ACCOUNTING AND FINANCE
FOR NON-SPECIALISTS

Twelfth Edition

Peter Atrill
Eddie McLaney

Pearson

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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 or some other organisation.
- 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 technical issues but rather examines basic principles and underlying concepts. The primary concern throughout is the ways in which financial statements and information can be used to improve the quality of the decisions made by those who use them. To reinforce this practical emphasis, throughout the text, there are numerous illustrative extracts with commentary from real life including company reports, survey data and other sources.

The text is written in an 'open-learning' style. This means there are numerous integrated activities, worked examples and questions throughout each of the chapters to help you understand the topics fully. In framing these questions and tasks, we have tried to encourage critical thinking by requiring analysis and evaluation of various concepts and techniques. To help broaden understanding, questions and tasks often require readers to go beyond the material in the text and/or to link the current topic with material covered earlier in the book. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you are using the book as part of a taught course or for personal study, we have found that this approach is more 'user-friendly' and makes it easier for you to learn.

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

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

In this twelfth edition, we have taken the opportunity to make improvements suggested by students and lecturers who used the previous edition. We have updated and expanded the number of examples from real life and have continued to reflect the latest international rules relating to the main financial statements. To aid understanding, we have also increased the number of student progress questions (Activities) and explanatory diagrams.

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

Peter Atrill
Eddie McLaney

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

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; and
- explain why an understanding of accounting and finance is likely to be relevant to you.

WHAT ARE ACCOUNTING AND FINANCE?

Let us begin by trying to understand the purpose of each. **Accounting** is concerned with *collecting, analysing* and *communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. Unless the financial information being communicated can lead to better decisions being made, there really is no point in producing it. We shall see who uses financial information and for what kind of decisions it is useful a little later in the chapter.

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

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

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

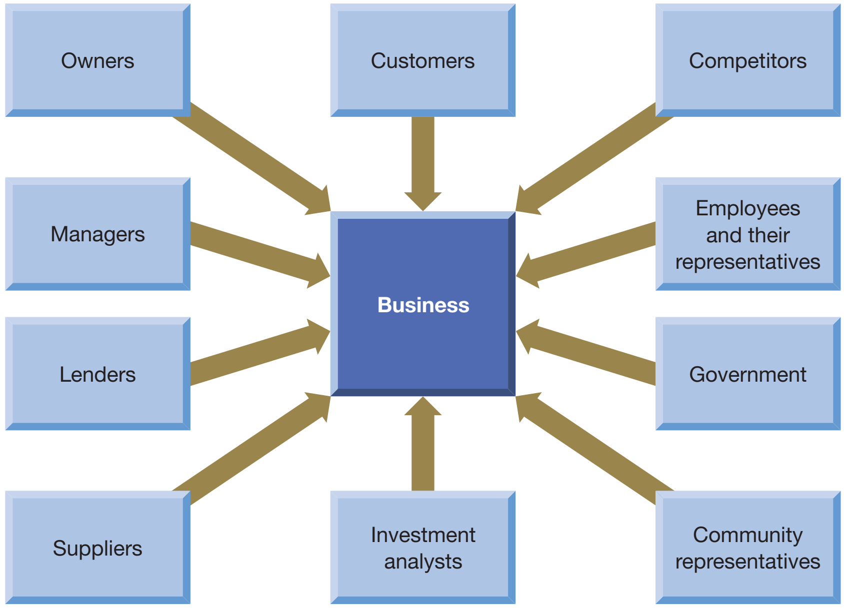
- the main forms of finance available;
- the costs and benefits of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

Once funds have been raised, they must be invested wisely. Thus, investment opportunities must be identified and then subjected to careful scrutiny. Finance can play a vital role in evaluating the risks and returns associated with each investment opportunity. The results of this evaluation should provide a major input to the decision concerning whether to accept or to reject a particular 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 a typical private sector business, the more important of these groups are shown in Figure 1.1. Take a look at this figure and then try Activity 1.1.



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

Figure 1.1 Main users of financial information relating to a business

Activity 1.1

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

Your answer may be along the following lines:

User group	*Decision*
Customers	Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet customers' needs, particularly in respect of any insurance claims made.
Competitors	How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This may involve competitors using various aspects of PI's performance as a 'benchmark' when evaluating their own performance. They may also try to assess PI's financial strength and to identify changes that may signal PI's future intentions (for example, raising funds as a prelude to market expansion).
Employees	Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions.
Government	Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions an assessment of PI's profits, sales revenues and financial strength would be made.
Community representatives	Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making these decisions, PI's ability to provide employment for the community, its use of community resources and its willingness to fund environmental improvements are likely to be important considerations.

User group	*Decision*
Investment analysts	Whether to advise clients to invest in PI. This would involve an evaluation of the likely risks and future returns associated with PI.
Suppliers	Whether to continue to supply PI and, if so, whether to supply on credit. This would require an assessment of PI's ability to pay for goods and services supplied at the due dates.
Lenders	Whether to lend money to PI and/or whether to demand repayment of any existing loans. PI's ability to pay the interest due and to repay the principal sum on time would be important factors in such decisions.
Managers	Whether the performance of the business needs to be improved. Performance to date would be compared with earlier plans or some other 'benchmark' to decide whether action needs to be taken. Managers may also wish to consider a change in PI's future direction. This may involve determining whether it has the financial flexibility and resources to take on new challenges.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. As with investment analysts (see above) this would involve an evaluation of the likely risks and returns associated with PI. Owners may also have to decide on the rewards offered to senior managers. When doing so, the financial performance and position of the business would normally be considered.

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

PROVIDING A SERVICE

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

To be useful to users, particularly investors and lenders, the information provided should possess certain qualities, or characteristics. In particular, it must be relevant and it must faithfully represent what it is meant to represent. These two qualities, **relevance** and **faithful representation**, are regarded as fundamental qualities and require further explanation:

- **Relevance**. Accounting information should make a difference. That is, it should be capable of influencing user decisions. To do this, it should 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 is considered material, or significant, if its omission or misstatement would change the decisions that users make.

Activity 1.2

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

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

Ultimately, what is considered material is a matter of judgement. When making this kind of judgement, managers should consider how this information is likely to be used. If a piece of information is not considered 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 meant to represent. To do so, the information provided must reflect the *substance* of what has occurred rather than simply its *legal form.* Take, for example, a manufacturer that provides goods to a retailer on a sale-or-return basis. The manufacturer may wish to treat this arrangement as two separate transactions. Thus, a contract may be agreed for the sale of the goods and a separate contract agreed for the return of the goods if unsold by the retailer. This may result in a sale being reported when the goods are delivered to the retailer even though they are returned at a later date. The economic substance, however, is that the manufacturer made no sale as the goods were subsequently returned. They were simply moved from the manufacturer's business to the retailer's business and then back again. Accounting reports should reflect this economic substance. To do otherwise would be misleading.

To provide a perfectly faithful representation, the information should be *complete.* In other words, it should incorporate everything needed to understand what is being portrayed. Thus, information relating to a particular item would normally contain a description of its nature, some suitable numerical measurement and, where necessary, explanations of important facts. Information should also be *neutral,* which means that it should be presented and selected without bias. No attempt should be made to manipulate the information in an effort to affect user attitudes and behaviour. Finally, it should be *free from error.* This is not the same as saying that it must be perfectly accurate. Accounting information often contains estimates, such as futures sales or costs, which may turn out to be inaccurate. Nevertheless, estimates may still be faithfully represented providing they are accurately described and properly prepared.

Activity 1.3

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

Probably not – however, each piece of information should be produced with these aims in mind.

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

Further qualities

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

- *Comparability.* When choosing between alternatives, users of accounting information often make comparisons. They may compare performance of the business over time (for example, profit this year compared to last year). They may also compare certain aspects of business performance (such as the level of sales achieved during the year) to those of similar businesses. Better comparisons can be made where the accounting system treats items that are alike in the same way – both over time and between businesses. Items that are not alike, on the other hand, should not be treated as though they are. Users must be able to detect both similarities and differences in items being compared.
- *Verifiability.* This quality provides assurance to users that the accounting information provided faithfully portrays what it is supposed to portray. Accounting information is verifiable where different, independent

experts can reach broad agreement that it provides a faithful portrayal. Verification can be direct, such as checking a bank account balance, or indirect, such as checking the underlying assumptions and methods used to derive an estimate of a future cost.

- *Timeliness.* Accounting information should be made available in time for users to make their decisions. A lack of timeliness undermines the usefulness of the information. Broadly speaking, the later that an item of accounting information is produced, the less useful it is.
- *Understandability.* Accounting information should be presented in as clear and as concise a form as possible. Nevertheless, some accounting information may be too complex to be presented in an easily digestible form. This does not mean, however, that it should be ignored. To do so would result in reporting only a partial view of financial matters (see Reference 1 at the end of the chapter).

Activity 1.4

Accounting reports are aimed at users with a reasonable knowledge of accounting and business and who are prepared to invest time in studying them. Do you think, however, that accounting reports should be understandable to users without any knowledge of accounting or business?

It would be very helpful if everyone could understand accounting reports. This, however, is unrealistic as complex financial events and transactions cannot normally be expressed in simple terms. Any attempts to do so are likely to produce a very 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 when an item of accounting information may have all the qualities described, it does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.5.

Activity 1.5

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

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

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

In theory, a particular item of accounting information should be produced only if the costs of providing it are less than the benefits, or value, to be derived from its use. In practice, however, these costs and benefits are difficult to assess.

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

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

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

The economic benefit of having the information on the price of the job is also hard 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 £450?

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

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

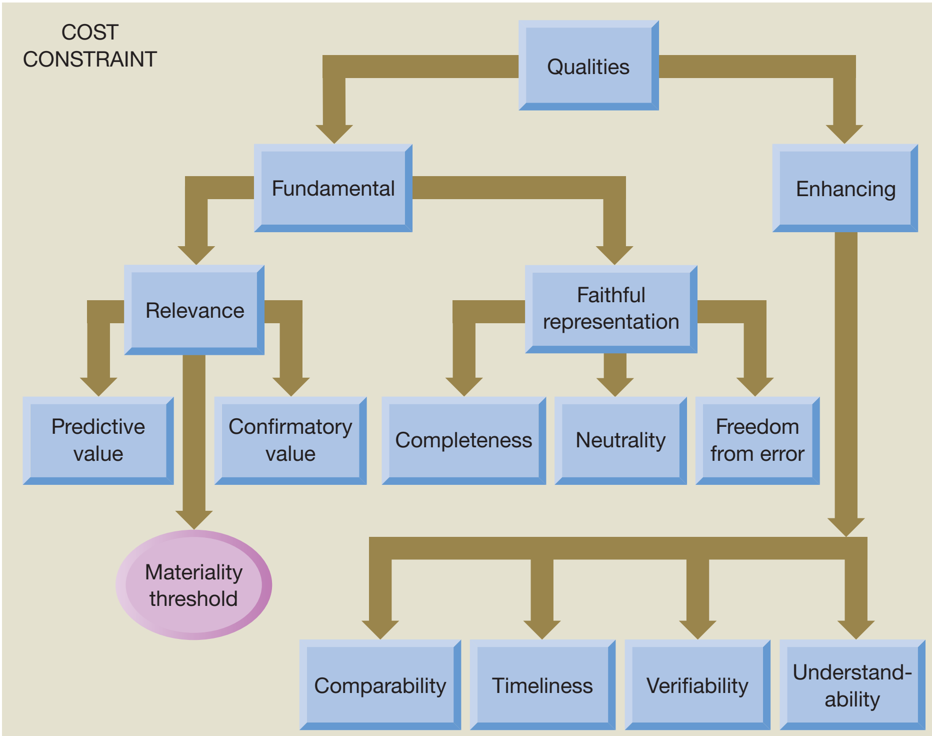
Activity 1.6

Which do you think is the harder to assess, the economic benefits of accounting information or the costs of producing it?

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

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

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



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

Figure 1.2 The qualities that influence the usefulness of accounting information

ACCOUNTING AS AN INFORMATION SYSTEM

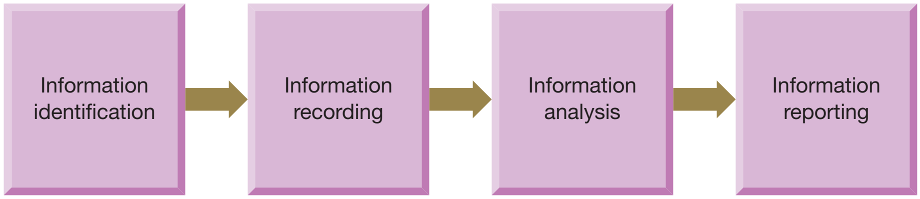
We have already seen that accounting can be viewed as the provision of a service to 'clients'. Another way of viewing accounting is as a part of the business's total information system. Users, both inside and outside the business, make decisions concerning the allocation of scarce resources. For these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

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

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

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

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



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

The output from accounting systems must be reliable if businesses are to operate efficiently. When accounting systems produce unreliable information, there may be serious consequences. **Real World 1.1** describes how a UK bank suffered as a result of producing unreliable accounting information.

REAL WORLD 1.1

Systems error!

Some of Metro Bank's largest customers left the bank after the discovery of a historic accounting error in the first quarter, damaging growth at the under-fire British lender. Chief executive Craig Donaldson said "adverse sentiment" had led to the departure of a "small number of large commercial and partnership customers", contributing to a 4 per cent quarter-on-quarter reduction in deposits.

Metro Bank in January revealed that it had miscategorised a large number of commercial loans, meaning it did not have as much capital against them as it should. The discovery prompted a sharp drop in its stock — it is down 54 per cent since the start of the year — and forced the lender to cut its long-term growth plans.

FT *Source*: Extract from Megaw, M. (2019) 'Big customers desert Metro Bank over accounting error', FT.com, 1 May.

MANAGEMENT ACCOUNTING AND FINANCIAL ACCOUNTING

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

- **management accounting**, which seeks to meet the accounting needs of managers; and
- **financial accounting**, which seeks to meet the needs of owners and lenders. It should also, however, be useful to other users that were identified, earlier in the chapter (see Figure 1.1).

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

- *Nature of the reports produced.* Financial accounting reports tend to be general-purpose. As mentioned above, they are aimed primarily at providers of finance (owners and lenders) but contain financial information that will be useful for a broad range of users and decisions. Management accounting reports, on the other hand, are often specific-purpose reports. They are designed with a particular decision in mind and/or for a particular manager.