ACCOUNTING AND FINANCE

AN INTRODUCTION

TENTH EDITION

Eddie McLaney
Peter Atrill

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PEARSON EDUCATION LIMITED
KAO Two
KAO Park
Harlow CM17 9SR
United Kingdom
Tel: +44 (0)1279 623623
Web: www.pearson.com/uk

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Brief contents

Contents

Part 1 Financial accounting

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 a useful introduction to the main principles and 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 how financial statements and other financial information can be used to improve the quality of decisions made by their users. 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. In framing these questions and tasks, we have tried to encourage critical thinking by requiring analysis and evaluation of various concepts and techniques. To help broaden understanding, questions and tasks often require readers to go beyond the material in the text and/or to link the current topic with material covered earlier in the book. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you are using the book as part of a taught course or for personal study, we have found that this approach is more 'user-friendly' and makes it easier for you to learn.

We recognise that most readers will not have studied accounting or finance before, and we have therefore tried to write in a concise and accessible style, minimising the use of technical jargon. We have also tried to introduce topics gradually, explaining everything as we go. Where technical terminology is unavoidable we try to provide clear explanations. In addition, you will find all of the key terms highlighted in the text. These are then listed at the end of each chapter with a page reference. They are also listed alphabetically, with a concise definition, in the glossary given in Appendix 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 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 tenth edition, we have taken the opportunity to make improvements suggested by students and lecturers who used the previous edition. We have also revised the coverage of corporate governance regulations to reflect recent changes. 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. We have tried to introduce international comparisons where possible and useful. To aid understanding, we have also increased the number of student progress questions (Activities) and explanatory diagrams. We have also increased the number of questions that require readers to demonstrate critical thinking.

We hope that you will find the book both 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 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 **Critical 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 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 four 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.

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CHAPTER 1

Introduction to accounting and finance

Introduction

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

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; and
- 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. Unless the financial information being communicated can improve the quality of decisions made by users, there is really no point in producing it. We shall see who the main users are, and why they use financial information, a little later in the chapter.

Sometimes the impression is given that the purpose of accounting is simply to prepare financial (accounting) reports on a regular basis. While it is true that accountants undertake this kind of work, it does not represent an end in itself. As already mentioned, the ultimate aim of the accountant's work is to give users 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.

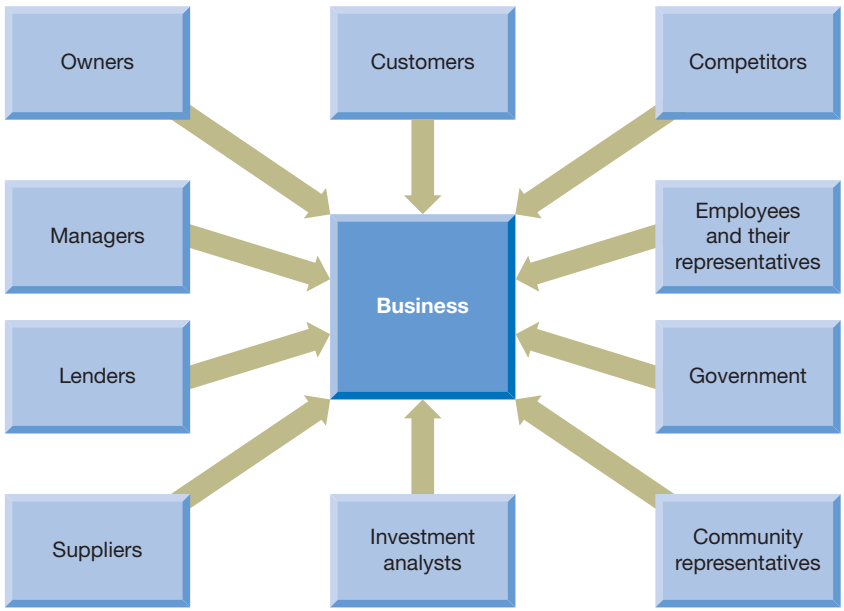
Once funds are raised, they must be invested in a way that will provide the business with a worthwhile return. An understanding of finance should also help in evaluating the risks and returns associated with an investment.

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:

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

Activity 1.1 *continued*

User group	*Decision*
Employees	Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions.
Government	Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions an assessment of PI's profits, sales revenues and financial strength would be made.
Community representatives	Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making such decisions, PI's ability to continue to provide employment for the community, its use of 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 with goods and services and, if so, whether to supply these on credit. This would require an assessment of PI's ability to pay for any goods and services supplied at the due dates.
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 on time would be important factors in such decisions.
Managers	Whether the performance of the business needs to be improved. Performance to date would be compared with earlier plans or some other 'benchmark' to decide whether action needs to be taken. Managers may also wish to consider a change in PI's future direction. This may involve determining whether the business has the financial flexibility and resources to take on new challenges.
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on the rewards offers to senior managers. When doing so, the financial performance of the business would normally be taken into account.

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 a risk, however, that the interests of the various user groups will collide. The distribution of a particular business's wealth provides the most likely area for collisions to take place. Take, for example, the position 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. Owners may, therefore, rely on accounting information to see whether pay and benefits received by managers are appropriate and are in line 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 intended purpose. They may be withdrawn by the owners for their own use rather than used to expand the business as agreed. Thus, lenders may 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 line with particular agreements? Try to think of at least one example.

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; and
- 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. It should reduce uncertainty about the financial position and performance of the business. It should also 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?

Activity 1.3 *continued*

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' credit-worthiness or credit ratings);
- industry reports; and
- 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 reports, 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 shows 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. 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.

Activity 1.4

Can you figure out why it is impossible to measure this?

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 normally be accurately assessed.

We cannot say with certainty, therefore, whether the cost of producing these reports represents value for money.

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. Let us 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 'clients' and the accounting (financial) information produced can be seen as the service provided. The value of this service to these 'clients' can be judged according to whether the accounting information meets their needs.

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

- *Relevance.* Accounting information should make a difference. That is, it should be capable of influencing decisions made. To do this, it must help to predict future events (such as predicting the next year's profit), or help to confirm past events (such as establishing the previous year's profit), or do both. By confirming past events, users can check on the accuracy of their earlier predictions. This may, in turn, help them to improve the ways in which they make predictions in the future.

  To be relevant, accounting information must cross a threshold of **materiality**. An item of information should be considered material, or significant, if its omission or misstatement would change the decisions that users make.

Activity 1.5

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

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

Ultimately, what is considered material is a matter of judgement. When making this kind of judgement, managers should consider how this information is likely to be used. If a piece of information is not considered material, it should not be included within the accounting reports. It will merely clutter them up and, perhaps, interfere with the users' ability to interpret them.

- *Faithful representation.* Accounting information should portray what it is supposed to portray. To do so, the information provided must reflect the substance of what has occurred rather than simply its legal form. Take, for example, a manufacturer that provides goods to a retailer on a sale-or-return basis. The manufacturer may wish to treat this arrangement as two separate transactions. Thus, a contract may be agreed for the sale of the goods and a separate contract agreed for the return of the goods, if unsold by the retailer. This may result in a sale being reported when the goods are delivered to the retailer even though they are returned at a later date. The economic substance, however, is that the manufacturer made no sale as the goods were subsequently returned. They were simply moved from the manufacturer's business to the retailer's business and then back again. Accounting reports should reflect this economic substance. To do otherwise would be misleading.

  To provide a perfectly faithful portrayal, the information provided should be complete. In other words, it should incorporate everything needed to understand what is being portrayed. This will normally include a description of its nature, some suitable numerical measurement and, where necessary, explanations of important facts. Information should also be neutral, which means that the information should be presented and selected without bias. No attempt should be made to manipulate the information is such a way as to influence user attitudes and behaviour. Finally, it should be free from error. This is not the same as saying that it must be perfectly accurate; this may not be possible. Accounting information often contains estimates, such as future costs and sales, which may turn out to be inaccurate. Nevertheless, estimates can still be faithfully represented providing they are accurately described and properly prepared.

Activity 1.6

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

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

Accounting information must contain both 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**. Each of these qualities is now considered.

- *Comparability.* When making choices, users of accounting information often seek 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 alike in the same way. Items that are not alike, on the other hand, should not be treated as though they are. Users must be able to detect both similarities and differences in items being compared.
- *Verifiability.* This quality provides assurance to users that the accounting information provided faithfully portrays what it is supposed to portray. Accounting information is verifiable where different, independent experts could reach broad agreement that it provides a faithful portrayal. Verification can be direct, such as checking a bank account balance, or indirect, such as checking the underlying assumptions and methods used to derive an estimate of a future cost.
- *Timeliness.* Accounting information should be made available in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Broadly speaking, the later accounting information is produced, the less useful it becomes.
- *Understandability.* Accounting information should be set out in as clear and as concise a form as possible. Nevertheless, some accounting information may be too complex to be presented in an easily digestible form. This does not mean, however, that it should be ignored. To do so would result in reporting only a partial view of financial matters. (See Reference 1 at the end of the chapter.)

Activity 1.7

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

It would be very helpful if everyone could understand accounting reports. This, however, is unrealistic as complex financial events and transactions cannot normally be expressed in simple terms. Any attempts to do so are likely to produce a very distorted picture of reality.

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

It is worth emphasising that the four qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented.

Weighing up the costs and benefits

Even though an item 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 1.8.