Having said this, much of the first eight chapters underpin the later chapters and students should not get too hung up on which area is which.

Chapter 1 provides a general introduction to the scope, purpose and interrelationships of the text's core coverage – financial accounting, management accounting and financial management – together with a brief overview of the main financial statements. It also examines user groups and their needs, introduces the main types of business organisation, together with the way in which a business is typically organised and managed and identifies ways in which business and accounting have been changing over time.

Chapter 2 explains the nature and purpose of the statement of financial position. This is done in the context of relatively simple organisations, so as to not unnecessarily complicate things. The method in which the statement is built up, and its typical format, are both covered, followed by the main factors that influence the content and values in the statement. Finally the main uses and limitations of the statement are examined. Chapter 3 explains the nature and purpose of a statement of financial performance, usually referred to as an income statement. The way in which the statement is built up, and the way in which it is typically presented are covered comprehensively, for relatively simple organisations.

Chapter 4 introduces limited companies in some detail, including the main financial statements. Chapter 5 explains the importance of company law, accounting standards, the stock exchange and the importance of good corporate governance. Corporate governance remains an ongoing issue for many businesses. The chapter then identifies the

main requirements relating to the published annual report and explains the concept of a group of companies and the need for a set of consolidated accounts.

Chapter 6 focuses on the statement of cash flows and the importance of cash to any business. It also introduces the idea of using the financial statements framework for planning and budgeting purposes

Chapter 7 introduces the areas of corporate social responsibility together with social and environmental accounting and also explains the current state of development of sustainability reporting and integrated reporting. Further work on these areas is likely to be needed over the foreseeable future as the world faces continued issues including climate change, a range of other environmental issues, peak oil, world poverty, child labour abuse, and human rights and responsibilities generally.

Chapter 8 deals with the analysis and interpretation of the main financial statements.

Our formal coverage of management accounting begins in Chapter 9 with a discussion of the interrelationships between costs, volume and profit in decision-making. Chapter 10 covers full costing and activity-based costing. Chapter 11 focuses on short-term planning and control and deals with various aspects of budgeting.

Chapter 12 is the first chapter that relates to what is generally termed financial management. It deals with capital budgeting, the decision to invest in medium- and long-term assets, and considers how businesses appraise such projects. Chapter 13 deals with the management of short-term assets and liabilities. Chapter 14 covers the main sources of finance available to a business in making an investment.

Peter Atrill
Eddie McLaney
David Harvey



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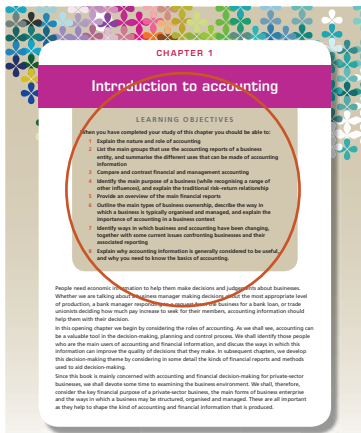
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Chartered Association of Certified Accountants

We would like to thank the Chartered Association of Certified Accountants for their permission to use some questions from the Certified Diploma.

for students: how can I use this book?

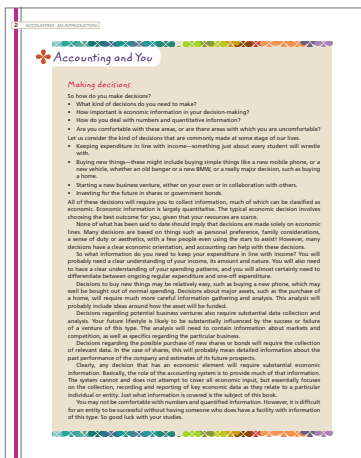


Learning objectives

These are listed at the beginning of each chapter and explain the key concepts that you should understand after studying the chapter. They are restated in the chapter, so you know where these objectives are covered. End-of-chapter questions are also keyed to the objectives.

Key term definitions

To help you understand key accounting terminology and concepts, definitions are presented in the margin. All these terms are also in the glossary at the end of the book for easy reference.

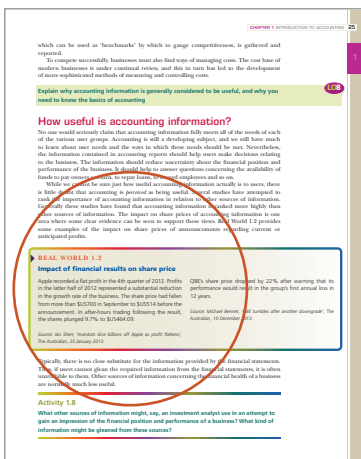


Accounting and You boxes

This feature appears in each chapter to help you see the relevance of accounting concepts to your everyday life.

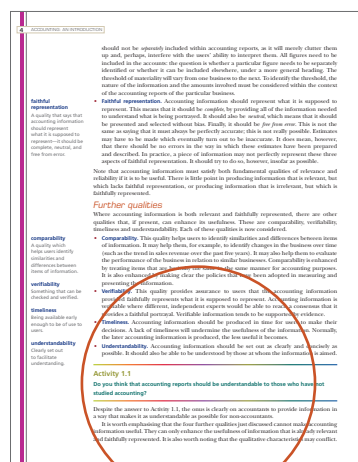
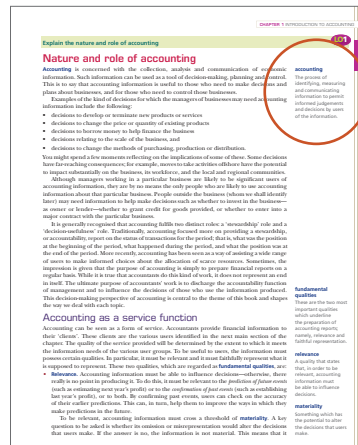
In-chapter activities

These are designed to test your comprehension of the material you have just read, as well as to make links to topics already covered or still to be covered. Answers to the activities are provided at the end of each chapter.



Real World examples

Integrated throughout the text, these illustrative examples highlight the practical application of accounting concepts and techniques by real businesses, including extracts from published financial reports, articles from the media, survey data and other interesting insights from business.



resources for students and educators

MyAccountingLab for Atrill/McLaney/Harvey *Accounting: An Introduction*, 6th edition A guided tour for students and educators

Auto-generated tests and assignments

Each MyLab comes with pre-loaded assignments, all of which are automatically graded and include selected end-of-chapter questions and problems from the textbook.

The screenshot displays the MyAccountingLab dashboard. On the left, under 'My Upcoming Assignments', there are three items: 'Chapter 1 Revision quiz', 'Chapter 2 Test', and 'Chapter 3 homework'. Below this is a 'View Course Documents' link. The 'Announcements' section features a 'Welcome to MyAccountingLab' message with a 'Get Started' list: 1. Run the Browser Check, 2. For self-directed study: Build your Study Plan, 3. For assigned content: Review your Assignments. A 'Please complete this survey' link is also present. On the right, the 'My Results' section shows an 'Overall Score' of 0% and a 'Course Timeline' graph. The 'My Progress' section includes progress bars for Homework (1/2), Quizzes (1/2), Tests (1/2), and Study Plan (1/2).

Unlimited practice

Many Study Plan and Instructor-assigned exercises contain algorithms to ensure students get as much practice as they need. As students work through Study Plan or Homework exercises, instant feedback and tutorial resources guide them towards understanding.

The screenshot shows an exercise interface for 'Chapter 4: Measuring and reporting financial performance'. The exercise is 'Exercise 4.7-19' and shows '0 correct | 0 of 31 complete'. The question asks: 'The graph shown opposite charts the written-down value [carrying amount] of a non-current asset against time. Which depreciation method is shown here?'. A graph plots 'Carrying amount (\$000s)' on the y-axis (0 to 40) against 'life (years)' on the x-axis (0 to 5). A straight line starts at (0, 40) and ends at (5, 0). A green feedback box says 'Well done! Well done - the graph shows that the written-down value [carrying amount] falls evenly over the asset's life under the straight-line method.' The method shown is 'straight-line method'. The interface includes navigation buttons, a 'Check Answer' button, and a 'Print' button.



MyAccountingLab www.pearson.com.au/atrill6

Exercise 11.5-14
0 correct | 0 of 91 complete

Caravans Ltd is a company that is deciding between two vehicle purchasing alternatives. Alternative E which would require a first payment of \$65 000 followed by five annual instalments, or Alternative F that would require a first payment of \$80 000 followed by four annual instalments.

Video: Positive Cashflow

The chosen alternative under Alternative E is...
The discount rate is...

Year	First payment			
1		0.909		
2		0.826		
3		0.751		

Enter any number in the edit fields, then click Check Answer.

2 parts remaining

Buttons: Clear All, Check Answer, Close

Help Me Solve This, eText Pages, Calculator, Print

Learning resources

To further reinforce understanding, Study Plan and Homework problems link to additional learning resources.

- Step-by-step guided solutions
- Graphing tool
- eText linked to sections for all Study Plan questions.

Study Plan

You have earned 0 of 164 mastery points (MP). [View progress](#)

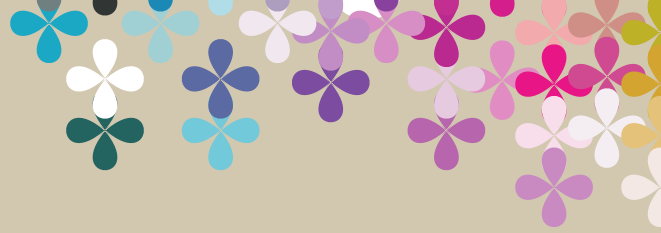
Practice these sections and then take a Quiz Me to prove mastery and earn more points.

What to work on next

0.1	Tutorial Examples for Students	Practice	Quiz Me	0 of 1 MP
More Sections to practice and master View all chapters				
1.1	Nature and role of accounting	Practice	Quiz Me	0 of 1 MP
1.2	Users of accounting	Practice	Quiz Me	0 of 1 MP
1.3	Financial and management accounting	Practice	Quiz Me	0 of 1 MP
1.4	Balancing risk and return	Practice	Quiz Me	0 of 1 MP

Study plan

A Study Plan is generated from each student's results on quizzes and tests. Students can clearly see which topics they have mastered and, more importantly, which they need to work on.



Students

These additional resources are available on MyAccountingLab:

- ❖ **Workbook:** Use this as an excellent revision and study tool designed to match the structure and content of the textbook. This workbook gives you a wide variety of questions (e.g. multiple choice, true/false, matching, fill in the blanks, classification and practical questions), as well as a list of the textbook's chapter objectives and a chapter overview. Solutions to all the question material are provided at the end of each chapter.
- ❖ **Solutions** to the self-assessment questions (also available on www.pearson.com.au/9781486008797).

Educators

A full suite of additional materials is provided with this textbook. The Educator Resources contain a variety of useful features including:

- ❖ A **Test Bank** of questions for each chapter containing a range of multiple choice and essay-type questions featuring problems of varying complexity and structured by Learning Objective for the educator's convenience. The Test Bank has been tagged by AACSB standards as well as by difficulty level.
The Test Bank is now also available in Word as well as Pearson's Testgen which allows the creation of customised exams in minutes.
- ❖ **Solutions Manual:** Fully revised and updated by the author team to include answers to all the questions contained in the text. For each chapter it provides the learning objectives, solutions to all end-of-chapter discussion questions and case studies, together with suggested answers for the application exercises.
Both the Test Bank and Solutions Manual have been technically edited by leading subject matter experts to ensure the highest accuracy and quality standards are met.
- ❖ **Digital Image PowerPoint® Slides:** The images, figures and tables from the text are provided within the new edition's branded PowerPoint® template enabling the personalisation of the lecturer's presentation.

CHAPTER 1

Introduction to accounting

LEARNING OBJECTIVES

When you have completed your study of this chapter you should be able to:

- 1 Explain the nature and role of accounting**
- 2 List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information**
- 3 Compare and contrast financial and management accounting**
- 4 Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship**
- 5 Provide an overview of the main financial reports**
- 6 Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context**
- 7 Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting**
- 8 Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting.**

People need economic information to help them make decisions and judgements about businesses. Whether we are talking about a business manager making decisions about the most appropriate level of production, a bank manager responding to a request from the business for a bank loan, or trade unionists deciding how much pay increase to seek for their members, accounting information should help them with their decision.

In this opening chapter we begin by considering the roles of accounting. As we shall see, accounting can be a valuable tool in the decision-making, planning and control process. We shall identify those people who are the main users of accounting and financial information, and discuss the ways in which this information can improve the quality of decisions that they make. In subsequent chapters, we develop this decision-making theme by considering in some detail the kinds of financial reports and methods used to aid decision-making.

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

Accounting and You

Making decisions

So how do you make decisions?

- What kind of decisions do you need to make?
- How important is economic information in your decision-making?
- How do you deal with numbers and quantitative information?
- Are you comfortable with these areas, or are there areas with which you are uncomfortable?

Let us consider the kind of decisions that are commonly made at some stage of our lives.

- Keeping expenditure in line with income—something just about every student will wrestle with.
- Buying new things—these might include buying simple things like a new mobile phone, or a new vehicle, whether an old banger or a new BMW, or a really major decision, such as buying a home.
- Starting a new business venture, either on your own or in collaboration with others.
- Investing for the future in shares or government bonds.

All of these decisions will require you to collect information, much of which can be classified as economic. Economic information is largely quantitative. The typical economic decision involves choosing the best outcome for you, given that your resources are scarce.

None of what has been said to date should imply that decisions are made solely on economic lines. Many decisions are based on things such as personal preference, family considerations, a sense of duty or aesthetics, with a few people even using the stars to assist! However, many decisions have a clear economic orientation, and accounting can help with these decisions.

So what information do you need to keep your expenditure in line with income? You will probably need a clear understanding of your income, its amount and nature. You will also need to have a clear understanding of your spending patterns, and you will almost certainly need to differentiate between ongoing regular expenditure and one-off expenditure.

Decisions to buy new things may be relatively easy, such as buying a new phone, which may well be bought out of normal spending. Decisions about major assets, such as the purchase of a home, will require much more careful information gathering and analysis. This analysis will probably include ideas around how the asset will be funded.

Decisions regarding potential business ventures also require substantial data collection and analysis. Your future lifestyle is likely to be substantially influenced by the success or failure of a venture of this type. The analysis will need to contain information about markets and competition, as well as specifics regarding the particular business.

Decisions regarding the possible purchase of new shares or bonds will require the collection of relevant data. In the case of shares, this will probably mean detailed information about the past performance of the company and estimates of its future prospects.

Clearly, any decision that has an economic element will require substantial economic information. Basically, the role of the accounting system is to provide much of that information. The system cannot and does not attempt to cover all economic input, but essentially focuses on the collection, recording and reporting of key economic data as they relate to a particular individual or entity. Just what information is covered is the subject of this book.

You may not be comfortable with numbers and quantified information. However, it is difficult for an entity to be successful without having someone who does have a facility with information of this type. So good luck with your studies.

Explain the nature and role of accounting

Nature and role of accounting

Accounting is concerned with the collection, analysis and communication of economic information. Such information can be used as a tool of decision-making, planning and control. This is to say that accounting information is useful to those who need to make decisions and plans about businesses, and for those who need to control those businesses.

Examples of the kind of decisions for which the managers of businesses may need accounting information include the following:

- decisions to develop or terminate new products or services
- decisions to change the price or quantity of existing products
- decisions to borrow money to help finance the business
- decisions relating to the scale of the business, and
- decisions to change the methods of purchasing, production or distribution.

You might spend a few moments reflecting on the implications of some of these. Some decisions have far-reaching consequences; for example, moves to take activities offshore have the potential to impact substantially on the business, its workforce, and the local and regional communities.

Although managers working in a particular business are likely to be significant users of accounting information, they are by no means the only people who are likely to use accounting information about that particular business. People outside the business (whom we shall identify later) may need information to help make decisions such as whether to invest in the business—as owner or lender—whether to grant credit for goods provided, or whether to enter into a major contract with the particular business.

It is generally recognised that accounting fulfils two distinct roles: a ‘stewardship’ role and a ‘decision-usefulness’ role. Traditionally, accounting focused more on providing a stewardship, or accountability, report on the status of transactions for the period; that is, what was the position at the beginning of the period, what happened during the period, and what the position was at the end of the period. More recently, accounting has been seen as a way of assisting a wide range of users to make informed choices about the allocation of scarce resources. Sometimes, the impression is given that the purpose of accounting is simply to prepare financial reports on a regular basis. While it is true that accountants do this kind of work, it does not represent an end in itself. The ultimate purpose of accountants’ work is to discharge the accountability function of management and to influence the decisions of those who use the information produced. This decision-making perspective of accounting is central to the theme of this book and shapes the way we deal with each topic.

Accounting as a service function

Accounting can be seen as a form of service. Accountants provide financial information to their ‘clients’. These clients are the various users identified in the next main section of the chapter. The quality of the service provided will be determined by the extent to which it meets the information needs of the various user groups. To be useful to users, the information 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:

- **Relevance.** Accounting information must be able to influence decisions—otherwise, there really is no point in producing it. To do this, it must be relevant to the *prediction of future events* (such as estimating next year’s profit) or to the *confirmation of past events* (such as establishing last year’s profit), or to both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

To be relevant, accounting information must cross a threshold of **materiality**. A key question to be asked is whether its omission or misrepresentation would alter the decisions that users make. If the answer is no, the information is not material. This means that it

accounting

The process of identifying, measuring and communicating information to permit informed judgements and decisions by users of the information.

fundamental qualities

These are the two most important qualities which underline the preparation of accounting reports; namely, relevance and faithful representation.

relevance

A quality that states that, in order to be relevant, accounting information must be able to influence decisions.

materiality

Something which has the potential to alter the decisions that users make.

should not be *separately* included within accounting reports, as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret them. All figures need to be included in the accounts: the question is whether a particular figure needs to be separately identified or whether it can be included elsewhere, under a more general heading. The threshold of materiality will vary from one business to the next. To identify the threshold, the nature of the information and the amounts involved must be considered within the context of the accounting reports of the particular business.

faithful representation

A quality that says that accounting information should represent what it is supposed to represent—it should be complete, neutral, and free from error.

- **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 it 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 information may not perfectly represent these three aspects of faithful representation. It should try to do so, however, insofar as possible.

Note that accounting information must satisfy both fundamental qualities of relevance and reliability if it is to be useful. There is little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, but which is faithfully represented.

Further qualities

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

comparability

A quality which helps users identify similarities and differences between items of information.

- **Comparability.** This quality helps users to identify similarities and differences between items of information. It may help them, for example, to identify changes in the business over time (such as the trend in sales revenue over the past five years). It may also help them to evaluate the performance of the business in relation to similar businesses. Comparability is enhanced by treating items that are basically the same in the same manner for accounting purposes. It is also enhanced by making clear the policies that have been adopted in measuring and presenting the information.

verifiability

Something that can be checked and verified.

- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.

timeliness

Being available early enough to be of use to users.

- **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

Clearly set out to facilitate understanding.

- **Understandability.** Accounting information should be set out as clearly and concisely as possible. It should also be able to be understood by those at whom the information is aimed.

Activity 1.1

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

Despite the answer to Activity 1.1, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible for non-accountants.

It is worth emphasising that the four further qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented. It is also worth noting that the qualitative characteristics may conflict.

Costs and benefits of accounting information

Beside the characteristics described above, there is also a seventh key characteristic which is at least as important as any of these six. In theory, a particular piece of accounting information should be produced only if the cost of providing it is less than the benefits, or value, to be derived from its use. This cost–benefit issue will limit the amount of accounting information provided. In practice, however, these costs and benefits are difficult to assess.

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 1.1.

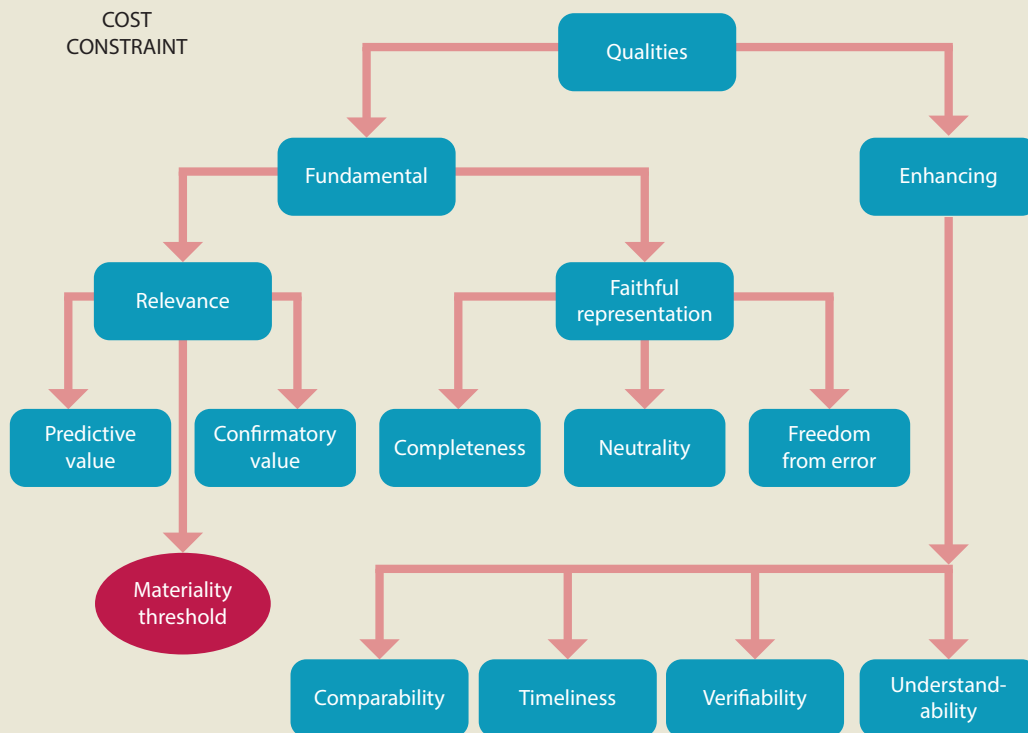


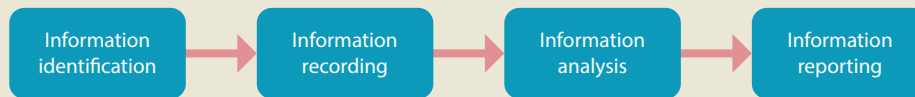
FIGURE 1.1

The characteristics that influence the usefulness of accounting information.

Two fundamental qualities determine the usefulness of accounting information. In addition, four qualities enhance the usefulness of accounting information. The benefits of providing the information, however, should outweigh the costs.

Accounting as an information system

Accounting can be seen as an important part of the total information system for a business. Users, both inside and outside the business, have to decide how to allocate scarce economic resources. To try to ensure that these allocation decisions are efficient and effective, users require economic and other information. It is the role of the accounting system to provide much of that information. Thus, we can view accounting as an information-gathering,

**FIGURE 1.2****The accounting information system**

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

processing and communication system. The accounting system will involve the following four stages shown in Figure 1.2:

- 1 identifying and capturing relevant economic information
- 2 recording the information collected in a systematic manner
- 3 analysing and interpreting the information collected
- 4 reporting the information in a manner that suits the needs of users.

Given the decision-making emphasis of this text, we shall concentrate on the final two elements of the process—the analysis and reporting of financial information. We are concerned with how information is used by, and is useful to, decision-makers rather than with how it is collected and recorded.

LO2

List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information

Users of accounting

Accounting seeks to satisfy the needs of a wide range of users. In a particular business, there may be various groups who are likely to have an interest in its financial health. (Although the points made in this chapter and throughout this book may apply to a variety of organisations—such as public-sector business enterprises, local authorities and charities—we concentrate on private-sector businesses.)

The major user groups for a business organisation are shown in Figure 1.3.

Activity 1.2

Ptarmigon Insurance Ltd (PI) is a large motor insurance business. Taking the user groups identified in Figure 1.3, 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.

Activity 1.2 illustrates that each user group looks at the business from a different perspective and has its own particular interest. Inevitably there will be occasions when these perspectives and interests may clash. One of the more likely causes relates to the way in which the wealth of the business is generated and distributed. Recent years have seen considerable debate as to the salary level of management teams, especially that of the chief executive officer (CEO). High bonus payments in a year in which performance has not been judged to be good do not sit well with investors. Another area of potential conflict is likely to be between investors and lenders,

**FIGURE 1.3****Main users of financial information relating to a business organisation**

The figure shows that several user groups have an interest in the financial information relating to a business organisation. Most of them are outside the business but, nevertheless, have a stake in it. This is not meant to be an exhaustive list of potential users, but the user groups identified here are normally the most important.

with lenders wishing to be sure that the money lent has been invested appropriately and with due regard to their interests, while borrowers are likely to want to be able to have maximum flexibility.

Compare and contrast financial and management accounting

LO3

Financial and management accounting

In providing information for the various user groups identified, accounting has divided into two main areas: management accounting and financial accounting. **Management accounting**, as the name suggests, is concerned with providing managers with the information they require for the day-to-day running of the organisation. **Financial accounting** is concerned with providing the other users with useful information.

The main differences between the two types of accounting reflect the range of recipients, as follows:

- **Nature of the reports produced.** Financial accounting tends to produce general-purpose financial reports; that is, they contain financial information that will be useful for a broad range of users and decisions. Management accounting reports, on the other hand, are often specific-purpose reports, designed either with a particular decision or manager in mind.
- **Level of detail.** Financial accounting reports provide users with a broad overview of the position, performance and cash flows of the business for a period. As a result, information is aggregated and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular decision.
- **Restrictions.** Financial reporting for many businesses is subject to legal and accounting regulations that seek to ensure that specified content is presented in a fairly standard form. Because management accounting reports are for internal use only, there are no restrictions on the form and content of the reports.

management accounting

An approach which aims to provide managers with the information they require to run the organisation.

financial accounting

Financial accounting provides general-purpose financial information for a variety of users, with the information being of a general-purpose nature.

- *Reporting interval.* For most businesses, financial accounting reports are produced on an annual basis. However, large companies may produce half-yearly reports and a few produce quarterly reports. Management accounting reports may be produced as frequently as required by managers. In many businesses, managers are provided with certain weekly or monthly reports to allow them to check progress on a regular basis. In addition, special-purpose reports will be prepared when required (e.g. to evaluate a proposal for a piece of equipment).
- *Time horizon.* Financial accounting reports reflect the performance and position of the business to date. In essence, they are backward-looking. Management accounting reports, on the other hand, often provide information on expected future performances as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release forecast information to other users in order to raise capital or to fight off unwanted takeover bids. Even preparation of the routine financial reports typically requires making some judgements about the future, as we shall see in Chapter 3.
- *Range of information.* Financial accounting reports concentrate on information that can be quantified in monetary terms. Management accounting produces such reports, too, but is also more likely to produce additional reports on non-financial matters, such as measures of physical quantities of inventory (stocks) and output. Financial accounting places greater emphasis on objective, verifiable evidence when preparing reports. Management accounting reports intended for managers may use information that is less objective and verifiable, but which nevertheless provides managers with the information they need. So the basic accounting statements will be used historically by the financial accountant, where the emphasis is on information which is as reliable and as objective as possible, whereas the management accountant may well use the same format to assist in some decisions, but will inevitably be using estimates which are clearly less reliable. This does not detract from the usefulness of the forecasts.

We can see from the above list that management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of reliability. The only real test of the value of the information produced for managers is whether or not it improves the quality of decisions made.

Activity 1.3

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

The distinction between the two areas reflects, to some extent, the differences in access to financial information. Managers have much more control over the form and content of the information they receive. Other users have to rely on what managers are prepared to provide or what the financial reporting regulations state must be provided. Although the scope of financial accounting reports has increased over time, fears over loss of competitive advantage and fears of user ignorance about the reliability of forecast data have led businesses to resist making information available to users other than managers.

There is little doubt that in the past financial accounting has been the dominant partner, and many of the ground rules reflect this. However, modern accounting systems typically are developed in a manner that enables both the specific external reporting requirements to be fulfilled and relevant management accounting reports to be prepared. Financial accounting and management accounting should not be seen as two different topics, but rather different perspectives reflecting the justifiable needs of users.

Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship

What is the financial objective of a business?

A business is normally created to enhance the wealth of its owners. Throughout this book we shall assume that this is its main objective. This may come as a surprise, as there are other objectives that a business may pursue that are related to the needs of others associated with the business. For example, a business may seek to provide good working conditions for its employees, or it may seek to conserve the environment for the local community. While a business may pursue these objectives, it is normally set up with a view to increasing the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

Within a market economy there are strong competitive forces at work that ensure that failure to enhance owners' wealth will not be tolerated for long. Competition for the funds provided by the owners and competition for managers' jobs will normally mean that the owners' interests will prevail. If the managers do not provide the expected increase in ownership wealth, the owners have the power to replace the existing management team with a new team that is more responsive to owners' needs. Does this mean that the needs of other groups associated with the business (employees, customers, suppliers, the community and so on) are not really important? The answer to this question is certainly no, if the business wishes to survive and prosper over the longer term.

Satisfying the needs of other groups is usually consistent with increasing the wealth of the owners over the longer term. A business with disaffected customers, for example, may find that they turn to another supplier, resulting in a loss of shareholder wealth.

A dissatisfied 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, or ignoring human rights issues, may attract bad publicity, resulting in a loss of customers and heavy fines.

While the idea of an objective of wealth enhancement is still reasonable, there is now considerably more awareness of the damage that can be done to individuals, to the environment and to society at large, by unconstrained wealth maximisation. Real World 1.1, written when the global financial crisis was in the forefront of most people's minds, provides clear recognition of the potential problems that can arise.

REAL WORLD 1.1

Short-term gains, long-term problems

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

Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them was not

their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was thirty years ago. Public anger at the crisis will make visible what was previously hidden. Take the building up of