ACCOUNTING
for non-accounting students

Ninth Edition

John R. Dyson & Ellie Franklin

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ACCOUNTING

FOR NON-ACCOUNTING STUDENTS

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Brief contents

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Companion website for students

- Multiple choice questions to help test your learning
- Extra question material
- Links to relevant sites on the web
- Glossary explaining key terms mentioned in the book

For instructors

- Complete, downloadable Lecturer's Guide
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Preface

Why study accounting?

This book provides a solid introduction to accounting for those students who are required to study it as part of a non-accounting course. It is also of benefit to those managers in business, government or industry whose work involves them in dealing with accounting information.

Non-accountants are often puzzled why they are required to take a course in accounting, and even more so when they have to take a demanding examination at the end of it. The fact is that these days, no matter what your job, you need to have some knowledge of accounting matters. The main reason for this is that for different specialists to talk to each other they have to speak in a language that everyone understands. In business (in its widest sense) that language is money and that happens to be the accountants' language. The use of a common language enables all the various activities that take place within a business to be translated into monetary terms and for all reports to be prepared on the same basis. So if you need to know what is going on in other departments (as you almost certainly will), you will find it much easier if you speak the language of accounting.

The book's purpose

The problem with many accounting textbooks is that they are written primarily for accounting students. As a result, they go way beyond what a non-accountant needs. This book is different. The subject is not covered superficially but it avoids going into the technical detail that is of relevance only to accountants. Nevertheless, by the time you get to the end of the book you will have gained a perfectly adequate knowledge and understanding of accounting that will enable you to talk to accountants with great confidence and which will help you to do your job much more effectively.

Some guidance for lecturers

The book is divided into four parts. Part 1 introduces students to the world of accounting, Part 2 deals with financial accounting, Part 3 with financial reporting and Part 4 with management accounting.

As you will probably be aware, many further and higher education institutions now operate a modular structure for the delivery of their courses. This book is particularly useful if your own institution does the same. Some accounting syllabi for non-accounting students combine both financial accounting and management accounting in one module while others split them between separate modules. The book is designed so that it can easily be adapted irrespective of whether you combine them or split them.

It is highly unlikely, of course, that the contents of the book will match precisely the syllabus requirements of your own course. There are bound to be topics to which you give more or less emphasis and there will be others that are not covered at all in the book. Nevertheless, the book has now been widely used throughout the UK and in many overseas countries for over 25 years. From the feedback that has been received, the contents appear to continue to meet the main requirements of most introductory accounting courses for non-accounting students.

There is one topic, however, that splits opinion right down the middle: double-entry bookkeeping. Some lecturers are absolutely convinced that non-accounting students need to have a grounding in this topic if they are to understand where the information comes from, what problems there are with it and how it can be used. Other lecturers are adamant that it is totally unnecessary for non-accounting students.

As opinion is so evenly divided on this subject we have decided to retain double-entry bookkeeping in the main part of the book. If you do not include the topic in your syllabus it can be easily left out by skipping the whole of Chapter 3 (Recording data) and possibly parts of Chapter 4 (Sole trader accounts). You could then pick up the thread of the book in Chapter 5 (Company accounts), provided you are sure that your students know something about a trial balance, a statement of profit or loss , and a statement of financial position.

In this edition we have taken the opportunity to revise and update the eighth edition. There are no structural changes made to this edition but a number of chapters have been significantly rewritten or updated:

1 Chapter 2 (Accounting rules and regulations),
2 Chapter 7 (Statement of cash flows), and
3 Chapter 10 (Interpretation of accounts).

By their nature, substantial additions and revisions have had to be made to two other chapters: Chapter 11 (Contemporary issues) and Chapter 20 (Emerging issues). It has not been too difficult to select contemporary financial issues for Chapter 11 because the various accounting bodies have a clearly established development programme and the financial reporting world has been sufficiently dynamic to present us with ample examples to choose from for discussion.

It has proved much more difficult to select emerging management accounting issues for the Chapter 20. Management accounting is not as fast moving as financial accounting and, as yet, there is no such body as a 'management accounting standards board' driving the discipline forward. The main source comes from accountants pursuing academic research in universities but as yet there is no consensus on what changes are needed. When preparing this chapter, therefore, we examined the syllabi of several accounting bodies and also took note of various suggestions made by reviewers. These two sources enabled us to select some likely emerging management issues over the next few years.

The old feature of interspersing the text with news clips has been retained. News clips are brief extracts or summaries of recent newspaper articles that are of relevance to the particular chapters in which they are placed. They are intended to demonstrate that the accounting matters discussed in the various chapters are not theoretical but that they are of practical importance and relevance in the real world.

The news stories introduced into an earlier edition at the beginning of each chapter have been replaced with more recent ones. As before, broad questions on each of these stories may then be found towards the end of the chapter. Students are strongly encouraged to have a go at answering these questions even though some of the issues covered may sometimes appear to be somewhat beyond non-accountants. However, it would be surprising if this were to be the case since most of them were first published in newspapers intended for a general audience.

As publicly traded companies in the European Union (EU) are now required to prepare their financial statements in accordance with International Accounting Standards (IASs), various amendments have had to be made throughout the text. Most notably this has resulted in the update of the terminology in the financial accounting part of the textbook. This has caused a problem for a book aimed at non-accountants as financial statements have become more and more difficult to understand. However, strenuous attempts have been made to keep the text as simple and as relevant as possible.

An additional complexity is that non-listed companies in the UK can adopt UK accounting standards while listed companies must adopt international ones. A similar problem may arise in other EU countries if non-listed companies are allowed to adopt their own accounting standards.

This problem was particularly acute when choosing the names of the financial statements to be used throughout the text. As far as published accounts are concerned, we have limited our discussion to IAS-prepared statements as these are of relevance to *all* EU-based students as well as to students based in other non-EU countries.

Some guidance for college and university students

If you are using this book as part of a formal course, your lecturer should have provided you with a work scheme. The work scheme will outline just how much of the book you are expected to cover each week. In addition to the work done in your lecture you will probably have to read each chapter at least twice.

As you work through a chapter, you will come across a number of 'activities'. Most of them require you to do something or to find something out. The idea of these activities is to encourage you to stop your reading of the text at various points and to think about what you have just read.

There are few right and wrong answers in accounting so we want you to gain some experience in deciding for yourself what you would do if you were faced with the type of issues covered in the activities.

You are also recommended to attempt as many of the questions that follow each chapter as you can. The more questions that you do, the more confident you will be that you really do understand the subject matter. However, avoid looking at the answers (there are some at the back of the book) until you are absolutely certain that you do not know how to do the question. If the answer is not at the back of the book, ask your lecturer to download it for you from the *Lecturer's Guide*.

Some guidance for students studying on their own

If you are studying accounting without having the opportunity of having face-to-face tuition, we suggest that you adopt the following study plan.

1. Organise your private study so that you have covered every topic in your syllabus at least two weeks before your examination. A proven method is to divide the number of weeks (or perhaps days!) you have available by the number of topics. This gives you the *average* time that you should spend on each topic. Allow for some topics requiring more time than others but don't rush though a topic just because you are behind your timetable. Instead, try to put in a few extra hours that week.
2. Read each chapter slowly. Be careful to do each activity and to work through each example. Don't worry if you do not understand each point immediately. Read on to the end of the chapter.
3. Read the chapter again, this time making sure that you understand each point. If necessary, go back and re-read and repeat until you do understand the point.
4. Attempt as many questions at the end of each chapter as you can, but do not look at the answers until you have completed the question or you are certain that you cannot do it. The questions are generally graded so the more difficult ones come towards the end. If you can do them all without too much difficulty, then you can move on to the next chapter with great confidence. However, before you do, it is not a bad idea to re-read the chapter again.

More guidance for all students

At this early stage of your accounting career we want to emphasise that accounting involves much more than being good at doing simple arithmetic (contrary to popular opinion, it is not highly mathematical). The solution to many accounting problems often calls for a considerable amount of personal judgement and this means that there is bound to be an element of subjectivity in whatever you decide to do.

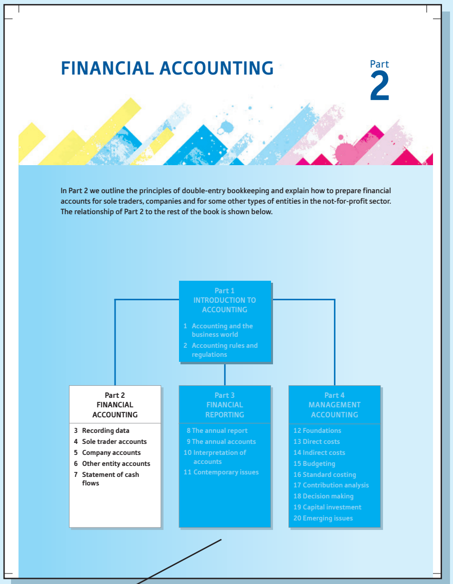
The simplified examples used in this book illustrate some complicated issues and problems in the real world that are not easily solved. You should, therefore, treat the suggested answers with caution and use them as an opportunity to question the methodology adopted. This will mean that when you are presented with some accounting information in your job, you will automatically subject it (rightly) to a great deal of questioning. That is as it should be because, as you will shortly discover, if you were an accountant and you happened to be asked '*What do 2+2 make?*' you might well reply by asking another question: '*What do you want it to make?*'

Puzzled? Intrigued? Then read on – and good luck with your studies.

An explanation

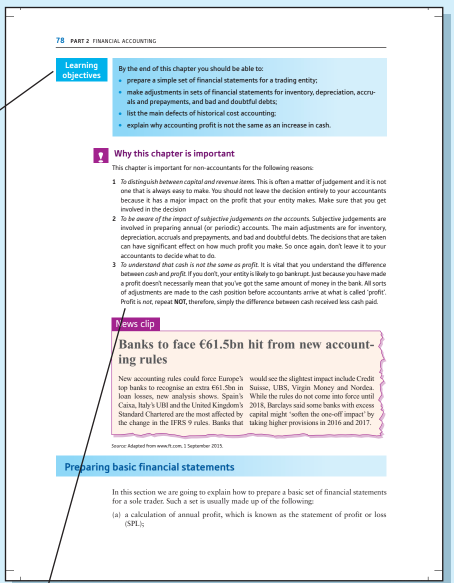
In order to avoid tedious repetition and tortuous circumlocution, the masculine pronoun has generally been adopted throughout this book. No offence is intended to anyone, most of all to our female readers, and we hope that none will be taken.

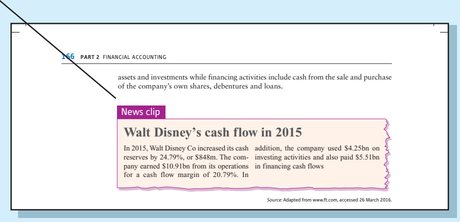
Guided tour

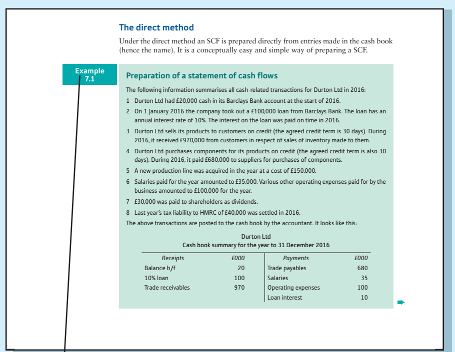


Part openers contain a diagram to help you find your way around the book.

Chapter openers feature a topical news article relating chapter content to the real world, and there are shorter **News clips** throughout.





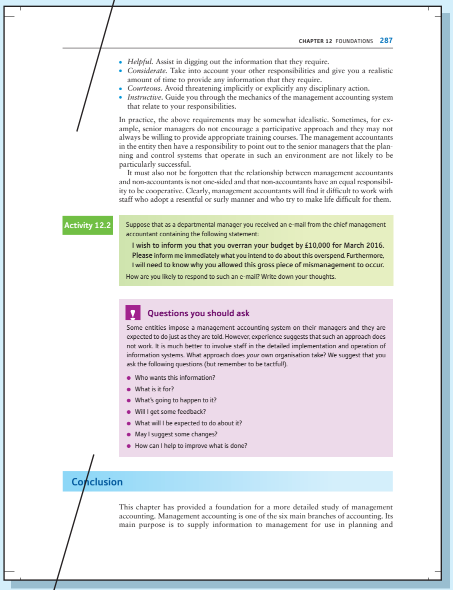


Learning objectives are provided in each chapter.

Why this chapter is important explores the applications and benefits of chapter content for the non-accountant.

Examples are spread throughout the chapter.

Activities test student understanding at regular intervals throughout the chapter.



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- *Helpful*. Assist in digging out the information that they require.
- *Considerate*. Take into account your other responsibilities and give you a realistic amount of time to provide any information that they require.
- *Courteous*. Avoid threatening implicitly or explicitly any disciplinary action.
- *Instructive*. Guide you through the mechanics of the management accounting system that relate to your responsibilities.

In practice, the above requirements may be somewhat idealistic. Sometimes, for example, senior managers do not encourage a participative approach and they may not always be willing to provide appropriate training courses. The management accountants in the entity then have a responsibility to point out to the senior managers that the planning and control systems that operate in such an environment are not likely to be particularly successful.

It must also not be forgotten that the relationship between management accountants and non-accountants is not one-sided and that non-accountants have an equal responsibility to be cooperative. Clearly, management accountants will find it difficult to work with staff who adopt a resentful or surly manner and who try to make life difficult for them.

Activity 12.2 Suppose that as a departmental manager you received an e-mail from the chief management accountant containing the following statement:

> I wish to inform you that you overran your budget by £10,000 for March 2016. Please inform me immediately what you intend to do about this overspend. Furthermore, I will need to know why you allowed this gross piece of mismanagement to occur.

How are you likely to respond to such an e-mail? Write down your thoughts.

Questions you should ask

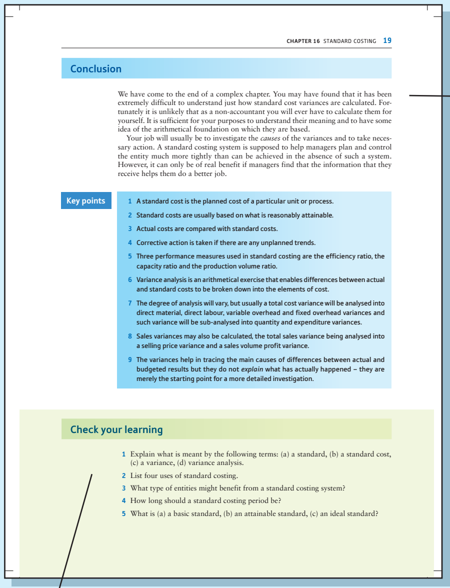
Some entities impose a management accounting system on their managers and they are expected to do just as they are told. However, experience suggests that such an approach does not work. It is much better to involve staff in the detailed implementation and operation of information systems. What approach does *your* own organisation take? We suggest that you ask the following questions (but remember to be tactful!).

- Who wants this information?
- What is it for?
- What's going to happen to it?
- Will I get some feedback?
- What will I be expected to do about it?
- May I suggest some changes?
- How can I help to improve what is done?

Conclusion

This chapter has provided a foundation for a more detailed study of management accounting. Management accounting is one of the six main branches of accounting. Its main purpose is to supply information to management for use in planning and

Questions you should ask are questions business managers might ask to assist in the decision-making process.



CHAPTER 16 STANDARD COSTING 19

Conclusion

We have come to the end of a complex chapter. You may have found that it has been extremely difficult to understand just how standard cost variances are calculated. Fortunately it is unlikely that as a non-accountant you will ever have to calculate them for yourself. It is sufficient for your purposes to understand their meaning and to have some idea of the arithmetical foundation on which they are based.

Your job will usually be to investigate the *causes* of the variances and to take necessary action. A standard costing system is supposed to help managers plan and control the entity much more tightly than can be achieved in the absence of such a system. However, it can only be of real benefit if managers find that the information that they receive helps them do a better job.

Key points

1 A standard cost is the planned cost of a particular unit or process.
2 Standard costs are usually based on what is reasonably attainable.
3 Actual costs are compared with standard costs.
4 Corrective action is taken if there are any unplanned trends.
5 Three performance measures used in standard costing are the efficiency ratio, the capacity ratio and the production volume ratio.
6 Variance analysis is an arithmetical exercise that enables differences between actual and standard costs to be broken down into the elements of cost.
7 The degree of analysis will vary, but usually a total cost variance will be analysed into direct material, direct labour, variable overhead and fixed overhead variances and such variance will be sub-analysed into quantity and expenditure variances.
8 Sales variances may also be calculated, the total sales variance being analysed into a selling price variance and a sales volume profit variance.
9 The variances help in tracing the main causes of differences between actual and budgeted results but they do not *explain* what has actually happened – they are merely the starting point for a more detailed investigation.

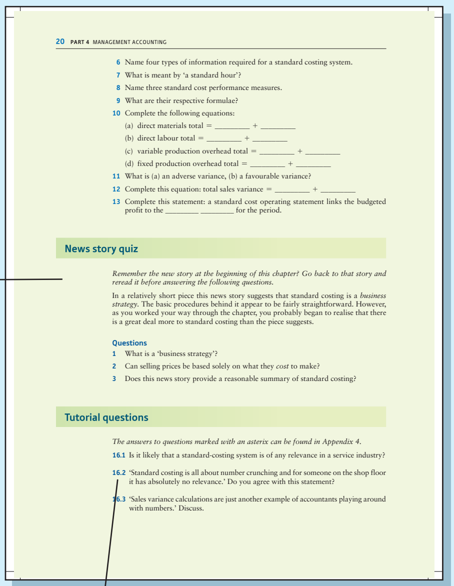
Check your learning

1 Explain what is meant by the following terms: (a) a standard, (b) a standard cost, (c) a variance, (d) variance analysis.
2 List four uses of standard costing.
3 What type of entities might benefit from a standard costing system?
4 How long should a standard costing period be?
5 What is (a) a basic standard, (b) an attainable standard, (c) an ideal standard?

Key points recap the main concepts studied in the chapter.

Check your learning tests absorption of chapter content and offers a useful revision aid.

News story quizzes provide thought-provoking questions relating to topical news articles.



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6 Name four types of information required for a standard costing system.
7 What is meant by 'a standard hour'?
8 Name three standard cost performance measures.
9 What are their respective formulae?
10 Complete the following equations:
(a) direct materials total = ________ + ________
(b) direct labour total = ________ + ________
(c) variable production overhead total = ________ + ________
(d) fixed production overhead total = ________ + ________
11 What is (a) an adverse variance, (b) a favourable variance?
12 Complete this equation: total sales variance = ________ + ________
13 Complete this statement: a standard cost operating statement links the budgeted profit to the ________ ________ for the period.

News story quiz

Remember the new story at the beginning of this chapter? Go back to that story and reread it before answering the following questions.

In a relatively short piece this news story suggests that standard costing is a *business strategy*. The basic procedures behind it appear to be fairly straightforward. However, as you worked your way through the chapter, you probably began to realise that there is a great deal more to standard costing than the piece suggests.

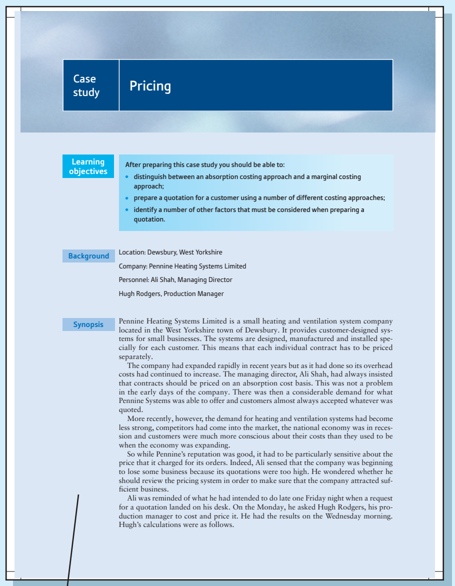
Questions

1 What is a 'business strategy'?
2 Can selling prices be based solely on what they *cost* to make?
3 Does this news story provide a reasonable summary of standard costing?

Tutorial questions

The answers to questions marked with an asterix can be found in Appendix 4.

16.1 Is it likely that a standard-costing system is of any relevance in a service industry?
16.2 'Standard costing is all about number crunching and for someone on the shop floor it has absolutely no relevance.' Do you agree with this statement?
16.3 'Sales variance calculations are just another example of accountants playing around with numbers.' Discuss.



Case study **Pricing**

Learning objectives After preparing this case study you should be able to:

- distinguish between an absorption costing approach and a marginal costing approach;
- prepare a quotation for a customer using a number of different costing approaches;
- identify a number of other factors that must be considered when preparing a quotation.

Background Location: Dewsbury, West Yorkshire
Company: Pennine Heating Systems Limited
Personnel: Ali Shah, Managing Director
Hugh Rodgers, Production Manager

Synopsis Pennine Heating Systems Limited is a small heating and ventilation system company located in the West Yorkshire town of Dewsbury. It provides customer-designed systems for small businesses. The systems are designed, manufactured and installed specially for each customer. This means that each individual contract has to be priced separately.

The company had expanded rapidly in recent years but as it had done so its overhead costs had continued to increase. The managing director, Ali Shah, had always insisted that contracts should be priced on an absorption cost basis. This was not a problem in the early days of the company. There was then a considerable demand for what Pennine Systems was able to offer and customers almost always accepted whatever was quoted.

More recently, however, the demand for heating and ventilation systems had become less strong, competitors had come into the market, the national economy was in recession and customers were much more conscious about their costs than they used to be when the economy was expanding.

So while Pennine's reputation was good, it had to be particularly sensitive about the price that it charged for its orders. Indeed, Ali sensed that the company was beginning to lose some business because its quotations were too high. He wondered whether he should review the pricing system in order to make sure that the company attracted sufficient business.

Ali was reminded of what he had intended to do late one Friday night when a request for a quotation landed on his desk. On the Monday, he asked Hugh Rodgers, his production manager to cost and price it. He had the results on the Wednesday morning. Hugh's calculations were as follows.

Tutorial questions offer ideas for assignments or class discussion.

Case studies appear at the end of parts.

Visit the Companion Website at www.pearsoned.co.uk/dyson to find further practice questions, study material and links to relevant sites on the World Wide Web. See page vii for full contents.

Acknowledgements

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Figures

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Text

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Abbreviations

AAT	Association of Accounting Technicians
ABB	Activity-based budgeting
ABC	Activity-based costing
ABCM	Activity-based cost management
ABM	Activity-based management
AC	Average cost
ACCA	Association of Chartered Certified Accountants
AMT	Advanced manufacturing technology
ARR	Accounting rate of return
ASB	Accounting Standards Board
ASC	Accounting Standards Committee
ASSC	Accounting Standards Steering Committee
BB	Beyond budgeting/Better budgeting
BBC	British Broadcasting Corporation
CA	Chartered Accountant/Companies Act
CE	Capital employed/expenditure
CI	Capital investment
CIMA	Chartered Institute of Management Accountants
CIPFA	Chartered Institute of Public Finance and Accountancy
Cr	Credit
DCF	Discounted cash flow
Dr	Debit
EA	Environmental accounting
ED	Exposure draft
EMA	Environmental management accounting
EPS	Earnings per share
EU	European Union
FA	Financial accounting
FASB	Financial Accounting Standards Board
FCA	Financial Conduct Authority
FIFO	First in, first out
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
FTSE	Financial Times and London Stock Exchange
GAAP	Generally accepted accounting principles
GBV	Gross book value
HCA	Historic cost accounting
HP	Hire purchase
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee

ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants in Ireland
ICAS	Institute of Chartered Accountants of Scotland
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IFRSF	International Financial Reporting Standards Foundation
IRR	Internal rate of return
JIT	Just-in-time
KPI	Key performance indicator
LCC	Life cycle costing
LIFO	Last-in, first-out
LLP	Limited liability partnership
LSE	London Stock Exchange
LTD	Limited
MA	Management accounting
MV	Market value
NBV	Net book value
NCF	Net cash flow
NPV	Net present value
PBIT	Profit before interest and tax
PFI	Private finance initiative
PI	Performance indicator
PLC	Public limited company
PLCC	Product/project life cycle costing
R&D	Research and development
RI	Residual income
ROCE	Return on capital employed
SBU	Strategic business unit
SC	Standard cost/costing
SCE	Statement of changes in equity
SCF	Statement of cash flows
SFP	Statement of financial position
SI	Statutory Instrument
SMA	Strategic management accounting
SME	Small and medium-sized enterprise
SPL	Statement of profit or loss
SRE	Statement of retained earnings
SSAP	Statement of Standard Accounting Practice
TB	Trial balance
TOC	Theory of constraints
TQM	Total quality management
UK	United Kingdom
VA	Value added
VCA	Value chain analysis
WACC	Weighted average cost of capital
ZBB	Zero base budgeting

INTRODUCTION TO ACCOUNTING

Part 1

This book is divided into four main parts, as shown below. Part 1 contains two chapters. In Chapter 1 we provide some background about accounting, the accountancy profession and the organisations that accountants work for. In Chapter 2 we outline the rules and regulations that accountants are expected to follow when preparing accounting statements.

Part 1
INTRODUCTION TO ACCOUNTING

1 Accounting and the business world
2 Accounting rules and regulations

Part 2
FINANCIAL ACCOUNTING

3 Recording data
4 Sole trader accounts
5 Company accounts
6 Other entity accounts
7 Statement of cash flows

Part 3
FINANCIAL REPORTING

8 The annual report
9 The annual accounts
10 Interpretation of accounts
11 Contemporary issues

Part 4
MANAGEMENT ACCOUNTING

12 Foundations
13 Direct costs
14 Indirect costs
15 Budgeting
16 Standard costing
17 Contribution analysis
18 Decision making
19 Capital investment
20 Emerging issues

Chapter 1

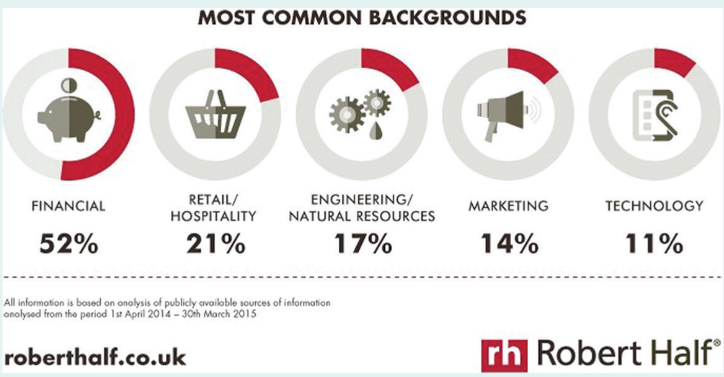
Accounting and the business world

News clip

The most common routes to the top job in FTSE 100 companies

The general career backgrounds of today's FTSE 100 CEOs remain similar to those analysed in previous years' studies with 52% having a financial background.

Phil Sheridan, the UK Managing Director at Robert Half, said: 'Finance has again proven itself to be the route to the top of Britain's biggest businesses as the ability to provide strong financial leadership and commercial acumen continues to be a key asset of FTSE 100 CEOs. **Professionals with an education or background in finance are highly sought after by organisations and demand continues to outweigh supply in today's job market.**'



Source: Extract adapted and graphics reproduced from The 2015 Robert Half FTSE 100 CEO Tracker report, with the permission of the copyright owner.

Questions relating to this news story can be found on page 22.

About this chapter

This chapter sets the scene for the rest of the book.

The chapter begins with what accounting is and an explanation of why it is vital for you as a non-accountant to study accounting. It then gives a brief explanation of the nature and purpose of accounting and of its historical development. This is followed by an outline of the main branches of accounting and how one becomes an accounting professional. The last main section of the chapter gives a brief overview of the main forms and structures used to set up and run businesses and other enterprises.

Learning objectives

By the end of this chapter you should be able to:

- summarise the nature and purpose of accounting;
- outline its history;
- explain why you need to know something about it in the context of your main subject of study and your career aspirations;
- identify the main branches of accounting;
- list the principal UK accountancy bodies;
- describe the most important types of public and private entities.

Why accounting is important

News clip

The importance of financial education

The importance of financial literacy and specifically the need to promote financial education has been recognised as an important contributor to improved financial inclusion and individuals' financial well-being, as well as a support to financial stability. The relevance of financial education policies is acknowledged at the highest global policy level and has received endorsement by the G20 Leaders and APEC Finance Ministers.

Source: Adapted from the abstract of *Financial Education for Youth, an OECD Report*, April 2014.

You've probably got hold of this book because you're a student. You may be doing a certificate, diploma or degree course in perhaps business, marketing, human resource management, economics, banking, engineering, languages, law, management or one of the sciences, to name but a few possibilities. And then you find to your horror that you have to do some accounting. Why?

OK, we'll try to explain. You probably have a vague idea that accounting has something to do with numbers and profits and tax and, er, *stuff* but you are certainly not sure what that has to do with the subject you're studying. And you resent it.

Right. You might be surprised then to find out that accounting information has to do with many things in a business (from procurement of a new IT systems, through hiring or firing staff, to financing the development of a new product) and impacts on many people in a business (from the marketing manager who has to manage an advertising budget to a banker who has to make lending decisions to a small jewellery shop owner who has to price her products appropriately). Not to mention that we all use accounting in our personal affairs – managing the income that we get from our employer or business and allocating that to various items of spending, calculating and paying our taxes and saving and investing to grow our personal wealth.

Accounting information is just information. And like all information it can be useful for making decisions – if you get hold of it, understand it and act on it.

Accounting (the process by which accounting information is generated) is basically about recording business transactions and summarising them in a way which is useful to people who need to know that information to make decisions – like shareholders and managers (e.g. the marketing managers, the human resource managers and the production managers). Perhaps just like you hope to be. 'So what?' you might well ask. 'If I need it or want it, I'll just ask the accountants to get it for me.' That's fine, but if you were a manager, would you really be quite happy to accept at face value *all* that the accountants gave you? Would you know what it meant, how reliable it was, what you were supposed to do with it or what are the right decisions to be made on the basis of it? We suspect that if you really think about the repercussions of *not* questioning what your accountants gave you, you would be (to say the least) a little unhappy. Maybe even a bit worried, especially if you were legally responsible for it all (and under UK law, the directors are responsible for the accounting records and the preparation of accounts by the businesses they manage).

The point we are making is that accountants provide a service for other people. Most accountants are probably highly qualified, experienced and good at their job, but as accountants they should not make the *decisions.* That is the manager's job – it could be your job and you will know much more about your business than any accountant. Rest assured that there is no doubt that you will be able to make even *better* decisions: (a) if you have some knowledge and some understanding of the nature of accounting information and (b) if you know what it can and what it cannot do in helping you plan and control your business.

So in a sentence, if you know something about accounting, you will become a *better* manager. By the end of this book you will be well on the way to becoming one.

This first chapter sets the scene for what follows. It is important because it provides you with the necessary background information to enable you to become a better manager.

Nature and purpose

We begin our accounting studies by giving a brief explanation of what accounting *is* and what it *does*. We will then tell you something of what it *doesn't* do. For our purposes we will use the following definition of accounting:

> Accounting is a service provided for those who need information about an entity's financial performance, its assets and its liabilities.

This definition contains a number of features that require some explanation:

- *Service*. Accounting is of assistance to other people – if nobody wanted the service, there would be no such thing as accounting.
- *Information*. The information traditionally collected by accountants is restricted to what can be quantified and translated into monetary terms.
- *Entity*. An entity is a jargon term used by accountants to describe any type of organisation, e.g. a person running his (or her) own business or a company.
- *Financial performance*. The financial performance is usually judged by matching incomes received with expenditure incurred over a period of time (usually one year) to calculate profit made in that period.
- *Assets*. In accounting, an asset is regarded as being a resource acquired by an entity as a result of a past event and that will result in a future economic benefit for the entity. For example, the purchase of plant and machinery will provide a benefit over very many years and thereby help the entity generate income in those years.

- *Liabilities*. A liability in accounting is defined as an obligation arising from a past event. For example, you may have bought some furniture but you don't have to start paying for it until next year. So for the time being, what you owe is a debt or an obligation, i.e. a liability.

The above summary shows that accounting information is somewhat restricted:

- It relates to only one entity (although it is possible to aggregate accounting information for groups of entities).
- It has to be quantifiable.
- It must be capable of being converted into monetary terms.
- It relates to an arbitrary period of time.
- A distinction is made between economic benefits that relate to past, current and future periods.

Non-accountants are often surprised when they realise that accounting information is restricted in such ways. This gives rise to what is sometimes called the *expectations gap*, i.e. when users expect accounting to do more than it can.

The expectations gap often causes considerable misunderstanding between accountants and the public, especially when an 'accounting scandal' erupts from time to time. Such scandals are often the result of genuine accounting problems but the public tend to think that they can all be put down to fraud. There have been many examples of high-profile financial fraud and accounting scandals in recent times. In 2008, Lehman Brothers, a global financial services firm, went bankrupt (curiously only in 2007 it had been voted Number 1 'Most Admired Securities Firm' by *Fortune* Magazine). It allegedly hid billions of loans disguised as sales. Closer to home, in early autumn 2014, we saw billions wiped off Tesco's value as the profit overstating scandal broke: Tesco had been artificially manipulating payments to and from suppliers. Questionable accounting practices certainly come to the fore in such high-profile cases.

We now move on to give you a review of the historical development of accounting. We do so in the next section.

Activity 1.1

Look up the definition of accounting in three different sources. Copy the definitions into your notebook. Then outline your ideas about how accounting and accounting information, as defined in the sources you referred to, could be helpful to you in the job or career you aspire to be in (in, say, 5 or 10 years time). Maybe you plan to run your own business, or to be involved in product design, or work in an advertising agency, or invest on the stock market while working for a big bank? Whatever your dream is – explain how accounting and accounting information might be used in your professional and personal life and what benefits would that bring to you.

Historical development

The word *account* in everyday language is often used as a substitute for an *explanation* or a *report* of certain actions or events. If you are an employee, for example, you may have to explain to your employer just how you have been spending your time or if you are a manager you may have to report to the owner on how the business is doing. In order to explain or to report, you will, of course, have to remember what you were doing or what happened. As it is not always easy to remember, you may need to keep some written record. In effect, such records can be said to provide the basis of a rudimentary accounting system.

In a primitive sense, man has always been involved in some form of accounting. It may have gone no further than a farmer measuring his worth simply by counting the number of cows or sheep that he owned (Figure 1.1).

His possessions	A year ago	Now	Change
Cows	••••••••••	•••••••••••••••	+5
Hens [• = 10]	••••••••••	•••••••	−30
Pigs	•••••••••	••••	−2
Sheep [• = 10]	•••••	•••••••	+20
Land [• = 1 acre]	••••	••••	No change
Cottage	•	•	No change
Carts	•••	•	−2
Ploughs	•	••	+1

Figure 1.1 Accounting for a farmer's wealth

Activity 1.2

A-a-a-a-h! Counting! Is that what accounting is all about?

So how many sheep do you count in this flock?

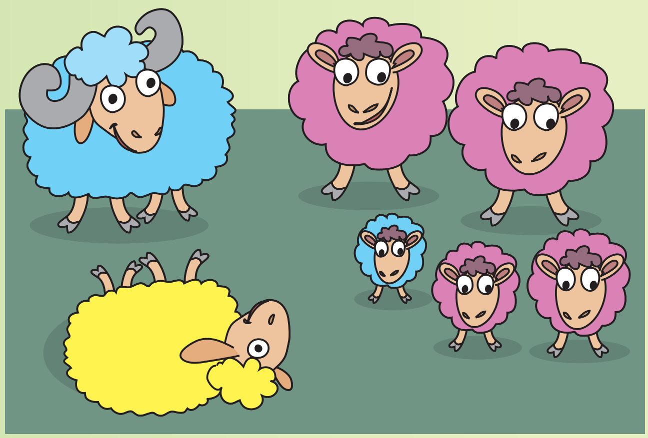
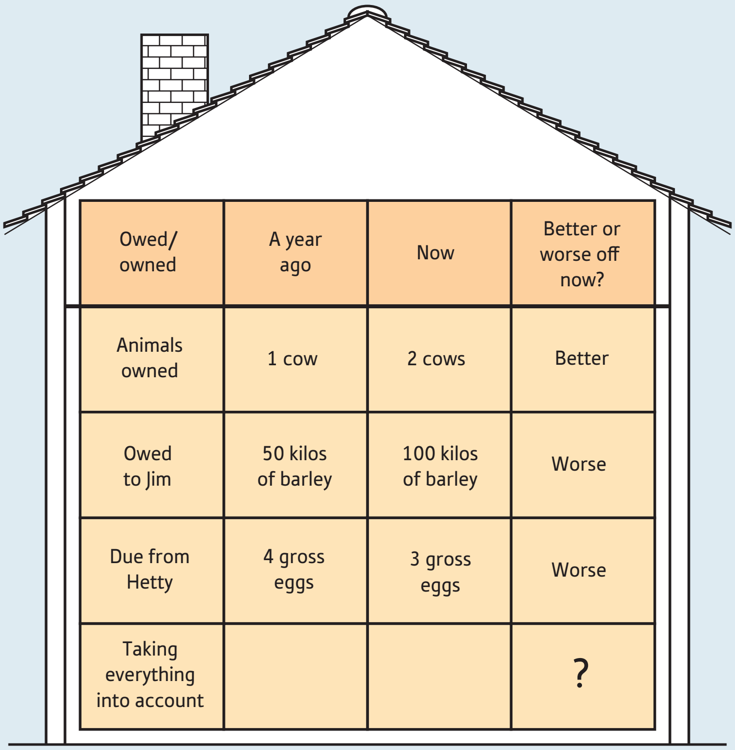


Figure 1.2 How many sheep can you (ac)count in this flock?

Accounting may be about counting, but that is not quite so straightforward as you may think. Are rams sheep? Or do we need to introduce categories to be able to (ac) count for what we have got here – 2 sheep, 1 ram and 3 lambs? And after how many days does a lamb become a sheep? We can make up an arbitrary rule (say, 3 months) so on the last day of that period there are 2 sheep, 1 ram and 3 lambs in the field but as soon as the clock ticks over to the next day there is all of a sudden a 150% increase in the population of sheep – 1 ram and 5 sheep, no lambs! If one of them dies – do we still (ac)count for it? If yes, why yes? If no, why not? (Ac)counting is full of judgements and not as straightforward as you may think!

The growth of a monetary system enabled an even more sophisticated method to be developed. It then became possible to calculate the increase or decrease in individual wealth over a period of time and to assess whether a farmer with perhaps 10 cows and 50 sheep was wealthier than one who had 60 pigs. Figure 1.3 illustrates just how difficult it would be to assess the wealth of a farmer in a non-monetary system.

Even with the growth of a monetary system, it took a very long time for formal documentary systems to become commonplace, although it is possible to trace the origins of modern bookkeeping back to at least the twelfth century. We know that from about that time, traders began to adopt a system of recording information called *double-entry*



Owed/ owned	A year ago	Now	Better or worse off now?
Animals owned	1 cow	2 cows	Better
Owed to Jim	50 kilos of barley	100 kilos of barley	Worse
Due from Hetty	4 gross eggs	3 gross eggs	Worse
Taking everything into account			?

Figure 1.3 An owner's vital questions

bookkeeping. By the end of the fifteenth century, double-entry bookkeeping was widely used in Venice and the surrounding areas (the first-known book on the subject was published in 1494 by an Italian mathematician called Pacioli, who is often referred to as 'The Father of Accounting'). Modern bookkeeping systems are still based on principles established in the fifteenth century, although they have had to be adapted to suit modern conditions.

There are two main reasons why a recording system devised in medieval times has lasted for so long:

- It provides an accurate record of what has happened to a business over a given period of time.
- Information extracted from the system can help the owner or the manager to operate the business much more effectively.

In essence, the system provides the answers to three basic questions that both owners and managers want to know. They are as follows:

- What profit has the business made?
- How much does the business owe?
- What does the business have and how much is owed to it?

The medieval system dealt largely with simple agricultural and trading entities. In the eighteenth century, however, the United Kingdom underwent the *Industrial Revolution*. Economic activity gradually moved away from growing things to making or manufacturing them and the size of some businesses grew so much that managers had to be employed to run them on behalf of the owners.

In the early days of the Industrial Revolution the type of information supplied to the owners of the then 'big business' was to meet their needs for *financial* purposes, i.e. to calculate how much profit they had made and what the assets of their business were now worth (after taking into account how much they owed and what was owed to them). Financial information was prepared infrequently (perhaps only once a year) and then not in any great detail.

Managers, on the other hand, needed information largely for *costing* purposes, so they could work out the cost of making individual products and so that they can price these products appropriately. The information required needed to be in much more detail and prepared much more frequently.

As a result of the different information needs of owners and managers, separate accounting systems were developed. However, as much of the basic data was common to both systems, they were gradually brought together. It would be rare now to find any entity that had a separate financial accounting system and a separate costing system.

Another change that has come about over the years is that it is possible to identify more than two user groups (often referred to in the press as 'stakeholders'). Besides owners and managers, accounting information may also now be required by other users such as regulators (e.g. for the purpose of granting operating licences in some regulated industries and monitoring standards over time), lenders (e.g. for making a decision whether to lend to a business and what interest to charge for the loan) or the government (e.g. for the purpose of calculating taxes). Other stakeholders such as employees and potential investors also may find accessing accounting information useful for their own purposes and decision making.

While accounting gradually evolved into two main branches in the late nineteenth century (*financial* accounting and *cost* accounting), there were additional developments in the twentieth century. We examine the structure of accounting as it is today in the next section.

Branches of accounting

The work that accountants now undertake ranges far beyond that of simply preparing financial and cost statements. It is possible to identify at least six main branches of accounting and a number of important sub-branches. We will deal with each of them broadly in the order that they have developed over the past 100 years, i.e. financial accounting, management accounting, auditing, taxation, financial management, and insolvency. You will see from Figure 1.4 how they all fit together.

Financial accounting

Until about the middle of the nineteenth century, the nature, purpose and development of accounting described in the last two sections were mainly about the type of accounting that we would now describe as *financial* accounting. We do not, therefore, need to add much more to our outline except to give you a more formal definition of financial accounting. We will adopt that used by the Chartered Institute of Management Accountants (CIMA). It is as follows:

> Classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation in [financial statements], during and at the end of an accounting period. (CIMA, Official Terminology, 2005)

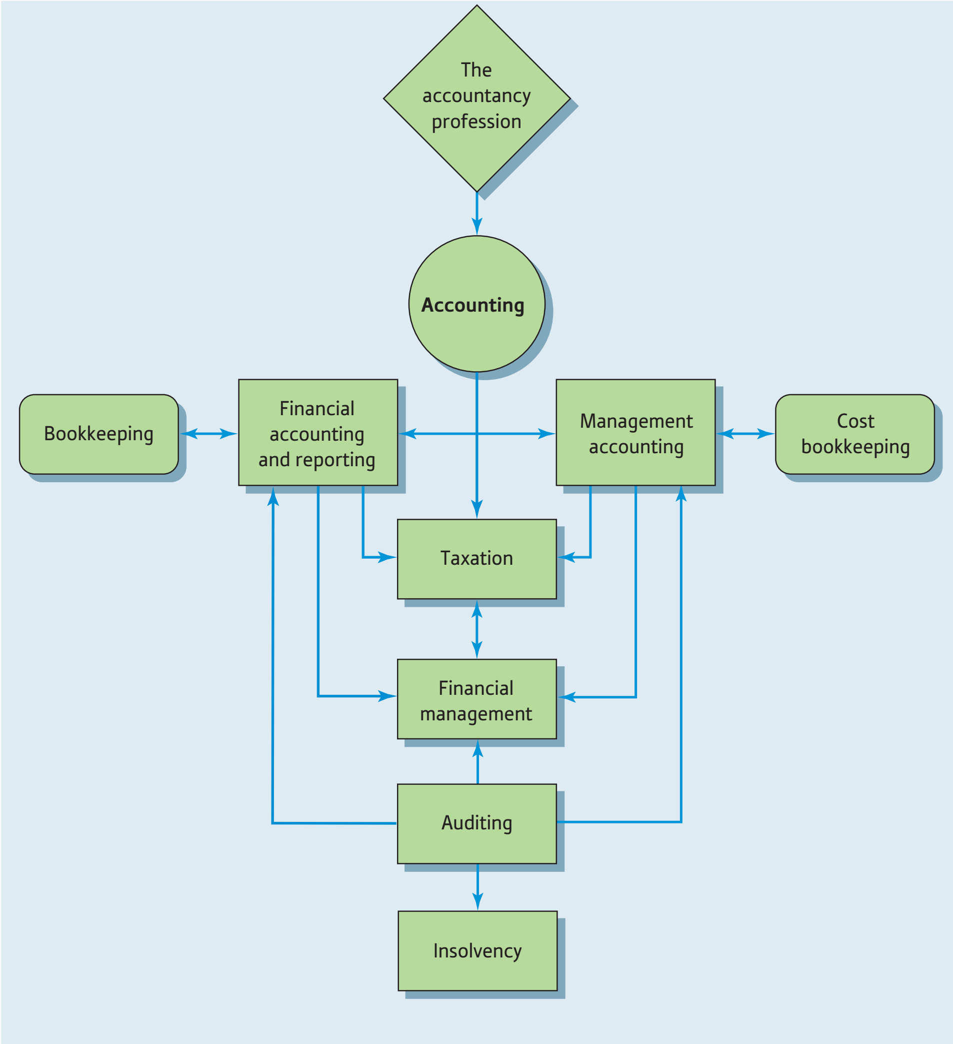


Figure 1.4 The main branches of accounting

'Concepts, principles, accounting standards and legal requirements' are the rules and regulations that govern accounting. We shall be dealing with them in Chapter 2. The financial statements, namely, the statement of profit or loss and other comprehensive income, statement of changes in equity, statements of financial position and statements of cash flows, are dealt with in Part 2 of this book. A statement of profit or loss and other comprehensive income (we will refer to it for short as 'statement of profit or loss') is a calculation of what profit or loss you might have made over a period of time. A statement of changes in equity shows how much of a dividend is paid to shareholders out of the profit for the period and any other contributions to or from shareholders. A statement of financial position (also known as a balance sheet) is a summary of what you own and what you are owed at the end of the period, and a statement of cash flows is a summary of what cash you have received and what cash you have paid in that particular period. The statement of profit or loss, statement of changes in equity, statements of financial position and statements of cash flows are known collectively as the *financial statements*.

A distinction is sometimes made between *financial accounting* and *financial reporting*. We do so in this book mainly for practical reasons in order to break the information