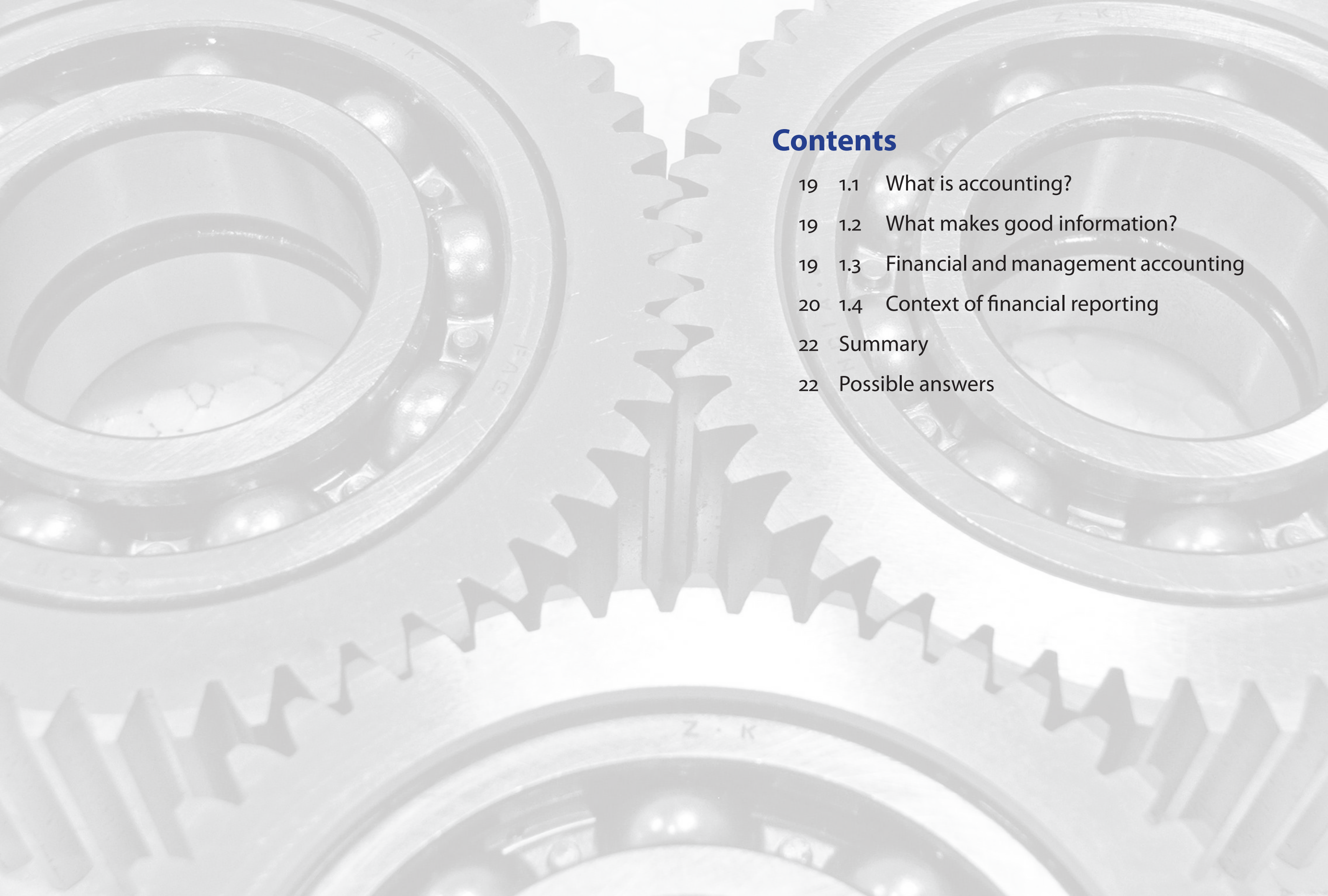

Contents

Topic 1

Introduction to the Course

Overview

In this first topic, you will be given an introduction to the subject of accounting. The topic will define what accounting is, why we need accounting, what makes good accounting information and who uses accounting information. The topic will also explain that accounting is split into two distinct areas: financial and management accounting. In this course the first half is dedicated to financial accounting and the second half to management accounting.

Learning outcomes

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

- define what accounting is;
- explain what constitutes good accounting information and why we need good quality accounting data;
- identify a number of different groups of people who require accounting information;
- explain why the different user groups require different financial information needs;
- outline the difference between financial and management accounting.

1.1 What is accounting?

It is always a good idea to start a topic with a definition. Let us look at the following one:

> [Accounting] is the process of identifying, *measuring and communicating* economic information to permit informed judgements and decisions by the user of the information. (American Accounting Association, 1966)

Note the three key words highlighted. This sums up accounting in general:

- Accounting is all about *identifying*. What do you want to analyse? Do you want to analyse a particular department, business unit, etc …?
- Accounting is about *measuring* and recording business transactions. Where have we spent our money? How much income have we generated?
- And finally it is about *communicating*. Once we have recorded the data/information, we need to pass that information on to whoever requires it, so that they can make a decision.

1.2 What makes good information?

Some qualities of good information are that it is:

i. Relevant
ii. Represents faithfully the economic reality
iii. Understandable
iv. Timely
v. Comparable
vi. Verifiable

Task …

Task 1.1

In your own words, write down what you think those six terms mean.

Now that we have some ideas about what makes good information, let us look at who uses such information. Some possible users include:

i. Managers
ii. Present owners/potential owners
iii. Lenders
iv. Financial analysts/advisors
v. Governments
vi. Suppliers
vii. Customers
viii. Competitors
ix. Employees
x. General public

Task …

Task 1.2

Write down descriptions of each type of person and their possible interests in accounting information.

1.3 Financial and management accounting

Accounting can be split into two main areas:

1) Financial accounting
2) Management accounting

Let us have a look at the differences between these two areas.

Financial accounting

This is the provision of financial information to outside parties (external users). We listed earlier some external users of accounting information, e.g. shareholders, governments, etc.

Typical financial documents produced under this category are:

- Income Statement
- Balance Sheet
- Cash flow Statement

The key points to mention are that such statements are:

- required by law
- in a prescribed format (laid out in a particular manner)
- based on past activities (what a company did in its last accounting period)

Management accounting

This is the provision of financial information to the managers of the firm (internal users).

Typical financial documents produced under this category are:

- Break-even Reports (Break-even Analysis)
- Budgets (Cash Budgets)
- Costing Reports

The key points to mention are that such documents are:

- prepared frequently and can be very detailed;
- not required by law;
- not in any prescribed format (depends entirely upon each company);
- based on past, present and future activities.

There is an overlap between the two areas of accounting, financial and management. Both are based on the collection of financial information, normally through a system called double-entry bookkeeping.

In this course, we will also cover some topics that could be called 'finance': a field that deals with how companies raise money and how they spend it. In particular, we will look at how businesses raise finance, and later at how companies make decisions about which projects to undertake and which assets to buy.

1.4 Context of financial reporting

In the next topic, we will be examining financial reporting. This is the part of accounting that deals with presenting information to users outside of the company, especially shareholders, bondholders and bankers.

The objectives of financial reporting can be very different from one country to the next, or from one century to the next. Figure 1.1 lists some of the possible objectives. In many countries, the main purpose is still (b): tax calculations. For many years, up until recently, purpose (d) was the main focus in the US and the UK. However, the official purpose of accounting now in the US, the UK and under International Financial Reporting Standards (IFRS) is (e): giving useful information to investors to help them to predict cash flows and then make financial decisions. The decisions in question include which shares to buy and which company to lend money to.

This purpose is a practical commercial one and is controlled by rules written by committees of accounting experts such as the International Accounting Standards Board (IASB). Of course, the rules need to be imposed and monitored by official authorities. Companies do their financial reporting in the context of national company laws.

Financial reporting concentrates on three issues about a company:

- cash flows for the period
- financial position at the end of the period
- performance for the period

The purposes of accounting have varied from time to time and from country to country. They could include:

(a) Information for managers to help them manage a business. However, this is not the purpose of "financial reporting", which is for outsiders.

(b) Calculation of taxable income. If so, the state is in charge of the rules.

(c) Calculation of the maximum profit that can be distributed to the owners/shareholders. This limit would be imposed by the state (i.e. in laws) in order to protect creditors.

(d) Explaining to owners/shareholders how well the managers have looked after the resources. This purpose is called accountability or stewardship.

(e) Helping existing and potential shareholders and lenders to predict future cash flows in order to make investment decisions.

Figure 1.1 Objectives of accounting

Task ...

Task 1.3

a. Find the latest published financial statements of a listed company. Choose the company according to the following criteria:

- concentrate on well-known companies;
- ignore banks, insurance and shipping companies.

You will usually find the statements as part of the 'Investor Relations' section of a company's website.

Note: The statement will contain information on the group as a whole and the separate companies that make up that group.

The objective of this task is that you get the feel of a real example of financial accounting.

b. Answer the questions below for your company.

1. What is the name of your chosen company?
2. What year is under review?
3. What is the company's principal activity?
4. List the main sections (four to five headings) in the annual report. Looking at the contents page and flicking through the report, which sections dominate the report?
5. Who are the directors? List three or four main directors.
6. How much did the highest paid director earn in total during that year?
7. Who are the auditors?
8. What is the auditor's opinion?
9. Have sales increased or decreased? By how much, both in terms of money and in percentage terms?
10. What is the group's net cash inflow (outflow) from operating activities? (See the group's cash flow statement).
11. How has the group's net cash inflow changed from the previous year in terms of money and in terms of percentage?
12. What was the retained profit for the year?
13. Has the company any borrowings, i.e. loans, debentures, etc.?

Summary

This topic has been an introduction into the subject of accounting. We started off by looking at a simple definition of accounting. Then we looked at what makes good accounting information and why it is important to have good information.

We also looked at who the many users of accounting information are and concluded by looking at the difference between financial and management accounting.

The next topic examines the different types of businesses that can be set up, and how to raise finance for them. This is a necessary study before examining financial accounting, which is primarily designed to report to the financiers (e.g. shareholders).

Possible answers

Task 1.1

What makes good information? This list of qualities is drawn from the Framework of the International Accounting Standards Board.

i) Relevant

Information needs to be relevant to the users so that they can make good decisions. For example, there is no point in telling a production manager that there are two boxes of marketing leaflets left, when that information is more relevant to the marketing director. For investors, decisions often involve predicting cash flows. So, information is relevant if it helps with that.

ii) Faithful representation

Information should not be misleading. It should give the right impression of what actually happened. It should be in accordance with the facts. It should be unbiased.

iii) Understandable

There is so much data and information about these days that it is quite easy to get overwhelmed by masses of complex calculations. If the information is too complex, people are likely to be discouraged and not read it in the first place. If they do read it, some of it might make little sense.

iv) Timely

Investors and managers need information on time so that a correct decision can be made. There is no point receiving production reports six months after the event, especially if the company was suffering production problems. For investors, information is needed within weeks of a company's year end.

v) Comparable

Since the purpose of accounting is to make decisions, this involves choosing between possibilities, e.g. between two possible investment opportunities. It is therefore vital for information to be comparable between companies and across time.

vi) Verifiable

Anyone can make up false information about a company, especially if the company is doing poorly. People who have a financial stake in a business need to be sure that the information is verifiable, i.e. if need be the information can be traced back to source. Published accounting reports are checked by independent auditors.

Task 1.2

Users of accounting information

i) Managers

Managers from different departments inside a company will require all sorts of different financial information in order to make decisions. This group will also include the board of directors.

ii) Present owners/potential owners

We will call this stakeholder group 'the shareholders' as they have an ownership stake in the business. They own a particular proportion of the company based upon how many shares they hold. Shareholders have delegated the running of the business to managers who carry out the day-to-day control on their behalf, with the aim of making a profit and distributing dividends to shareholders while retaining some of the profits in the business for growth.

iii) Lenders

This includes banks and anyone else who lends the firm any sort of funds. Such groups of people will want to know if the company can pay back any loans plus the interest that will arise.

iv) Financial analysts/advisors

Investors wanting specialist financial advice may go to one of these people. Most likely a financial analyst/advisor would be asked to review the potential of the firm; for investment purposes, for example.

v) Governments (tax)

If a business makes a profit, the government will want a share of the profits in the form of tax. This is normally based on a calculation of the company's profits.

vi) Suppliers

In many cases, suppliers are not paid immediately for goods and services delivered to the business. So, they will want to ensure that the business can pay the monies owed.

vii) Customers

Customers will want to know if the business is credible; whether they can trust it. Will the business still be operating in five years' time (especially important if the customers take out extended warranties, etc.)? The customers may want to see the financial viability of the business.

viii) Competitors

Competitors want to know how good the business is, based on whether it is making money, what costs are like, what are expenses and what is the market share. All of this is valuable business information, which competitors would very much like. They may be interested in the information because they are thinking of buying the company.

ix) Employees

The employees depend on their company for continued prosperity and perhaps for future pension receipts. They would like to assess the company's long-term financial strength.

x) General public

These groups may want to know whether the company is, for example, an environmentally sound business. Is it spending money on helping the environment? If not, why not?