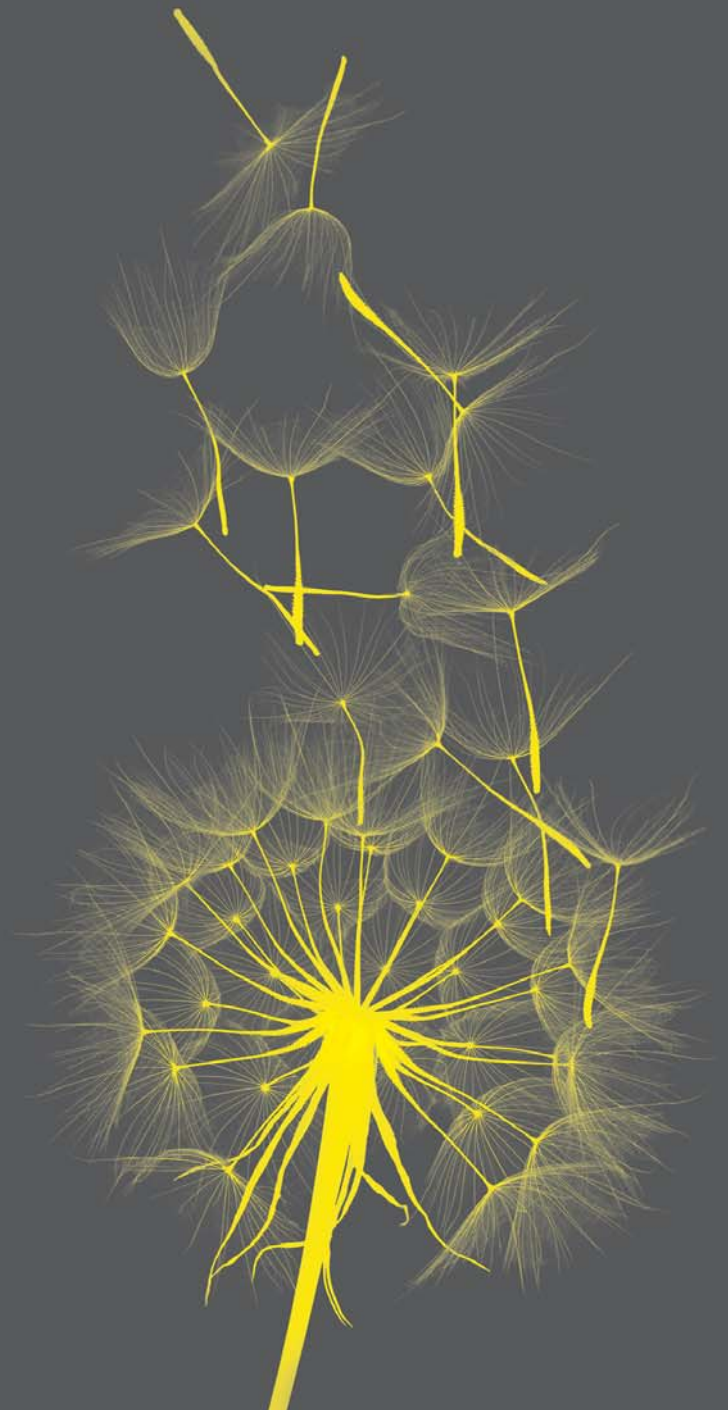


EIGHTH EDITION

# ACCOUNTING AND FINANCE AN INTRODUCTION

Eddie McLaney  
Peter Atrill



# **Accounting and Finance**

## An Introduction

## PEARSON

At Pearson, we have a simple mission: to help people make more of their lives through learning.

We combine innovative learning technology with trusted content and educational expertise to provide engaging and effective learning experiences that serve people wherever and whenever they are learning.

From classroom to boardroom, our curriculum materials, digital learning tools and testing programmes help to educate millions of people worldwide – more than any other private enterprise.

Every day our work helps learning flourish, and wherever learning flourishes, so do people.

To learn more, please visit us at [www.pearson.com/uk](http://www.pearson.com/uk)

**Eighth  
edition**

# **Accounting and Finance**

## An Introduction

**Eddie McLaney  
and  
Peter Atrill**

**PEARSON**

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney  
Auckland • Singapore • Hong Kong • Tokyo • Seoul • Taipei • New Delhi  
Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

**Pearson Education Limited**

Edinburgh Gate  
Harlow CM20 2JE  
United Kingdom  
Tel: +44 (0)1279 623623  
Web: [www.pearson.com/uk](http://www.pearson.com/uk)

---

First published 1999 by Prentice Hall Europe (print)  
Second edition published 2002 by Pearson Education Limited (print)  
Third edition published 2005 (print)  
Fourth edition published 2008 (print)  
Fifth edition published 2010 (print)  
Sixth edition published 2012 (print)  
Seventh edition published 2014 (print and electronic)  
**Eighth edition published 2016 (print and electronic)**

© Prentice Hall Europe 1999 (print)  
© Pearson Education Limited 2002, 2005, 2008, 2010, 2012 (print)  
© Pearson Education Limited 2014 (print and electronic)  
© Pearson Education Limited 2016 (print and electronic)

The rights of Eddie McLaney and Peter Atrill to be identified as authors of this work have been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

The print publication is protected by copyright. Prior to any prohibited reproduction, storage in a retrieval system, distribution or transmission in any form or by any means, electronic, mechanical, recording or otherwise, permission should be obtained from the publisher or, where applicable, a licence permitting restricted copying in the United Kingdom should be obtained from the Copyright Licensing Agency Ltd, Saffron House, 6–10 Kirby Street, London EC1N 8TS.

The ePublication is protected by copyright and must not be copied, reproduced, transferred, distributed, leased, licensed or publicly performed or used in any way except as specifically permitted in writing by the publishers, as allowed under the terms and conditions under which it was purchased, or as strictly permitted by applicable copyright law. Any unauthorised distribution or use of this text may be a direct infringement of the authors' and the publisher's rights and those responsible may be liable in law accordingly.

All trademarks used herein are the property of their respective owners. The use of any trademark in this text does not vest in the author or publisher any trademark ownership rights in such trademarks, nor does the use of such trademarks imply any affiliation with or endorsement of this book by such owners.

Pearson Education is not responsible for the content of third-party internet sites.

*The Financial Times*. With a worldwide network of highly respected journalists, *The Financial Times* provides global business news, insightful opinion and expert analysis of business, finance and politics. With over 500 journalists reporting from 50 countries worldwide, our in-depth coverage of international news is objectively reported and analysed from an independent, global perspective. To find out more, visit [www.ft.com/pearsonoffer](http://www.ft.com/pearsonoffer).

ISBN: 978-1-292-08829-7 (print)  
978-1-292-08890-7 (PDF)  
978-1-292-08830-3 (eText)  
978-1-292-12567-1 (ePub)

**British Library Cataloguing-in-Publication Data**

A catalogue record for the print edition is available from the British Library

**Library of Congress Cataloging-in-Publication Data**

McLaney, E. J., author.

Accounting and finance : an introduction / Eddie McLaney and Peter Atrill. – Eighth edition.  
pages cm

ISBN 978-1-292-08829-7

1. Accounting. I. Atrill, Peter, author. II. Title.

HF5636.M44 2016

657–dc23

2015026652

10 9 8 7 6 5 4 3 2 1  
16 15 14 13 12

Print edition typeset in 9.5/12.5pt Stone Serif ITC Pro by 71

Printed and bound by L.E.G.O. S.p.A., Italy

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

# Brief contents

Preface	xxi
How to use this book	xxiii
Acknowledgements	xxv
1 Introduction to accounting and finance	1
<b>Part 1 Financial accounting</b>	<b>37</b>
2 Measuring and reporting financial position	39
3 Measuring and reporting financial performance	77
4 Accounting for limited companies (1)	121
5 Accounting for limited companies (2)	159
6 Measuring and reporting cash flows	201
7 Analysing and interpreting financial statements	233
<b>Part 2 Management accounting</b>	<b>293</b>
8 Making management decisions	295
9 Cost–volume–profit analysis	319
10 Full costing	361
11 Costing and performance evaluation in a competitive environment	408
12 Budgeting	457
13 Accounting for control	501
<b>Part 3 Financial management</b>	<b>545</b>
14 Making capital investment decisions	547
15 Financing a business	596
16 Managing working capital	653 →

<b>Part 4</b>	<b>Supplementary information</b>	707
Appendix A	Recording financial transactions	709
Appendix B	Glossary of key terms	728
Appendix C	Solutions to self-assessment questions	745
Appendix D	Solutions to review questions	766
Appendix E	Solutions to selected exercises	781
Appendix F	Present value table	830
Index		833

# Contents

Preface	xxi
How to use this book	xxiii
Acknowledgements	xxv
<b>1 Introduction to accounting and finance</b>	<b>1</b>
<i>Introduction</i>	1
<i>Learning outcomes</i>	1
What are accounting and finance?	2
Who are the users of accounting information?	2
The conflicting interests of users	4
How useful is accounting information?	5
Evidence on the usefulness of accounting	6
Providing a service	7
Further qualities	8
Weighing up the costs and benefits	9
Accounting as an information system	11
Management accounting and financial accounting	13
Scope of this book	15
The changing face of accounting	16
Why do I need to know anything about accounting and finance?	17
Accounting for business	18
What is the purpose of a business?	18
What kinds of business ownership exist?	19
Sole proprietorship	19
Partnership	20
Limited company	21
How are businesses organised?	22
How are businesses managed?	25
The quest for wealth creation	27
Meeting the needs of other stakeholders	27
Balancing risk and return	29
Reasons to be ethical	31
Not-for-profit organisations	32
<i>Summary</i>	33
<i>Key terms</i>	35
<i>References</i>	35
<i>Further reading</i>	35
<i>Review questions</i>	36



## Part 1 Financial accounting

<b>2</b>	<b>Measuring and reporting financial position</b>	<b>39</b>
	<i>Introduction</i>	39
	<i>Learning outcomes</i>	39
	The major financial statements – an overview	40
	The statement of financial position	44
	Assets	44
	Claims	47
	The effect of trading transactions	50
	Classifying assets	52
	Current assets	53
	Non-current assets	53
	Classifying claims	55
	Current liabilities	55
	Non-current liabilities	55
	Statement layouts	56
	Capturing a moment in time	58
	The role of accounting conventions	58
	Business entity convention	58
	Historic cost convention	59
	Prudence convention	60
	Going concern convention	60
	Dual aspect convention	61
	Money measurement	62
	Goodwill and brands	62
	Human resources	63
	Monetary stability	64
	Valuing assets	64
	Non-current assets	65
	Non-current assets with finite lives	65
	Non-current assets with indefinite useful lives	65
	Fair values	66
	The impairment of non-current assets	67
	Inventories	69
	Meeting user needs	70
	<i>Self-assessment question 2.1</i>	71
	<i>Summary</i>	71
	<i>Key terms</i>	73
	<i>Further reading</i>	73
	<i>Review questions</i>	74
	<i>Exercises</i>	74
<b>3</b>	<b>Measuring and reporting financial performance</b>	<b>77</b>
	<i>Introduction</i>	77
	<i>Learning outcomes</i>	77

The income statement	78
Different roles	79
Income statement layout	80
Gross profit	81
Operating profit	81
Profit for the period	81
Further issues	82
Cost of sales	82
Classifying expenses	83
Recognising revenue	85
Long-term contracts	86
Continuous and non-continuous services	88
Recognising expenses	88
When the expense for the period is more than the cash paid during the period	89
When the amount paid during the period is more than the full expense for the period	91
Profit, cash and accruals accounting	93
Depreciation	94
Calculating the depreciation expense	94
Depreciation method	96
Impairment and depreciation	100
Depreciation and asset replacement	101
Depreciation and judgement	101
Costing inventories	103
Inventories – some further issues	107
Trade receivables problems	108
Doubtful debts	110
Uses and usefulness of the income statement	112
<i>Self-assessment question 3.1</i>	113
<i>Summary</i>	114
<i>Key terms</i>	115
<i>Further reading</i>	116
<i>Review questions</i>	117
<i>Exercises</i>	117
<b>4 Accounting for limited companies (1)</b>	<b>121</b>
<i>Introduction</i>	121
<i>Learning outcomes</i>	121
The main features of limited companies	122
Legal nature	122
Perpetual life	122
Limited liability	124
Legal safeguards	125
Public and private companies	125
Taxation	127
The role of the Stock Exchange	128

Managing a company	128
Financing limited companies	129
Equity (the owners' claim)	129
The basic division	129
Share capital	130
Reserves	132
Bonus shares	134
Share capital jargon	136
Borrowings	137
Raising share capital	138
Withdrawing equity	139
The main financial statements	142
The income statement	143
The statement of financial position	145
Dividends	145
Accounting for groups of companies	146
<i>Self-assessment question 4.1</i>	150
<i>Summary</i>	151
<i>Key terms</i>	153
<i>Further reading</i>	153
<i>Review questions</i>	154
<i>Exercises</i>	154

## **5 Accounting for limited companies (2) 159**

<i>Introduction</i>	159
<i>Learning outcomes</i>	159
The framework of annual financial reports	160
The directors' duty to account	161
The need for accounting rules	161
Sources of accounting rules	164
The growing authority of the IASB	164
Adopting IFRSs	165
Presenting the financial statements	167
Fair representation	167
Statement of financial position	168
Statement of comprehensive income	169
Statement of changes in equity	171
Statement of cash flows	172
Notes	173
General points	173
The need for a conceptual framework	173
The IASB framework	174
The auditors' role	175
Segmental financial reports	176
Segmental reporting rules	177
Segmental disclosure	178
Segmental reporting problems	179

Corporate governance	180
Strengthening the framework of rules	181
The UK Corporate Governance Code	182
Management commentary	184
Directors' report	184
Strategic report	185
Creative accounting	187
Creative accounting methods	188
Checking for creative accounting	193
Creative accounting and economic growth	194
<i>Self-assessment question 5.1</i>	195
<i>Summary</i>	195
<i>Key terms</i>	197
<i>References</i>	197
<i>Further reading</i>	198
<i>Review questions</i>	199
<i>Exercises</i>	199

<b>6</b> <b>Measuring and reporting cash flows</b>	<b>201</b>
<i>Introduction</i>	201
<i>Learning outcomes</i>	201
The statement of cash flows	202
Why is cash so important?	203
The main features of the statement of cash flows	205
A definition of cash and cash equivalents	205
The relationship between the main financial statements	206
The layout of the statement of cash flows	207
Cash flows from operating activities	207
Cash flows from investing activities	208
Cash flows from financing activities	208
Net increase or decrease in cash and cash equivalents	209
The normal direction of cash flows	209
Preparing the statement of cash flows	211
Deducing net cash flows from operating activities	211
Deducing the other areas of the statement of cash flows	216
Reconciliation of liabilities from financing activities	219
What does the statement of cash flows tell us?	219
Problems with IAS 7	222
<i>Self-assessment question 6.1</i>	222
<i>Summary</i>	224
<i>Key terms</i>	225
<i>Reference</i>	225
<i>Further reading</i>	225
<i>Review questions</i>	226
<i>Exercises</i>	226

<b>7</b>	<b>Analysing and interpreting financial statements</b>	<b>233</b>
	<i>Introduction</i>	233
	<i>Learning outcomes</i>	233
	Financial ratios	234
	Financial ratio classifications	234
	The need for comparison	236
	Past periods	236
	Similar businesses	237
	Planned performance	237
	Calculating the ratios	237
	A brief overview	240
	Profitability	241
	Return on ordinary shareholders' funds (ROSF)	241
	Return on capital employed (ROCE)	242
	Operating profit margin	244
	Gross profit margin	245
	Efficiency	247
	Average inventories turnover period	247
	Average settlement period for trade receivables	248
	Average settlement period for trade payables	249
	Sales revenue to capital employed ratio	251
	Sales revenue per employee	251
	Relationship between profitability and efficiency	253
	Liquidity	254
	Current ratio	255
	Acid test ratio	255
	Cash generated from operations to maturing obligations ratio	256
	Financial gearing	257
	Gearing ratio	260
	Interest cover ratio	261
	Investment ratios	262
	Dividend payout ratio	262
	Dividend yield ratio	263
	Earnings per share	264
	Cash generated from operations per share	266
	Price/earnings (P/E) ratio	266
	Financial ratios and the problem of overtrading	270
	Trend analysis	272
	Using ratios to predict financial failure	272
	Using single ratios	273
	Using combinations of ratios	274
	Z-score models	276
	Limitations of ratio analysis	278
	Quality of financial statements	278
	Inflation	279
	The restricted view given by ratios	279

The basis for comparison	280
Statement of financial position ratios	280
<i>Self-assessment question 7.1</i>	281
<i>Summary</i>	282
<i>Key terms</i>	283
<i>References</i>	284
<i>Further reading</i>	284
<i>Review questions</i>	285
<i>Exercises</i>	285

## Part 2 Management accounting

<b>8</b>	<b>Making management decisions</b>	<b>295</b>
	<i>Introduction</i>	295
	<i>Learning outcomes</i>	295
	Cost–benefit analysis	296
	What is meant by ‘cost’?	297
	Relevant costs: opportunity and outlay costs	299
	Sunk costs and committed costs	304
	Non-measurable costs and benefits	306
	Risk	307
	Sensitivity analysis	308
	<i>Self-assessment question 8.1</i>	311
	<i>Summary</i>	312
	<i>Key terms</i>	313
	<i>Further reading</i>	313
	<i>Review questions</i>	314
	<i>Exercises</i>	314
<b>9</b>	<b>Cost–volume–profit analysis</b>	<b>319</b>
	<i>Introduction</i>	319
	<i>Learning outcomes</i>	319
	Cost behaviour	320
	Fixed cost	320
	Variable cost	322
	Semi-fixed (semi-variable) cost	323
	Analysing semi-fixed (semi-variable) costs	324
	Finding the break-even point	325
	Contribution	332
	Contribution margin ratio	332
	Margin of safety	333
	Achieving a target profit	335
	Operating gearing	336
	Operating gearing and its effect on profit	337

Profit–volume charts	338
The economist's view of the break-even chart	339
Failing to break even	341
Weaknesses of break-even analysis	341
Using contribution to make decisions: marginal analysis	344
Pricing/assessing opportunities to enter contracts	345
The most efficient use of scarce resources	347
Make-or-buy decisions	349
Closing or continuation decisions	351
<i>Self-assessment question 9.1</i>	353
<i>Summary</i>	354
<i>Key terms</i>	355
<i>Further reading</i>	355
<i>Review questions</i>	356
<i>Exercises</i>	356

<b>10 Full costing</b>	<b>361</b>
<i>Introduction</i>	361
<i>Learning outcomes</i>	361
What is full costing?	362
Why do managers want to know the full cost?	362
Single-product businesses	364
Multi-product businesses	365
Direct and indirect cost	366
Job costing	367
Full (absorption) costing and the behaviour of cost	368
The problem of indirect cost	370
Overheads as service renderers	370
Job costing: a worked example	370
Selecting a basis for charging overheads	374
Segmenting the overheads	377
Dealing with overheads on a cost centre basis	377
Batch costing	387
Non-manufacturing overheads	388
Full (absorption) costing and estimation errors	389
Using full (absorption) cost information	391
Full cost (cost-plus) pricing	393
Price makers and price takers	393
Use of cost-plus information by price takers	394
Criticisms of full (absorption) costing	396
Full (absorption) costing versus variable costing	396
Which method is better?	398
<i>Self-assessment question 10.1</i>	400
<i>Summary</i>	401
<i>Key terms</i>	402
<i>Reference</i>	403
<i>Further reading</i>	403

<i>Review questions</i>	404
<i>Exercises</i>	404

## **11 Costing and performance evaluation in a competitive environment** **408**

<i>Introduction</i>	408
<i>Learning outcomes</i>	408
Cost determination in the changed business environment	409
Costing and pricing: the traditional way	409
Costing and pricing: the new environment	410
Cost management systems	410
The problem of overheads	411
Taking a closer look	411
Activity-based costing	412
Attributing overheads	413
Benefits of ABC	414
ABC versus the traditional approach	414
ABC and service industries	414
Criticisms of ABC	419
Other costing approaches in the modern environment	421
Total life-cycle costing	421
Total quality management	424
Costing quality procedures	426
Target costing	427
Kaizen costing	428
Value chain analysis	429
Benchmarking	431
Non-financial measures of performance	433
The balanced scorecard	434
Scorecard problems	440
Measuring shareholder value	440
The quest for shareholder value	441
How can shareholder value be created?	441
The need for new measures	442
Economic value added (EVA®)	443
<i>Self-assessment question 11.1</i>	448
<i>Summary</i>	450
<i>Key terms</i>	451
<i>Reference</i>	451
<i>Further reading</i>	451
<i>Review questions</i>	452
<i>Exercises</i>	452

## **12 Budgeting** **457**

<i>Introduction</i>	457
<i>Learning outcomes</i>	457



How budgets link with strategic plans and objectives	458
Time horizon of plans and budgets	460
How budgets help managers	461
Budgets and forecasts	463
Limiting factors	464
Periodic and continual budgets	464
How budgets link to one another	465
The budget-setting process	468
Using budgets in practice	471
Incremental and zero-base budgeting	473
Preparing budgets	476
The cash budget	476
Preparing other budgets	480
Activity-based budgeting	483
Non-financial measures in budgeting	485
Budgets and management behaviour	485
Who needs budgets?	485
Beyond conventional budgeting	487
Long live budgets!	489
<i>Self-assessment question 12.1</i>	492
<i>Summary</i>	493
<i>Key terms</i>	494
<i>References</i>	494
<i>Further reading</i>	494
<i>Review questions</i>	495
<i>Exercises</i>	495
<b>13 Accounting for control</b>	<b>501</b>
<i>Introduction</i>	501
<i>Learning outcomes</i>	501
Budgeting for control	502
Types of control	503
Variances from budget	505
Flexing the budget	506
Sales volume variance	507
Sales price variance	509
Materials variances	511
Labour variances	512
Fixed overhead variance	513
Reasons for adverse variances	518
Variance analysis in service industries	520
Non-operating profit variances	520
Investigating variances	520
Variance analysis in practice	523
Compensating variances	523
Standard quantities and costs	524
Setting standards	525

What kind of standards should be used?	525
Who sets the standards?	525
How is information gathered?	525
The learning-curve effect	526
Keeping standards relevant	527
Other uses for standard costing	528
Making budgetary control effective	528
Some problems . . .	529
The new business environment	530
Behavioural issues	532
The impact of management style	533
Failing to meet the budget	535
Budgets and innovation	536
<i>Self-assessment question 13.1</i>	537
<i>Summary</i>	537
<i>Key terms</i>	539
<i>Reference</i>	539
<i>Further reading</i>	539
<i>Review questions</i>	540
<i>Exercises</i>	540

## Part 3 Financial management

<b>14</b> <b>Making capital investment decisions</b>	<b>547</b>
<i>Introduction</i>	547
<i>Learning outcomes</i>	547
The nature of investment decisions	548
Investment appraisal methods	549
Accounting rate of return (ARR)	551
ARR and ROCE	552
Problems with ARR	553
Payback period (PP)	555
Problems with PP	557
Net present value (NPV)	559
Interest lost	560
Risk	560
Inflation	561
What will logical investors do?	562
Using present value tables	565
The discount rate and the cost of capital	566
Why NPV is better	567
NPV's wider application	568
Internal rate of return (IRR)	568
Problems with IRR	572
Some practical points	573
Investment appraisal in practice	577

Investment appraisal and strategic planning	580
Risk and investment	580
Managing investment projects	581
Stage 1: Determine investment funds available	582
Stage 2: Identify profitable project opportunities	583
Stage 3: Evaluate the proposed project	583
Stage 4: Approve the project	584
Stage 5: Monitor and control the project	584
<i>Self-assessment question 14.1</i>	586
<i>Summary</i>	587
<i>Key terms</i>	589
<i>Reference</i>	589
<i>Further reading</i>	589
<i>Review questions</i>	590
<i>Exercises</i>	590

## **15** **Financing a business** **596**

<i>Introduction</i>	596
<i>Learning outcomes</i>	596
The main objective of financing policy	597
Sources of finance	597
Internal sources of finance	597
Internal sources of long-term finance	598
Retained earnings	598
Dividend policy	599
Internal sources of short-term finance	600
Tighter credit control	600
Reducing inventories levels	600
Delaying payment to trade payables	600
Some further points	601
External sources of finance	602
External sources of long-term finance	602
Ordinary shares	603
Preference shares	603
Borrowing	604
Forms of borrowing	608
Finance leases	612
Sale-and-leaseback arrangements	615
Hire purchase	616
Securitisation	617
External sources of short-term finance	619
Bank overdrafts	619
Debt factoring	619
Invoice discounting	621
Long-term versus short-term borrowing	623
Gearing and the financing decision	624
Raising long-term finance	628

Share issues	628
Rights issues	629
Offers for sale and public issues	632
Setting a share price	632
Private placings	633
Bonus issues	633
The role of the Stock Exchange	634
Advantages of a listing	634
Disadvantages of a listing	636
Going private	638
The Alternative Investment Market	638
Providing long-term finance for the small business	639
Venture capital	639
Business angels	641
Government assistance	641
Islamic finance	642
<i>Self-assessment question 15.1</i>	642
<i>Summary</i>	644
<i>Key terms</i>	646
<i>References</i>	646
<i>Further reading</i>	647
<i>Review questions</i>	648
<i>Exercises</i>	648

<b>16</b>	<b>Managing working capital</b>	<b>653</b>
	<i>Introduction</i>	653
	<i>Learning outcomes</i>	653
	What is working capital?	654
	Managing working capital	655
	The scale of working capital	655
	Managing inventories	658
	Budgeting future demand	661
	Financial ratios	661
	Recording and reordering systems	661
	Levels of control	663
	Inventories management models	665
	Managing trade receivables	669
	Which customers should receive credit and how much should they be offered?	670
	Length of credit period	672
	Cash discounts	675
	Debt factoring and invoice discounting	676
	Credit insurance	676
	Collection policies	676
	Managing cash	680
	Why hold cash?	680
	How much cash should be held?	681

Controlling the cash balance	682
Cash budgets and managing cash	683
The operating cash cycle	683
Cash transmission	688
Bank overdrafts	689
Managing trade payables	690
Taking advantage of cash discounts	692
Controlling trade payables	693
<i>Self-assessment question 16.1</i>	695
<i>Summary</i>	696
<i>Key terms</i>	698
<i>Further reading</i>	699
<i>Review questions</i>	700
<i>Exercises</i>	700

## Part 4 Supplementary information

Appendix A Recording financial transactions	709
<i>Introduction</i>	709
<i>Learning outcomes</i>	709
The basics of double-entry bookkeeping	710
Recording trading transactions	712
Balancing accounts and the trial balance	715
Preparing the financial statements (final accounts)	719
The ledger and its division	722
<i>Summary</i>	723
<i>Key terms</i>	724
<i>Further reading</i>	724
<i>Exercises</i>	725
Appendix B Glossary of key terms	728
Appendix C Solutions to self-assessment questions	745
Appendix D Solutions to review questions	766
Appendix E Solutions to selected exercises	781
Appendix F Present value table	830
Index	833

# Preface

This text provides a comprehensive introduction to financial accounting, management accounting and core elements of financial management. It is aimed both at students who are not majoring in accounting or finance and those who are. Those studying introductory-level accounting and/or financial management as part of their course in business, economics, hospitality management, tourism, engineering or some other area should find that the book provides complete coverage of the material at the level required. Students, who are majoring in either accounting or finance, should find the book useful as an introduction to the main principles, which can serve as a foundation for further study. The text does not focus on technical issues, but rather examines basic principles and underlying concepts. The primary concern throughout is the ways in which financial statements and information can be used to improve the quality of the decisions made by those who use them. To reinforce this practical emphasis, 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 that there are numerous integrated activities, worked examples and questions through all of the chapters to help you to understand the subject fully. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you are using the book as part of a taught course or for personal study, we have found that this approach is more 'user-friendly' and makes it easier for you to learn.

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

A further 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 eighth edition, we have taken the opportunity to make improvements suggested by students and lecturers who used the previous edition. We have expanded the discussion on the need for managers to have some understanding of accounting and introduced a section on ethics in accounting (Chapter 1). The topic of risk has now been introduced much earlier in the book (Chapter 8) and has been linked more clearly to management decision making. In addition, the material in Chapters 12 and 13 has been reordered to make their development more logical. 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.

More detail about the nature and use of these features is given in the 'How to use this book' section below.

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

*Eddie McLaney*

*Peter Atrill*

# How to use this book

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

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

## Integrated assessment material

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

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

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

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

## End-of-chapter assessment material

At the end of each chapter there are four **Review questions**. These are short questions requiring a narrative answer or discussion within a tutorial group. They are intended to help you assess how well you can recall and critically evaluate the core terms and concepts covered in each chapter. Answers to these questions are provided in the Appendix D at the end of the book. At the end of each chapter, except for Chapter 1, there are seven **Exercises**. These are mostly computational and are designed to reinforce your knowledge and understanding. Exercises are graded as ‘basic’, ‘intermediate’ and ‘advanced’ according to their level of difficulty. The basic and intermediate level



exercises are fairly straightforward: the advanced level ones can be quite demanding but are capable of being successfully completed if you have worked conscientiously through the chapter and have attempted the basic exercises. Solutions to four of the exercises in each chapter are provided in Appendix D at the end of the book. A coloured exercise number identifies these five questions. Here, too, a thorough attempt should be made to answer each exercise before referring to the solution. Solutions to the other three exercises and to the review questions in each chapter are provided in a separate Instructors' Manual.

## **Content and structure**

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

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

# Acknowledgements

We are grateful to the following for permission to reproduce copyright material:

## Figures

Figure 1.5 from *Management Accounting for Decision Makers*, 7th edn, Pearson Education (Peter Atrill and Eddie McLaney 2012) © Pearson Education Ltd 2002, 2005, 2007, 2009, 2012; Figures 3.8, 5.5, 5.7, 7.1, 7.8 from *Financial Accounting for Decision Makers*, 6th edn, Financial Times/Prentice Hall (Peter Atrill and Eddie McLaney 2011) © Pearson Education Ltd 2002, 2011; Figure 4.1 adapted from/based on information in Companies Register Activities 2012, Statistical Tables on Companies Registration Activities 2013/14, [www.companieshouse.gov.uk](http://www.companieshouse.gov.uk), © Crown Copyright; Figure 7.2 from Figure compiled from information taken from 'Profitability of UK companies Q4 2011', Office of National Statistics ([www.statistics.gov.uk/](http://www.statistics.gov.uk/)) 4 April 2012, source: Office for National Statistics licensed under the Open Government Licence v.1.0; Figures 9.13, 13.2, 13.3, 13.5, 14.5 from *Management Accounting for Decision Makers*, 7th edn, Pearson Education (Peter Atrill and Eddie McLaney 2012) © Pearson Education Ltd 2002, 2005, 2007, 2009, 2012; Figure 10.12 from Management accounting tools for today and tomorrow' *CIMA Research Publications*, 2009, p.12; Figure 11.1 adapted from Activity Based Costing: A Review with Case Studies, *CIMA Research Publications*, 1990 (Innes, J., and Mitchell, F.), © Elsevier and the authors; Figure 11.2 from 'A survey of factors influencing the choice of product costing systems in UK organisations', *Management Accounting Research*, Vol. 18, Issue 4, pp. 399–424, 2007 (Al-Omiri, M., and Drury, C.), © 2007, Elsevier; Figures 11.4, 11.6, 11.8, 12.8, 12.9 from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009; Figure 11.5 from Based on information in D. Rigby Management Tools [www.bain.com](http://www.bain.com), Used with permission from Bain & Company, [www.bain.com](http://www.bain.com); Figure 11.9 from *Competitive Advantage*, The Free Press (Porter, M. 1985) pp. 11–15, adapted with the permission of Simon & Schuster Publishing Group, © 1985, 1998 by Michael E. Porter. All rights reserved; Figures 11.10, 11.13 based on information in D. Rigby Management Tools [www.bain.com](http://www.bain.com), 2009, used with permission from Bain & Company, [www.bain.com](http://www.bain.com); Figure 11.11, reprinted with permission from 'Using the Balanced Scorecard as a Strategic Management System' by Robert S. Kaplan and David P. Norton. *Harvard Business Review*, January/February 1996. © 1996 by Harvard Business Publishing; All rights reserved; Figures 11.10, 11.13 adapted from/based on information in D. Rigby, *Management Tools*, 2009, used with permission from Bain & Company, [www.bain.com](http://www.bain.com); Figure 12.7 from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 15; Figure 12.10 from Beyond budgeting, [www.bbbrt.org](http://www.bbbrt.org). Reproduced by permission of Beyond Budgeting Association Ltd; Figure 12.11 from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 15; Figures 13.11, 13.14 adapted from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 12; Figures 13.11, 13.14 from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 12; Figure 14.7 adapted from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 18; Figure 15.6 from *Financial Accounting for Decision Makers*, 6th edn, Financial Times/Prentice Hall (Peter Atrill, 2011), © Pearson Education Ltd 2011; Figures 15.7, 15.12 from *Financial Management for Decision Makers*, 6th edn, Financial Times/Prentice Hall (Peter Atrill 2011), © Pearson

Education Ltd 2011; Figure 15.15 from Cosh, A. and Hughes, A., *British Enterprise: Thriving or Surviving*, Centre for Business Research, University of Cambridge, 2007. Reproduced by permission.

### Tables

Table 2.1 adapted from BrandZ Top 100 Most Valuable Global Brands 2014, Millward Brown 2014 [www.millwardbrown.com](http://www.millwardbrown.com).

### Text

Extract 1.1 from ‘TUI chief contrite at accounting blunder’, *The Financial Times*, 21/10/2010 (Blitz R and O’Doherty, J.), © The Financial Times Limited. All Rights Reserved; Extract 1.2 from ‘Know your customers for a head start’, *The Financial Times*, 16/03/2012 (Moules, J.), © The Financial Times Limited. All Rights Reserved; Extract 1.3 from ‘Steve Ballmer shakes up Microsoft structure in battle to compete’, *The Financial Times*, 11/07/2013 (Waters R), © The Financial Times Limited. All Rights Reserved; Extract 1.4 from 2013 Management Tools and Trends and Top Ten Management Tools 2013, Bain and Company, [www.bain.com](http://www.bain.com), used with permission from Bain & Company; Extract 1.6 from ‘How we’ve poisoned the well of wealth’, *The Financial Times*, 15/02/2009 (Goyder M), © The Financial Times Limited. All Rights Reserved; Extract 2.4 adapted from ‘Johnston Press writes down £250m in assets’, *The Financial Times*, 28/08/2013 (R. Cookson Johnston), © The Financial Times Limited. All Rights Reserved; Extract 2.7 adapted from ‘Balance sheets: the basics’ <http://www.ccfplus.com/wp-content/uploads/balance-sheets-the-basics.pdf>, Accessed 14 April 2010. © Crown Copyright 2006; Extract 3.4 from ‘Accounting rules unravel the mysteries of Britain’s economy’, *The Financial Times*, 23/04/2014 (Giles, C.), © The Financial Times Limited. All Rights Reserved; Extract 4.1 from ‘Monotub Industries in a spin as founder gets Titan for £1’, *The Financial Times*, 23/01/2012 (Urquhart, L.), © The Financial Times Limited. All Rights Reserved; Extract 4.8 from ‘Betfair admits to £80m payouts mistake’, *The Financial Times*, 03/08/2014 (Mance, H.), © The Financial Times Limited. All Rights Reserved; Extract 4.9 from ‘Go-Ahead dividend driven up by rail franchise and bus successes’, *The Financial Times*, 04/09/2014 (Wild, J.), © The Financial Times Limited. All Rights Reserved; Extract 5.1 from © IFRS Foundation. All rights reserved. Reproduced by Pearson Education Ltd with the permission of the International Financial Reporting Standards Foundation®. No permission granted to third parties to reproduce or distribute. The IASB, the IFRS Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise. All rights reserved. Reproduction and use rights are strictly limited. No permission granted to third parties to reproduce or distribute; Extract 5.2 from ‘Google hit with €1 billion French tax bill’, *Accountancy Age*, 07/02/2014 (Fuller, C.), © Accountancy Age. All Rights Reserved; Extract 5.4 adapted from Cineworld Group plc Annual Report and Accounts 2013, pages. 6, 8 and 34, Cineworld Group plc, © Cineworld Group plc; Extract 5.6 from ‘Autonomy beset by revenues allegation’, *The Financial Times*, 05/01/2014 (Waters, R.), © The Financial Times Limited. All Rights Reserved; Extract 5.7 from Based on two personal views on WorldCom posted on the [ft.com](http://ft.com) site, *The Financial Times*, 27/06/2002, © The Financial Times Limited. All Rights Reserved; Extract 5.8 from ‘The rise and fall of Enron’, *Journal of Accountancy*, 2002 (William Thomas, C.), ©2012, AICPA. Used by permission; Extract 5.9 adapted from ‘Another Chinese company gets charged with fraud’, *The Financial Times*, 20/06/2013 (Kwan Yuk, P), © The Financial Times Limited. All Rights Reserved; Extract 5.11 from ‘It pays to read between the lines’, *The Financial Times*, 17/09/2013 (Sharon Smith), © The Financial Times Limited. All Rights Reserved; Extract 6.1 from ‘The most dangerous unforced errors’, *The Financial Times*, 09/07/2013 (Johnson, L.), ©

The Financial Times Limited. All Rights Reserved; Extract 6.2 from ‘The management column’, *The Daily Telegraph*, 14/06/2010 (John Timpson), © Telegraph Media Group Limited 2010; Extract 6.4 from ‘Lex column, Shell: white noise’, *The Financial Times*, 01/08/2013, © The Financial Times Limited. All Rights Reserved; Extract 6.5 from Ryanair’s summarised cash flow statement for the year ended 31 March 2014, Ryan Air Plc; Extract 6.6 from ‘Cash flow is king when judging a company’s prospects’, *Sunday Telegraph Business*, 2014 (White, G.), © Telegraph Media Group Limited; Extract 7.4 from ‘Ryanair sees sharp fall in profits due to higher fuel costs’, *The Financial Times*, 29/07/2013 (Jane Wild), © The Financial Times Limited. All Rights Reserved; Extract 7.5 from ‘Companies monitor companies credit scores’, *The Financial Times*, 26/01/2012 (Moules, J.), © The Financial Times Limited. All Rights Reserved; Extract 7.6 from ‘How investors ignored the warning signs at Tesco’, *The Financial Times*, 05/09/2014 (Smith, T.), © The Financial Times Limited. All Rights Reserved; Extract 7.10 from ‘New study re-writes the A to Z of value investing’, *The Financial Times*, 14/08/2009 (Patrick Mathurin), © The Financial Times Limited. All Rights Reserved; Extract 7.11 from *Arnold Weinstock and the Making of GEC*, Aurum Press, 1998 (Stephen Aris), published in *The Sunday Times*, 22/02/1998, p.3; Extract 8.1 from ‘Something for the weekend’, *The Financial Times*, 16/11/2012 (Anderson, L.), © The Financial Times Limited. All Rights Reserved; Extract 8.2 from ‘Murdoch’s MySpace dream turns to dust’, *The Financial Times*, 30/06/2011 (Garrahan M), © The Financial Times Limited. All Rights Reserved; Extract 8.3 from ‘Is a university degree a good investment?’, *The Financial Times*, 07/09/2014 (Foley, S.), © The Financial Times Limited. All Rights Reserved; Extract 8.4 from ‘UK taxpayer will lose in rush to exit’, *The Financial Times*, 05/05/2013, © The Financial Times Limited. All Rights Reserved; Extract 9.2 from ‘Australia’s iron ore producers steel themselves for casualties’, *The Financial Times*, 14/19/2014 (J. Smyth and L. Hornby), © The Financial Times Limited. All Rights Reserved; Extract 9.5 from ‘Volvo Cars swings into loss amid tough European markets’, *The Financial Times*, 04/09/2013 (Milne, R.), © The Financial Times Limited. All Rights Reserved; Extract 9.10 from ‘Npower pledges £1m after criticism’, *The Financial Times*, 03/12/2013 (Chazan, G.), © The Financial Times Limited. All Rights Reserved; Extract 10.1 from ‘Payment by Results national tariff payments system for 2014/15 Annex 5A: National prices’, Department of Health, 17 December 2013. © Crown Copyright via the Open Government Licence; Extract 10.2 from ‘A survey of factors influencing the choice of product costing systems in UK organisations’, *Management Accounting Research*, Vol. 18, Issue 4, pp. 399–424 (M. Al-Omiri and C. Drury 2007), © 2007, Elsevier; Extract 10.3 from NHS Better care better value indicators, NHS England, 15 May 2014 © Crown Copyright 2014; Extract 10.7 adapted from ‘Case Study: Elsevier’, *The Financial Times*, 19/06/2002, © The Financial Times Limited. All Rights Reserved; Extract 10.8 from ‘Flexible business models helps Spice Holdings power ahead in outsource market’, *The Financial Times* (Jansson, E.), © The Financial Times Limited. All Rights Reserved; Extract 10.9 from ‘An empirical investigation of the importance of cost-plus pricing’, *Management Auditing Journal*, Vol. 20, No. 2, 2005 (Guilding, C., Drury, C. and Tayles, M.), © 2005, Emerald Group Publishing Limited; Extract 10.10 from ‘Contemporary Management Accounting Practices in UK Manufacturing’, *CIMA Research Publication*, Vol. 1, No. 13, 2005 (Dugdale, D., Jones, C. and Green, S.); Extract 11.1 from ‘Banks have not tackled indirect costs’, *The Financial Times*, 07/01/2004 (Skorecki, A.), © The Financial Times Limited. All Rights Reserved; Extract 11.5 from Rolls-Royce Holdings plc, 2013 Annual report, p. 45, Rolls-Royce plc; Extract 11.9 from ‘It is all about the value chain’, *The Financial Times*, 23/02/2006 (Ian Bickerton), © The Financial Times Limited. All Rights Reserved; Extract 11.12 from Rigby, D. and Bilodeau, B., ‘Management Tools’, Bain & Company, 2011, used with permission from Bain & Company, www.bain.com; Extract 11.14 from ‘When misuse leads to failure’, *The Financial Times*, 24/05/2006, © The Financial Times Limited. All Rights Reserved; Extract 12.6 from



Callaghan, S., Hawke, K. and Mignerey, C., 'Five myths (and realities) about zero-based budgeting,' McKinsey & Company, [www.mckinsey.com/insights](http://www.mckinsey.com/insights), October 2014; Extracts 12.7, 12.8 from Management accounting tools for today and tomorrow, *CIMA Research Publications*, 2009, p. 15; Extract 12.9 from 'The management column', *The Daily Telegraph*, 06/06/2011 (John Timpson), © Telegraph Media Group Limited, 2011; Extract 12.10 from 'Toyota: A World Class manufacturing model, [www.bbrrt.org](http://www.bbrrt.org). Reproduced by permission of Beyond Budgeting Association Ltd; Extract 13.1 from 'Miscalculation on student loans poses £5bn loss risk', *The Financial Times*, 28/11/2013 (Warrell H), © The Financial Times Limited. All Rights Reserved; Extract 13.4 from 'Management accounting practices of UK small-medium-sized enterprises', *CIMA Research Publications*, July 2013, p. 7 (Lucas, M., Prowle, P. and Lowth, G); Extract 14.1 from Brittany Ferries launches an investment, [www.brittany-ferries.co.uk](http://www.brittany-ferries.co.uk); Extract 14.11 from 'With Standard life deal, Manulife targets growth at home', *The Globe and Mail*, 04/09/2014 (Nelson J), [www.theglobeandmail.com](http://www.theglobeandmail.com); Extract 14.12 from 'Result of first phase of Boamahun optimization work', Amara Mining plc, 30/01/2014; Extract 14.15 from Kingfisher plc Annual Report 2013/14, p. 25, [www.kingfisherco.uk](http://www.kingfisherco.uk); Extract 15.3 from 'Manchester United cuts its debt cost', *The Financial Times*, 24/05/2013 (Roger Blitz), © The Financial Times Limited. All Rights Reserved; Extract 15.5 from 'Sony – group bonding', *The Financial Times*, 15/11/2012, © The Financial Times Limited. All Rights Reserved; Extract 15.8 from 'Orange looks to offload Spanish mobile masts to cut costs', *The Financial Times*, 14/08/2014 (Thomas, D.), © The Financial Times Limited. All Rights Reserved; Extract 15.9 from Stagecoach Group plc, Annual report 2014, p. 85; Extract 15.11 from 'Shareholders back Mothercare's rights issue', *The Financial Times*, 27/10/2014 (Shubber, K.), © The Financial Times Limited. All Rights Reserved; Extract 15.12 from 'Hammerson raises £400m in share placing to develop outlet empire', *The Financial Times*, 25/09/2014 (Barrett, C.), © The Financial Times Limited. All Rights Reserved; Extract 15.13 from A good year: why 2014 was a good time to invest in IPOs, <http://blogs.deloitte.co.uk/scotland>, 28/01/2015 (Rick Ballard); Extract 15.15 from Ownership of UK Quoted Shares 2012, Office for National Statistics, 25 September 2013, © 2013 Crown Copyright, Source: Office for National Statistics licensed under the Open Government Licence v.3.0.; Extract 16.4 from 'Wal-Mart aims for further inventory cuts', *The Financial Times*, 19/04/2006 (Jonathan Birchallin Rogers), © The Financial Times Limited. All Rights Reserved; Extract 16.5 from 'Inventory control in retail', *The Financial Times*, 13/02/2012 (Jane Bird), © The Financial Times Limited. All Rights Reserved; Extract 16.10 from [www.atradius.us/news/press-releases](http://www.atradius.us/news/press-releases), 13 August 2008. Reproduced by permission of Atradius Trade Credit Insurance, Inc, Atradius provides trade credit insurance, surety and collections services worldwide through a strategic presence in 50 countries. Atradius has access to credit information on 200 million companies worldwide. Its credit insurance, bonding and collections products help protect companies throughout the world from payment risks associated with selling products and services on trade credit. Atradius forms part of Grupo Catalana Occidente (GCO.MC), one of the leading insurers in Spain and worldwide in credit insurance; Extract 16.13 from 'REL working capital survey 2013', *Financial Director*, 27/08/2013 (Crump, R.); Extract 16.14 from 'The TWO different definitions of prompt payment', *Accountancy Age*, 28/06/2010 (M. Williams), <http://www.accountancyage.com/aa/blog-post/1798994/the-two-definitions-prompt-payment>, © Accountancy Age, Incisive Media; Extract 16.15 from 'Mars accused of delaying payments to suppliers', *Daily Telegraph*, Business Section, 20/05/2014 (Gribbin, R.), © Telegraph Media Group Limited; Extract 16.17 from 'Uncovering cash and insights from working capital', McKinsey and Company, July 2014 (Davies, R. and Merin, D.)

In some instances we have been unable to trace the owners of copyright material, and we would appreciate any information that would enable us to do so.

# Introduction to accounting and finance

## Introduction

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

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

## Learning outcomes

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

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

## What are accounting and finance?

Let us start by trying to understand the purpose of each. **Accounting** is concerned with *collecting, analysing* and *communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. If the financial information that is communicated were not capable of improving the quality of decisions made, there would be no point in producing it. We shall see who uses financial information, and for what kind of decisions it is useful, a little later in this 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 better financial information on which to base their decisions. This decision-making perspective of accounting fits in with the theme of this book and shapes the way in which we deal with each topic.

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

The way in which funds are raised must fit with the particular needs of the business. An understanding of finance should help in identifying:

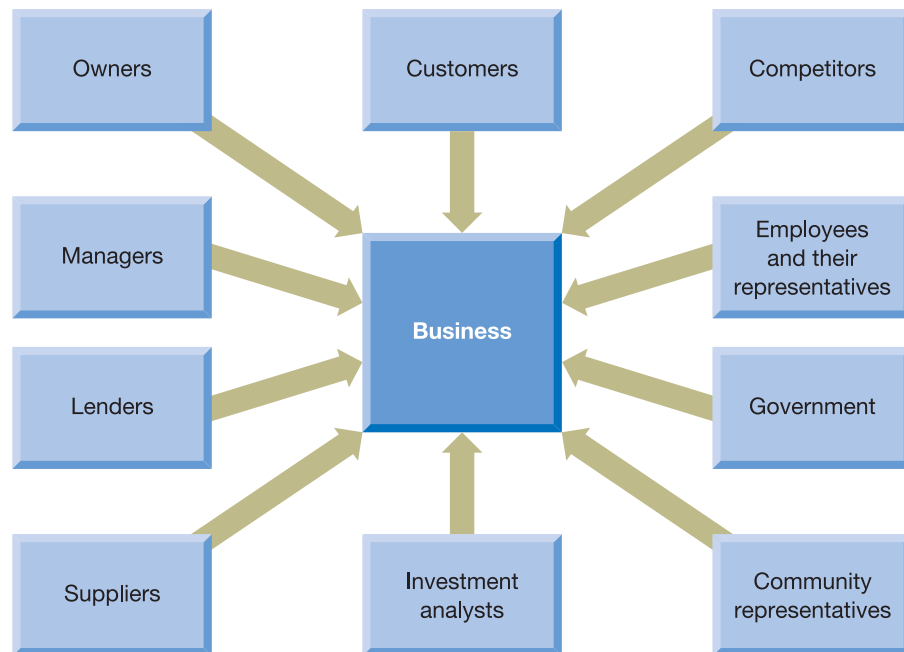
- the main forms of finance available;
- the costs, benefits and risks of each form of finance;
- the risks associated with each form of finance; and
- the role of financial markets in supplying finance.

Once the funds are raised, they must be invested in a way that will provide the business with a worthwhile return. An understanding of finance should also help in evaluating the risks and returns associated with an investment.

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

## Who are the users of accounting information?

For accounting information to be useful, the accountant must be clear *for whom* the information is being prepared and *for what purpose* the information will be used. There are likely to be various groups of people (known as 'user groups') with an interest in a particular organisation, in the sense of needing to make decisions about it. For the typical private-sector business, the more important of these groups are shown in Figure 1.1. Take a look at this figure and then try Activity 1.1.

**Figure 1.1** Main users of financial information relating to a business

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

**Activity 1.1**

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

Your answer may be along the following lines:

<i>User group</i>	<i>Decision</i>
Customers	Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet customers' needs, particularly in respect of any insurance claims made.
Competitors	How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This might involve competitors using PI's performance in various respects as a 'benchmark' when evaluating their own performance. They might also try to assess PI's financial strength and to identify significant changes that may signal PI's future actions (for example, raising funds as a prelude to market expansion).





**Activity 1.1 continued**

<i>User group</i>	<i>Decision</i>
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, the extent to which it is likely to use community resources, and its likely willingness to fund environmental improvements are likely to be important considerations.
Investment analysts	Whether to advise clients to invest in PI. This would involve an assessment of the likely risks and future returns associated with PI.
Suppliers	Whether to continue to supply PI and, if so, whether to supply on credit. This would involve an assessment of PI's ability to pay for any goods and services supplied.
Lenders	Whether to lend money to PI and/or whether to require repayment of any existing loans. PI's ability to pay the interest and to repay the principal sum would be important factors in such decisions.
Managers	Whether the performance of the business needs to be improved. Performance to date would be compared with earlier plans or some other 'benchmark' to decide whether action needs to be taken. Managers may also wish to consider a change in PI's future direction. This would involve looking at PI's ability to perform and at the opportunities available to it.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on rewarding senior managers. When making such a decision, the financial performance of the business would normally be considered.

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

## The conflicting interests of users

We have just seen that each user group will have its own particular interests. There is always the possibility that the interests of the various user groups will collide. The

distribution of business wealth provides the most likely area for a collision to take place. Let us take the example of owners and managers. Although managers are appointed to act in the best interests of the owners, they may not always do so. Instead, they may use the wealth of the business to award themselves large pay rises, to furnish large offices or to buy expensive cars for their own use. Accounting can play an important role in monitoring and reporting how various groups benefit from the business. Thus, owners may rely on accounting information to see whether pay and benefits received by managers are appropriate and accord with agreed policies.

There is also a potential collision of interest between lenders and owners. Funds loaned to a business, for example, may not be used for their agreed purpose. They may be withdrawn by the owners for their own use rather than used to expand the business as agreed. Lenders may, therefore, rely on accounting information to see whether the owners have kept to the terms of the loan agreement.

### Activity 1.2

Can you think of other examples where accounting information may be relied on by a user group to see whether the distribution of business wealth is appropriate and/or in accordance with particular agreements?

Two possible examples that spring to mind are:

- employees wishing to check that they are receiving a 'fair share' of the wealth created by the business and that managers are complying with agreed profit-sharing schemes;
- governments wishing to check that the owners of a monopoly do not benefit from excessive profits and that any pricing rules concerning the monopoly's goods or services have not been broken.

You may have thought of other examples.

## How useful is accounting information?

No one would seriously claim that accounting information fully meets all of the needs of each of the various user groups. Accounting is still a developing subject and we still have much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained in accounting reports should help users make decisions relating to the business. The information should reduce uncertainty about the financial position and performance of the business. It should help to answer questions concerning the availability of funds to pay owners a return, to repay loans, to reward employees and so on.

Typically, there is no close substitute for the information provided by the financial statements. Thus, if users cannot glean the required information from the financial statements, it is often unavailable to them. Other sources of information concerning the financial health of a business are normally much less useful.

**Activity 1.3**

What other sources of information might, say, an investment analyst use in an attempt to gain an impression of the financial position and performance of a business? (Try to think of at least four.) What kind of information might be gleaned from these sources?

Other sources of information available include:

- meetings with managers of the business;
- public announcements made by the business;
- newspaper and magazine articles;
- websites, including the website of the business;
- radio and TV reports;
- information-gathering agencies (for example, agencies that assess businesses' creditworthiness or credit ratings);
- industry reports;
- economy-wide reports.

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

The kind of information identified in Activity 1.3 is not really a substitute for accounting information. Rather, it is best used in conjunction with accounting information to provide a clearer picture of the financial health of a business.

### Evidence on the usefulness of accounting

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

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

While there is evidence that accounting reports are seen as useful and are used for decision-making purposes, it is impossible to measure just how useful they really are to users. We cannot say with certainty whether the cost of producing these reports represents value for money. Accounting reports will usually represent only one input to a particular decision. The weight attached to them by the decision maker, and the resulting benefits, cannot be accurately assessed.

It is possible, however, to identify the kinds of qualities which accounting information must possess in order to be useful. Where these qualities are lacking, the usefulness of the information will be diminished. We shall now consider this point in more detail.

## Providing a service

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

To be useful to users, the information provided must possess certain qualities. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. We shall now examine these two qualities, which are regarded as fundamental ones, in more detail.

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

### Activity 1.4

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

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

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 those reports.

- **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 contain all of the information needed to understand what is being portrayed. It should also be *neutral*, which means that the information should be presented and selected without bias. Finally, it should be *free from error*. This is not the same as saying that it must always be perfectly accurate; this is not really possible. Estimates may have to be made which eventually turn out to be inaccurate. It does mean, however,

that there should be no errors in the way in which these estimates have been prepared and described. In practice, a piece of accounting information may not reflect perfectly these three aspects of faithful representation. It should try to do so, however, insofar as is possible.

Accounting information must contain *both* of these fundamental qualities if it is to be useful. There is little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, even if it is faithfully represented.

## Further qualities

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

- **Comparability.** Users of accounting information often want to make comparisons. They may want to compare performance of the business over time (for example, profit this year compared to last year). They may also want to compare certain aspects of business performance (such as the level of sales achieved during the year) to those of similar businesses. Better comparisons can be made where the accounting system treats items that are basically the same in the same way and where policies for measuring and presenting accounting information are made clear.
- **Verifiability.** This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to agree that it provides a faithful portrayal. Verifiable information tends to be supported by evidence.
- **Timeliness.** Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later accounting information is produced, the less useful it becomes.
- **Understandability.** Accounting information should be set out as clearly and concisely as possible. It should also be understood by those at whom the information is aimed.

### Activity 1.5

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

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

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

It is worth emphasising that the four qualities just discussed (comparability, verifiability, timeliness and understandability) cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented.

## Weighing up the costs and benefits

Even though a piece of accounting information may have all the qualities described, this does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.6.

### Activity 1.6

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 and timely, and can be understood by the decision maker.

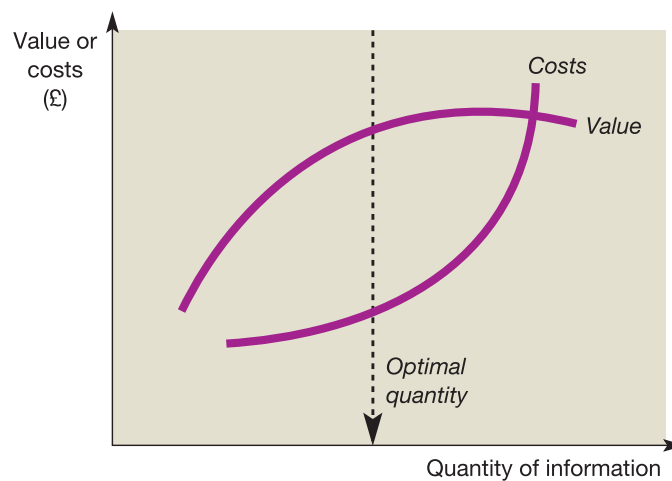
Can you think of the reason why, in practice, you might choose not to produce the information?

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 only be produced if the costs of providing it are less than the benefits, or value, to be derived from its use. Figure 1.2 shows the relationship between the costs and value of providing additional accounting information.

Figure 1.2

### Relationship between costs and the value of providing additional accounting information



The benefits of accounting information eventually decline. The cost of providing information, however, will rise with each additional piece of information. The optimal level of information provision is where the gap between the value of the information and the cost of providing it is at its greatest.