CHAPTER 1

INTRODUCTION TO ACCOUNTING

LEARNING OBJECTIVES

When you have completed your study of this chapter, you should be able to:

LO 1 Explain the nature and role of accounting

LO 2 List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information

LO 3 Compare and contrast financial and management accounting

LO 4 Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship

LO 5 Provide an overview of the main financial reports prepared by a business

LO 6 Outline the main types of business ownership, describe the way in which a business is typically organised and managed, and explain the importance of accounting in a business context

LO 7 Identify ways in which business and accounting have been changing, together with some current issues confronting businesses and their associated reporting, including current thinking on ethics in business

LO 8 Explain why accounting information is generally considered to be useful, and why you need to know the basics of accounting

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PEOPLE NEED ECONOMIC INFORMATION to help them make decisions and judgements about businesses. Whether we are talking about a business manager making decisions about the most appropriate level of production, a bank manager responding to a request from a business for a bank loan, or trade unionists deciding how much pay increase to seek for their members, accounting information should help them with their decision.

In this opening chapter, we begin by considering the roles of accounting. As we shall see, accounting can be a valuable tool in the decision-making, planning and control process. We shall identify those people who are the main users of accounting and financial information, and discuss the ways in which this information can improve the quality of the decisions they make. In other chapters we develop this decision-making theme by considering in some detail the kinds of financial reports and methods used to aid decision-making.

Since this text 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, therefore, consider the key financial purpose of a private-sector business, the main forms of business enterprise, and the ways in which a business may be structured, organised and managed. These are all important as they help to shape the kind of accounting and financial information that is produced.

Finally, we shall consider how business is changing, identify some current challenges being faced, and identify key issues regarding stakeholder interests, ethics and sustainability. These issues have considerable implications for the public perception of business, for businesses themselves, and for accountants and their measurement and reporting systems. Some of these issues are difficult and not easily resolved, but they are nevertheless issues that you need to be aware of.

ACCOUNTING AND YOU

MAKING DECISIONS

So how do you make decisions?

- What kinds of decision do you need to make?
- How important is economic information in your decision-making?
- How do you deal with numbers and quantitative information?

Let us consider the kinds of decision that are commonly made at some stage of our lives.

- Keeping expenditure in line with income—something just about every student will wrestle with.
- Buying new things—these might include buying simple things like a new mobile phone, or a new car, or a really major decision such as buying a house.
- Starting a new business venture, either on your own or in collaboration with others.
- Investing for the future in shares or government bonds.

All of these decisions will require you to collect information, much of which can be classified as economic, or quantitative. The typical economic decision involves choosing the best outcome for you, given that your resources are scarce. None of what has been said to date should imply that decisions are made solely on economic lines, though. Many decisions are based on things such as personal preference, family considerations, a sense of duty, aesthetics, or even using the stars to assist! However, many decisions have a clear economic orientation, and accounting can help with these decisions.

So what information do you need to keep your expenditure in line with your income? You will probably need a clear understanding of your income, its amount and nature. You will also need to have a clear understanding of your spending patterns, and you will almost certainly need to differentiate between ongoing regular expenditure and one-off expenditure.

Decisions to buy new things may be relatively easy, such as buying a new phone, which may well be purchased out of normal spending. Decisions about major assets, such as the purchase of a house, will require much more careful information-gathering and analysis. This analysis will probably include ideas around how the asset will be funded.

Decisions regarding potential business ventures also require substantial data collection and analysis. The analysis will need to contain information about markets and competition, as well as specifics regarding the particular business. Decisions regarding the possible purchase of new shares or bonds will require the collection of data relating to the past performance of the company and estimates of its future prospects.

Clearly, any decision that has an economic element will require substantial economic information. Basically, the role of the accounting system is to provide much of that information. The system cannot and does not attempt to cover all economic input, but essentially focuses on the collection, recording and reporting of key economic data as they relate to a particular individual or entity. Just what information is covered is the subject of this text.

You may not be comfortable with numbers and quantified information. However, it is difficult for an entity to be successful without having someone who does understand and can communicate such information. So good luck with your studies.

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NATURE AND ROLE OF ACCOUNTING

LO 1

Explain the nature and role of accounting

Accounting is concerned with the collection, analysis and communication of economic information. Such information can be used as a tool of decision-making, planning and control. This is to say that accounting information is useful to those who need to make decisions and plans about businesses, and for those who need to control those businesses. Unless the financial information being communicated can lead to better decisions being made, there is really no point in producing it.

accounting
The process of identifying, measuring and communicating information to permit informed judgements and decisions by users of the information.

Examples of the kinds of decision for which the managers of businesses may need accounting information include the following:

- decisions to develop or terminate new products or services
- decisions to change the price or quantity of existing products
- decisions to borrow money to help finance the business
- decisions relating to the scale of the business, and
- decisions to change the methods of purchasing, production or distribution.

REFLECTION 1.1

You might spend a few moments reflecting on the implications of some of the kinds of decision listed above. Some decisions have far-reaching consequences.

Consider, for example, a situation where you are working for a major call centre associated with a telecommunications business, working in a regional centre employing approximately 120 staff, when an announcement is made that the business plans to take the call-centre activities offshore. What possible impacts could this have on the business, its workforce, and the local and regional community?

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Although managers working in a particular business are likely to be significant users of accounting information, they are by no means the only people who are likely to use accounting information about that particular business. People outside the business (whom we shall identify later) may need information to help them make decisions such as whether to invest in the business (as owner or lender), whether to grant credit for goods provided, or whether to enter into a major contract with that particular business.

It is generally recognised that accounting fulfils two distinct roles:

- a 'stewardship' role and
- a 'decision-usefulness' role.

Traditionally, accounting focused more on providing a stewardship, or accountability, report on the status of transactions for the period; that is, what the position was at the beginning of the period, what happened during the period, and what the position was at the end of the period.

More recently, accounting has been seen as a way of assisting a wide range of users to make informed choices about the allocation of scarce resources. Sometimes, the impression is given that the purpose of accounting is simply to prepare financial reports on a regular basis. (Strictly speaking, financial reports consist of primary financial statements, notes to the financial statements and the directors' declaration. However, the term 'financial reports' is used interchangeably with 'financial statements' in the real world. Hence, this text does not differentiate the two terms.) While it is true that accountants do this kind of work, it does not represent an end in itself. The ultimate purpose of accountants' work is to discharge the accountability function of management and to influence the decisions of those who use the information produced. This decision-making perspective of accounting is central to the theme of this text and shapes the way we deal with each chapter.

Accounting as a service function

Accounting can be seen as a form of service. Accountants provide financial information to their 'clients'. These clients are the various users identified in the next main section of the chapter. The quality of the service provided will be determined by the extent to which it meets the information needs of the various user groups. To be useful to users, the information must possess certain qualities. In particular, it must be relevant and it must faithfully represent what it is supposed to represent. These two qualities are regarded as **fundamental qualities**.

fundamental qualities The two most important qualities underlining the preparation of accounting reports; namely relevance and faithful representation.

Relevance

The first fundamental quality we discuss is **relevance**. Accounting information must be able to influence decisions—otherwise, there really is no point in producing it. To do this, it must be relevant to the *prediction of future events* (such as estimating next year's profit) or to the *confirmation of past events* (such as establishing last year's profit), or to both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

relevance A quality that states that, in order to be relevant, accounting information must be able to influence decisions.

To be relevant, accounting information must cross a threshold of **materiality**. A key question to be asked is whether its omission or misrepresentation would alter the decisions that users make. If the answer is no, the information is not material. This means that it should not be *separately* included within accounting reports, as it will merely clutter them up and, perhaps, interfere with the users' ability to interpret them. All figures need to be included in the accounts: the question is whether a particular figure needs to be separately identified or whether it can be included elsewhere, under a more general heading.

materiality The quality of information that has the potential to alter the decisions that users make.

The threshold of materiality will vary from one business to the next. To identify the threshold, the nature of the information and the amounts involved must be considered within the context of the accounting reports of the particular business. Ultimately, what is considered material is a matter of judgement. In making this judgement, managers should consider how the information is likely to be used by the various user groups.

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Faithful representation

The other fundamental quality is **faithful representation**. Accounting information should represent what it is supposed to represent. To do so, the information provided must reflect the *substance* of what has occurred rather than its legal form.

faithful representation A quality that says that accounting information should represent what it is supposed to represent—it should be complete, neutral and free from error.

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

To provide a perfectly faithful representation, the information should be *complete*. In other words, it should incorporate everything needed for users to understand what is being portrayed. It should also be *neutral*, which means that the information should be selected and presented without bias. No attempt should be made to manipulate the information in 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 always be perfectly accurate; this may not be possible. Accounting information often contains estimates, such as future sales or costs, which may turn out to be inaccurate. Nevertheless, estimates can still be faithfully represented providing they are properly described and prepared.

ACTIVITY 1.1

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

Note that if accounting information is to be useful, it must satisfy both the fundamental quality of relevance *and* provide a faithful representation of what it purports to represent. There is little point in producing information that is relevant but which lacks faithful representation, or producing information that is irrelevant but which 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.

- **Comparability**. This quality helps users to identify similarities and differences between items of information. It may help them, for example, to identify changes in the business over time (such as the trend in sales revenue over the past five years). It may also help them to evaluate the performance of the business in relation to similar businesses. Comparability is enhanced by treating items that are basically the same in the same manner for accounting purposes. It is also enhanced by making clear the policies that have been adopted in measuring and presenting the information.
- **Verifiability**. This quality provides assurance to users that the accounting information provided faithfully represents what it is supposed to represent. Accounting information is verifiable where different, independent experts would be able to reach a consensus that it provides a faithful portrayal. Verifiable information tends to be supported by evidence, such as an invoice stating the cost of an item included in inventories.
- **Timeliness**. Accounting information should be produced in time for users to make their decisions. A lack of timeliness will undermine the usefulness of the information. Normally, the later the accounting information is produced, the less useful it becomes.
- **Understandability**. Accounting information should be set out as clearly and concisely as possible. It should also be able to be understood by those at whom the information is aimed.

comparability A quality that helps users identify similarities and differences between items of information.

verifiability A quality that enables something to be checked and verified.

timeliness Being available early enough to be of use to users.

understandability Clearly set out to facilitate understanding.

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ACTIVITY 1.2

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

Despite the answer to **Activity 1.2**, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible for non-accountants.

It is worth emphasising that the four further qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented. It is also worth noting that the qualitative characteristics may conflict.

Costs and benefits of accounting information

Beside the characteristics described in the previous section, there is also a seventh key characteristic that is at least as important as any of these six. In theory, a particular piece of accounting information should be produced only if the cost of providing it is less than the benefits, or value, to be derived from its use. This cost–benefit issue will limit the amount of accounting information provided. In practice, however, these costs and benefits are difficult to assess.

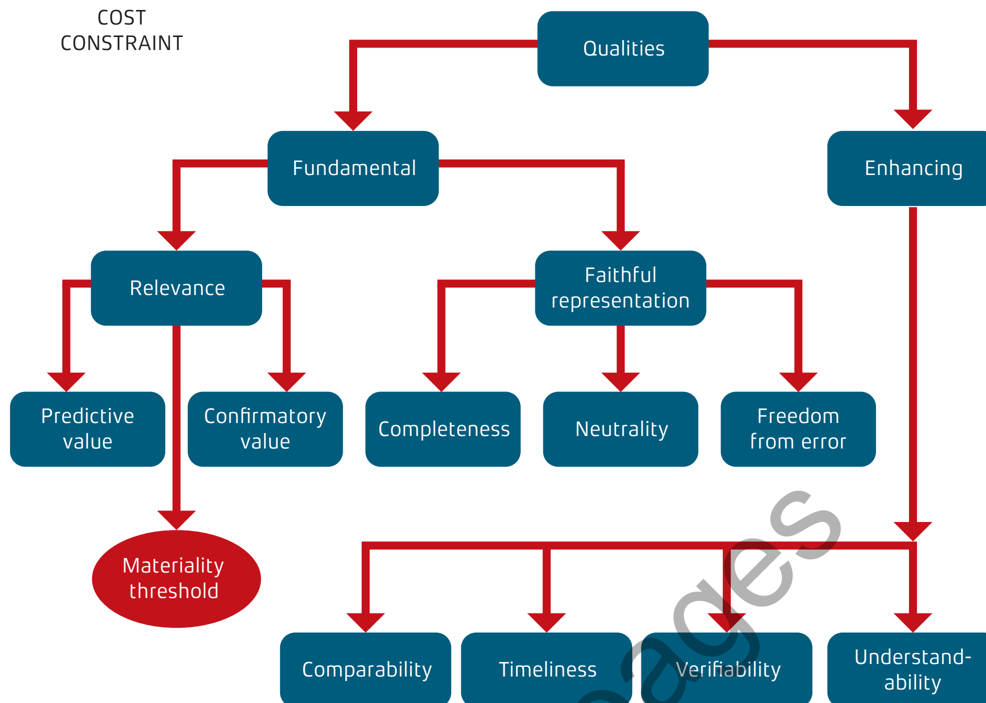
There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some 'science' to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, which have been discussed in the previous sections, are summarised in **Figure 1.1**.

FIGURE 1.1

The characteristics that influence the usefulness of accounting information

Two fundamental qualities determine the usefulness of accounting information. In addition, four qualities enhance the usefulness of accounting information. The benefits of providing the information, however, should outweigh the costs.



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Accounting as an information system

Accounting can be seen as an important part of the total information system for a business. Users, both inside and outside the business, have to decide how to allocate scarce economic resources. To try to ensure that these allocation decisions are efficient and effective, users require economic and other information. It is the role of the accounting system to provide much of that information.

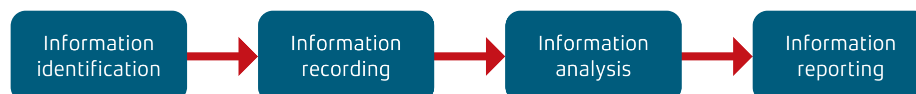
Thus, we can view accounting as an information-gathering, processing and communication system. The accounting system will involve the four stages shown in **Figure 1.2**.

1. identifying and capturing relevant economic information
2. recording the information collected in a systematic manner
3. analysing and interpreting the information collected
4. reporting the information in a manner that suits the needs of users.

FIGURE 1.2

The accounting information system

The figure shows the four sequential stages of an accounting information system. The first two stages are concerned with preparation, and the last two stages are concerned with using the information collected.



Given the decision-making emphasis of this text, we shall concentrate on the final two elements of the process—the analysis and reporting of financial information. We are concerned with how information is used by, and is useful to, decision-makers rather than with how it is collected and recorded.

CONCEPT CHECK 1

The purpose of accounting is to:

- **A** Provide financial information to clients
- **B** Report on the status of transactions for the period
- **C** Provide information to assist users' decision-making
- **D** Prepare financial reports on a regular basis

CONCEPT CHECK 2

The two most important qualities for accounting information are:

- **A** Relevance and materiality
- **B** Completeness and relevance
- **C** Relevance and accuracy
- **D** Faithful representation and relevance

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CONCEPT CHECK 3

The usefulness of accounting information is increased by:

- **A** Being supported by reasonable evidence
- **B** Not being overly complex
- **C** Being provided on schedule (e.g. not late)
- **D** All of these

USERS OF ACCOUNTING INFORMATION

LO 2

List the main groups that use the accounting reports of a business entity, and summarise the different uses that can be made of accounting information

Accounting seeks to satisfy the needs of a wide range of users. In a particular business, there may be various groups who are likely to have an interest in its financial health. (Although the points made in this chapter and throughout this text may apply to a variety of organisations—such as public-sector business enterprises, local authorities and charities—we concentrate on private-sector businesses.)

The major user groups for a business organisation are shown in **Figure 1.3**.

FIGURE 1.3

Main users of financial information relating to a business organisation

The figure shows that several user groups have an interest in the financial information relating to a business organisation. Most of them are outside the business but, nevertheless, have a stake in it. This is not meant to be an exhaustive list of potential users, but the user groups identified here are normally the most important.

ACTIVITY 1.3

Ptarmigon Insurance Ltd (PI) is a large motor insurance business. Taking the user groups identified in Figure 1.3, suggest for each group the sort of decision likely to be made about PI and the factors to be taken into account when making these decisions.

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Activity 1.3 illustrates that each user group looks at a business from a different perspective and has its own particular interests. Inevitably there will be occasions when these perspectives and interests may clash.

One of the more likely causes relates to the way in which the wealth of the business is generated and distributed. Recent years have seen considerable debate as to the salary level of management teams, especially that of the chief executive officer (CEO). High bonus payments in a year in which performance has not been judged to be good do not sit well with investors.

Another area of potential conflict is likely to be between investors and lenders, with lenders wishing to be sure that the money lent has been invested appropriately and with due regard to their interests, while borrowers are likely to want to be able to have maximum flexibility.

REFLECTION 1.2

You are very concerned about climate change and have become something of an activist. You are particularly worried about one particular coal mine, and regularly go to rallies against the mining company. One of your friends is not so adamant in his 'anti' views, and uses the financial information provided by the company to justify his stance. Should you both be seen as members of legitimate user groups?

stakeholder theory A theory which argues that organisations have a variety of interested parties, and that these interests need to be considered and incorporated in a harmonised manner in order to achieve the best overall outcomes.

Stakeholder theory uses a similar approach to that set out above, but additionally provides some useful insights into just what makes a successful business, and illustrates how the various user groups can interact. User groups can clearly be thought of as stakeholders in a business.

Stakeholder theory was effectively introduced by R. Edward Freeman in 1984 in his book *Strategic Management: A Stakeholder Approach*. Freeman's main point was that, at that time, business pretty much saw managerial self-interest and shareholder profit as the driving force of business. Freeman argued that this wasn't the view of the people who actually did business. They had other motivations and responded to other people—employees, customers, suppliers, regulators, industry bodies, trade unions, community groups—which Freeman called stakeholders. We shall come back to stakeholder theory later in the chapter.

CONCEPT CHECK 4

Accounting seeks to satisfy the needs of which of the following users?

A Stakeholders

B Prospective shareholders

C Shareholders

D Government (e.g. ATO)

CONCEPT CHECK 5

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Stakeholder theory:

A Attempts to meet the needs of the primary users

B Was introduced by R.E. Freeman in 1986

C Recognises that organisations have a variety of interested users

D Is focussed on business ethics

CONCEPT CHECK 6

Which of the following represented a shift in thinking introduced by stakeholder theory?

A Competing interests within a single stakeholder group can serve to strengthen a business rather than destabilize it

B Those who control businesses should focus on the needs and wants of stakeholders within the business, not those outside the business

C Business is driven not by managerial self-interest and shareholder profit, but by many groups, including employees and communities

D Business success cannot be measured by stakeholder profit alone, but must also be measured by qualitative metrics such as community support

FINANCIAL AND MANAGEMENT ACCOUNTING

LO 3

Compare and contrast financial and management accounting

In providing information for the various user groups identified, accounting has been divided into two main areas: management accounting and financial accounting. **Management accounting**, as the name suggests, is concerned with providing managers with the information they require for the day-to-day running of the organisation. **Financial accounting** is concerned with providing the other users with useful information.

management accounting
An approach that aims to provide managers with the information they require to run the organisation.

financial accounting
Provides financial information for a variety of users, with the information being of a general-purpose nature.

The main differences between the two types of accounting reflect the range of recipients, as follows:

- ***Nature of the reports produced.*** Financial accounting tends to produce general-purpose financial reports; that is, they contain financial information that will be useful for a broad range of users and decisions. Management accounting reports, on the other hand, are often specific-purpose reports, designed with either a particular decision or a particular manager in mind.
- ***Level of detail.*** Financial accounting reports provide users with a broad overview of the position, performance and cash flows of the business for a period. As a result, information is aggregated and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular decision.
- ***Regulations.*** Financial reporting for many businesses is subject to legal and accounting regulations that seek to ensure that specified content is presented in a fairly standard form. Because management accounting reports are for internal use only, there are no restrictions on the form and content of the reports. This means that reports can be, and are, designed to meet the needs of particular managers.
- ***Reporting interval.*** For most businesses, financial accounting reports are produced on an annual basis. However, large companies may produce half-yearly reports, and a few produce quarterly reports. Management accounting reports may be produced as frequently as required by managers. In many businesses, managers are provided with certain weekly or monthly reports to allow them to check progress on a regular basis.
- ***Time horizon.*** Financial accounting reports reflect the performance and position of the business to date. In essence, they are backward-looking. Management accounting reports, on the other hand, often provide information on expected future performances as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release forecast information to other users in order to raise capital or to fight off unwanted takeover bids. Even preparation of the routine financial reports typically requires making some judgements about the future, as we shall see in the chapter 'Measuring and reporting financial performance'.
- ***Range of information.*** Financial accounting reports concentrate on information that can be quantified in monetary terms. Management accounting produces such reports, too, but is also more likely to produce additional reports on non-financial matters, such as measures of physical quantities of inventory (stocks) and output. Financial accounting places greater emphasis on objective, verifiable evidence when preparing reports. Management accounting reports intended for managers may use information that is less objective and verifiable, but which nevertheless provides managers with the information they need. So the basic accounting statements will be used historically by the financial accountant, where the emphasis is on information that is as reliable and as objective as possible, whereas the management accountant may well use the same format to assist in some decisions, but will inevitably also use estimates that are clearly less reliable. This does not detract from the usefulness of the forecasts.

We can see from the above list that management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of

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reliability. The only real test of the value of the information produced for managers is whether or not it improves the quality of decisions made.

ACTIVITY 1.4

Can you think of any areas of overlap between the information needs of managers and those of other users? (*Hint*: Think about the time orientation and the level of detail of accounting information.)

The distinction between the two areas reflects, to some extent, the differences in access to financial information. Managers have much more control over the form and content of the information they receive. Other users have to rely on what managers are prepared to provide or what the financial reporting regulations state must be provided. Although the scope of financial accounting reports has increased over time, fears over loss of competitive advantage and fears of user ignorance about the reliability of forecast data have led businesses to resist making information available to users other than managers.

There is little doubt that in the past financial accounting has been the dominant partner, and many of the ground rules reflect this. However, modern accounting systems typically are developed in a manner that enables both the specific external reporting requirements to be fulfilled and relevant management accounting reports to be prepared. Financial accounting and management accounting should not be seen as two different topics, but rather as different perspectives reflecting the justifiable needs of users.

CONCEPT CHECK 7

Which of the following is FALSE?

- **A** There are more rules to follow in financial accounting than in management accounting
- **B** Financial accounting reports tend to provide a wider range of information than that provided by Management accounting
- **C** Management accounting reports tend to provide a wider range of information than that provided by financial accounting
- **D** Management accounting provides more scope for creativity than financial accounting

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CONCEPT CHECK 8

Of the reports listed, which is a financial accounting report?

- **A** Sales projection
- **B** Income statement
- **C** Cost reduction budget
- **D** Product costing report

CONCEPT CHECK 9

Which of the following is true?

- **A** Management accounting is subject to the same standards as financial accounting.
- **B** The financial accountant can plan their annual two-week vacation more reliably than the management accountant.
- **C** Financial accounting provides greater detail than management accounting.
- **D** Financial accounting is forward-looking.

WHAT IS THE FINANCIAL OBJECTIVE OF A BUSINESS?

LO 4

Identify the main purpose of a business (while recognising a range of other influences), and explain the traditional risk–return relationship

A business is normally created to enhance the wealth of its owners. Throughout this text we shall assume that this is its main objective. This may come as a surprise, as there are other objectives that a business may pursue that are related to the needs of others associated with the business. For example, a business may seek to provide good working conditions for its employees, or it may seek to conserve the environment for the local community. While a business may pursue these objectives, it is normally set up with a view to increasing the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

Within a market economy there are strong competitive forces at work which ensure that failure to enhance owners' wealth will not be tolerated for long. Competition for the funds provided by the owners and competition for managers' jobs will normally mean that the owners' interests will prevail. If the managers do not provide the expected increase in ownership wealth, the owners have the power to replace the existing management team with a new team that is more responsive to owners' needs. Does this mean that the needs of other groups associated with the business (employees, customers, suppliers, the community and so on) are not really important? The answer to this question is certainly no, if the business wishes to survive and prosper over the longer term.

Satisfying the needs of other groups is usually consistent with increasing the wealth of the owners over the longer term. A business with disaffected customers, for example, may find that those customers turn to another supplier, resulting in a loss of shareholder wealth. A dissatisfied workforce may result in low productivity, strikes and so forth, which will in turn have an adverse effect on owners' wealth. Similarly, a business that upsets the local community with unacceptable behaviour, such as polluting the environment or ignoring human rights issues, may attract bad publicity, resulting in a loss of customers and incurring heavy fines.

While the idea of an objective of wealth enhancement is still reasonable, there is now considerably more awareness of the damage that can be done to individuals, to the environment and to society at large by unconstrained wealth maximisation. **Real World 1.1**, written when the Global Financial Crisis (GFC) was in the forefront of most people's minds, provides clear recognition of the potential problems that can arise.

We should be clear that generating wealth for the owners is not the same as seeking to maximise the current year's profit. Wealth creation is concerned with the longer term. It relates not only to this year's profit but to that of future years as well. In the short term, corners can be cut and risks taken that improve current profit at the expense of future profit.

REFLECTION 1.3

You have been given the position of sustainability manager at BHP. How might a company like BHP measure social and environmental impacts?

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REAL WORLD 1.1

Short-term gains, long-term problems

For many years, under the guise of defending capitalism, we have been allowing ourselves to degrade it. We have been poisoning the well from which we have drawn wealth. We have misunderstood the importance of values to capitalism. We have surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made.

Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them were not their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was thirty years ago. Public anger at the crisis will make visible what was previously hidden. Take the building up of huge portfolios of loans to poor people on US trailer parks. These loans were authorised without proper scrutiny of the circumstances of the borrowers. Somebody else then deemed them fit to be securitised, and so on through credit default swaps and the rest, without anyone seeing the transaction in terms of its ultimate human origin.

Each of the decision makers thought it okay to act like the thoughtless footwear buyer of the 1970s. The price was attractive. There was money to make on the deal. Was it responsible? Irrelevant. It was legal, and others were making money that way. And the consequences for the banking system if everybody did it? Not our problem.

The consumer has had a profound shock. Surely we could have expected the clever and wise people who invested our money to be better at risk management than they have shown themselves to be in the present crisis? How could they have been so gullible in not challenging the bankers whose lending proved so flaky? How could they have believed that the levels of bonuses that were, at least in part, coming out of their savings could have been justified in 'incentivising' a better performance? How could they have believed that a 'better' performance would be one that is achieved for one bank without regard to its effect on the whole banking system? Where was the stewardship from those exercising investment on their behalf?

The answer has been that very few of them do exercise that stewardship. Most have stood back and said it doesn't really pay them to do so. The failure of stewardship comes from the same mindset that created the irresponsible lending in the first place. We are back to the mindset that has allowed us to poison the well: never mind the health of the system as a whole, I'm making money out of it at the moment. Responsibility means awareness for the system consequences of our actions. It is not a luxury. It is the cornerstone of prudence.

Source: *Extract from Mark Goyder, 'How we've poisoned the well of wealth',* Financial Times, *16 February 2009.* *© The Financial Times Limited 2009. All rights reserved. 'FT' and 'Financial Times' are trademarks of The Financial Times Ltd.*

CLASS DISCUSSION POINTS

1. Why do you think that Nike found it necessary to transform its business model?
2. How do you feel about the idea that 'it was legal, and others were making money that way'?
3. Assume that you are a member of a superannuation fund. Which investment choices did you/will you make? Did you consider anything green, or ethically based, or did you simply go for growth? Why did you make the choices you did?

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Stakeholder theory

Stakeholder theory was introduced in the earlier section on users of accounting information, but the theory now goes way beyond what users might need from accounting. Freeman has been developing his theory for the past 30 years. A sense of his current thinking is summarised in **Real World 1.2**.

Clearly, stakeholder theory has had considerable influence over time, but whether accounting is doing enough in this area remains debatable. What is not in doubt is that social and environmental

REAL WORLD 1.2

Stakeholder theory—current thinking

As we saw earlier, Freeman argued strongly that managerial self-interest and shareholder profits, which he described as 'the old story', were not the driving force of business. He felt that people were interested in, and motivated by, far more than profit, and that all of their interests needed to be given appropriate recognition. Of course, profits were part of the story, but profits were seen as the outcome rather than the aim.

So, what makes a successful business? Obvious elements include good products or services, a good and committed workforce, reliable suppliers who provide goods and services at the right quality, and a good relationship with the community at large.

Freeman now talks about working to 'harmonise' the various stakeholders' interests. There will of course be some conflict between some stakeholders, but such conflict should be seen as an opportunity to create value.

Value is perceived by Freeman as much broader than simply financial value. He believes that 'we create value when we do things that people find valuable'.

The traditional approach is reasonably easily associated with measurement. Most businesses know how to measure customer satisfaction and whether they are creating value for their customers. Other areas, such as value for employees and the community, are less commonly addressed—and these need to be worked on.

***Source:** Eva Tsahuridu, 'R. Edward Freeman', INTHEBLACK, 1 April 2015, updated 31 August 2016.*

CLASS DISCUSSION POINTS

1. What value do you think a company creates for its employees directly, and indirectly through corporate taxation and innovation?
2. What might be the components of value for employees in general? And at an individual level? How might they be measured?

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accounting has become much more important in assessing performance. Freeman believes that the way in which these have been 'bolted on' to the old business model of financial accounting suggests that there is a long way to go. We shall see in the chapter 'Corporate social responsibility and sustainability reporting' just how many improvements have been made in reporting on social and environmental aspects and impacts, more commonly now called sustainability reporting or integrated reporting. There also remains scope for considerably more work to be carried out to deal with some of the issues implicit in Freeman's theory. Just how easy it will be to find appropriate ways of dealing with the issues he raises remains to be seen.

Real World 1.5, found later in the chapter, provides examples of ethical failures, where some stakeholders' interests have been clearly abused. Some of the situations, especially those examined by the Financial Services Royal Commission, illustrate the need for considerably more discussion of this area.

REFLECTION 1.4

In recent years the banks have been the subject of much criticism. You have just been appointed to the management team of a small regional bank. You have been asked to consider how the bank should balance the conflicting needs of shareholders (owners), customers (both borrowers and depositors), and government. Outline your approach.

It is interesting to note that in August 2019 the Business Roundtable of America changed its statement of purpose as a corporation from one that emphasised the primacy of shareholders to one which recognised that there is a commitment to all of the stakeholders, including customers, employees, suppliers and communities, alongside the shareholders. All are seen as essential.

Balancing risk and return

In considering wealth enhancement as our primary goal, we must also recognise the need to balance the required **return** with the **risk** level associated with the business.

return
The gain that results from a particular event or occurrence.

risk
The likelihood that what is projected to occur will not actually occur.

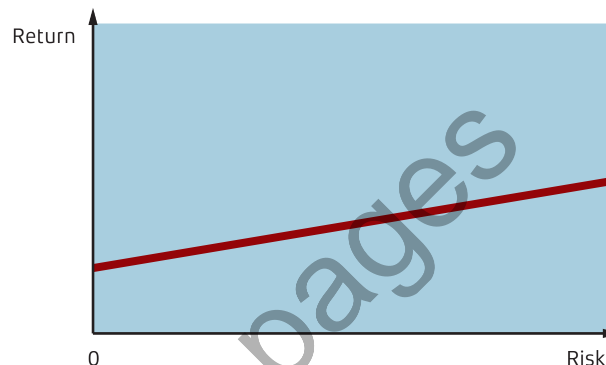
All decision-making involves the future. Business decision-making is no exception. The only thing certain about the future, however, is that we cannot be sure what will happen. Things may not turn out as planned, and this risk should be carefully considered when making financial decisions.

As in other aspects of life, risk and return tend to be related. Evidence shows that returns relate to risk in something like the way shown in **Figure 1.4**.

FIGURE 1.4

Relationship between risk and return

Even at zero risk, a certain level of return will be required. This will increase as the level of risk increases.



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ACTIVITY 1.5

Look at Figure 1.4 above and state, in broad terms, where an investment in:

(a) a government savings account, and
(b) a lottery ticket

should be placed on the risk–return line.

This relationship between risk and return has important implications for setting financial objectives for a business. The owners will require a minimum return to induce them to invest at all, but will require an additional return to compensate for taking risks; the higher the risk, the higher the required return. Managers must be aware of this, and must strike the appropriate balance between risk and return when setting objectives and pursuing particular courses of action.

The turmoil in the banking sector as a result of the GFC has shown that the right balance is not always struck. Some banks took excessive risks in pursuit of higher returns and, as a consequence, incurred massive losses. There is little doubt that the risk appetite of the banks then changed dramatically over the next few years, and with good reason. Whether this change in appetite was permanent is doubtful. Over the past few years we have seen considerable easing of conditions surrounding mortgages, followed by a move back to much tighter controls, leading to a downturn in the housing market.

CONCEPT CHECK 10

A corporate mission statement would usually include an objective relating to:

- **A** Provision of good working conditions for employees
- **B** Enhancement of the wealth to its owners
- **C** The need to be an industry leader
- **D** Conservation of the environment

CONCEPT CHECK 11

Increased business risk does NOT affect:

- **A** Employees of the business
- **B** Owners of the business
- **C** News media
- **D** Suppliers to the business

CONCEPT CHECK 12

Owners experiencing increased profitability should do the following EXCEPT:

- **A** Buy more products for resale to increase sales in the future
- **B** Increase their investment in the business
- **C** Take the profits out of the business as a reward
- **D** Hire more employees to increase production of goods

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THE MAIN FINANCIAL REPORTS—AN OVERVIEW

LO 5

Provide an overview of the main financial reports prepared by a business

How a business achieves its financial objectives is usually communicated through financial reporting. This section introduces the main financial reports.

Financial accounting

Financial accounting grew from the old idea of stewardship accounting, where stewards (managers/representatives) gave an accounting of how they had fulfilled their responsibilities. When you remember that this was happening throughout the Industrial Revolution, you should realise that these statements were all about wealth. There was little concern about staff (workers), social issues or the environment. Human rights was not a term even thought about, other than as it related to the bosses! Times have changed, as we shall see as we progress through this text.

However, the need for basic financial statements remains. A very simple illustration is given next. You will find that the rules and regulations surrounding these statements have become more rigorous as time has passed and business has become more complicated.

The main financial statements are designed to provide a picture of the overall financial position and performance of the business. To do this, the accounting system normally produces three main financial reports on a recurring basis. These financial statements are concerned with answering the following questions:

- What cash movements (i.e. cash in and cash out) took place over a particular period?
- How much did wealth increase over a particular period as a result of operating and other activities? In other words, how much profit did the business generate from its overall activities?
- What is the financial position of the business at the end of a particular period?

These questions are all addressed by the three main financial reports listed below:

1. the **statement of cash flows** for the period
2. the **statement of financial performance** for the period, commonly known as the **income statement**. It is often also referred to as the *profit and loss statement*, especially when used internally in a business. For limited companies, a **statement of comprehensive income** is also prepared to display profit and loss (normal income statement) and other comprehensive income. Formats and requirements will be dealt with in the chapters 'Measuring and reporting financial performance' and 'Regulatory framework for companies'.
3. the **statement of financial position** as at the end of the period, commonly known as the **balance sheet**.

In due course we will also introduce a fourth statement, the **statement of changes in equity**, but this statement is really only important for limited companies and so we will leave discussion until the appropriate chapter. Basically, **equity** is the term used to indicate the share of the business which represents the owners' interests.

The three main statements—an illustration

Perhaps the best way to introduce the financial reports is to look at an example of a very simple business (**Example 1.1**). From this we shall be able to see what sort of useful information each of the statements can provide. It is worth pointing out that while a simple business is our starting point, the principles for preparing the financial statements apply equally to the largest and most complex businesses. This means that we shall frequently encounter these principles again in other chapters.

We can see from the financial reports in part 1 of Example 1.1 that each provides part of the picture of the financial performance and position of the business. We begin by showing the cash movements. Cash is vital for any business to function effectively: to meet obligations, to acquire other resources (such as stock/inventory), to satisfy operating expenses, and to meet ownership distributions. Cash has been described as the 'life blood' of a business, and movements in cash are usually given close scrutiny by users of financial statements.

It is clear that reporting cash movements alone would not be enough to portray the financial health of the business. The changes in cash over time do not fully reveal the profit generated. The statement of financial performance provides an insight into this aspect of performance. For day 1, for example, we saw that the cash balance increased by $60 but the profit generated, as shown in the statement of financial performance, was $210. The increase in wealth ($210) was represented by $60 cash and $150 in the form of stock (inventory).

To determine the total wealth of the business, a statement of financial position is drawn up, in this case at the end of the day. Cash is only one form in which wealth can be held. In the case of this business, wealth is also held in the form of inventory (stock of goods for resale). Drawing up

statement of cash flows
The statement that shows the sources and uses of cash for a period.

statement of financial performance
The statement that measures and reports how much wealth (profit) has been generated in a period. Also called a 'profit and loss (P and L) statement'.

income statement
A commonly used name for the statement of financial performance, the statement that measures and reports how much profit (or loss) has been generated in a period.

statement of comprehensive income
A statement that presents all items of income and expense recognised in a period, in a single statement of comprehensive income, displaying components of profit and loss (normal income statement), and components of other comprehensive income.

statement of financial position
A statement that shows the assets of a business and the claim on those assets at a point in time. Commonly known as the balance sheet, as the assets must always equal the claims, represented by external liabilities and owner's equity.

balance sheet
A statement that shows the assets of a business and the claims on the business. The term 'balance' arises from the fact that assets must always equal claims. Claims will relate to external liabilities and owners' claims (known as 'equity').

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EXAMPLE 1.1 — PART 1

Paul was unemployed and unable to find a job. He decided to embark on a business venture to meet his living expenses. As Christmas was approaching, he decided to buy gift-wrapping from a local supplier and sell it on the corner of his local main street. He felt that the price of wrapping paper in the shops was excessive, and that this would give him a useful business opportunity.

He began the venture with $600 in cash. On the first day of trading he purchased wrapping paper for $600. This is called stock (of goods) or inventory. Later in the day he sold three-quarters of his inventory for $660 cash.

What cash movements took place in the first day of trading?
On the first day of trading a statement of cash flows, showing the cash movements for the day, can be prepared as follows:

	$
Statement of cash flows for day 1	
Opening balance (cash introduced)	600
Cash received from sale of wrapping paper	660
	1,260
Cash paid for purchase of wrapping paper	(600)
Closing balance	660

How much did wealth increase as a result of operations in the first day of trading? In other words, how much profit was generated by the business?
A statement of financial performance (income statement) can be prepared to show the increase in wealth (profit) generated on the first day. The wealth generated will represent the difference between the sales made and the cost of the goods (i.e. wrapping paper) sold.

	$
Statement of financial performance (income statement) for day 1	
Sales	660
Cost of goods sold ¾ of $600	(450)
Profit	210

Sample pages

Note that only the cost of the wrapping paper sold is matched against the sales to find the profit, not the whole cost of wrapping paper acquired. Any unsold wrapping paper (known as inventory or stock) will be charged against future sales.

What is the financial position at the end of the first day?
To establish this we can draw up a statement of financial position listing the resources held at the end of the day.

	$
Statement of financial position (balance sheet) at the end of day 1	
Cash (closing balance)	660
Inventory (stock of goods for resale: ¼ of $600	150
Total assets held	810
= Paul's wealth in the business (equity)	810

Note that the profit has led to an increase in wealth ($210). In this particular business, all of the business wealth is the entitlement of Paul, so Paul’s equity can be seen to be $810. As we shall see in the chapter ‘Measuring and reporting financial position’, the situation in which there are no other claims on the business wealth is unusual. The situation in practice is rather more involved than that found in this simple example.

the statement of financial position involves listing both forms of wealth held. In the case of a large business, there may be many other forms of holding wealth, such as land and buildings, equipment and motor vehicles.

Let us now continue with our example.

EXAMPLE 1.1 — PART 2

On the second day of trading, Paul purchased more wrapping paper for $300 cash. He managed to sell all of the new wrapping paper and half of the earlier stock for a total of $540.

The statement of cash flows on day 2 is as follows:

	$
Statement of cash flows for day 2	
Opening balance (i.e. closing balance from day 1)	660
Cash received from sale of wrapping paper	540
	1,200
Cash paid for purchase of wrapping paper	(300)
Closing balance	900

The statement of financial performance for day 2 is:

	$
Statement of financial performance for day 2	
Sales	540
Cost of goods sold $300 + ½ of $150	(375)
Profit	165

The statement of financial position (balance sheet) at the end of day 2 is:

	$
Statement of financial position (balance sheet) at the end of day 2	
Cash	900
Inventory (stock of goods for resale: ½ of $150	75
Total assets	975
= Paul's wealth in the business (equity)	975

We can see that the total business wealth increased to $975 by the end of day 2. This represents an increase of $165 (i.e. $975 − $810) over the previous day. Note that this is the amount of profit made during day 2 as shown on the statement of financial performance.

Sample pages

ACTIVITY 1.6

On the third day of his business venture, Paul purchased more stock for $600 cash. However, it was raining hard for much of the day and sales were slow. After Paul had sold half of his total stock for $390, he decided to stop trading until the following day. Have a go at drawing up the three financial reports for day 3 of Paul's business venture.

The solution to **Activity 1.6** shows that the total business wealth increased by $52.50 (i.e. the amount of the day's profit) even though the cash balance declined. This is due to the fact that the business is holding more of its wealth in the form of inventory than in cash, compared with at the end of day 2.