BUSINESS ACCOUNTING AND FINANCE

TONY DAVIES AND TONY BOCZKO

SECOND EDITION

Business Accounting and Finance

Second edition

Tony Davies and Tony Boczko

The McGraw·Hill Companies

London Boston Burr Ridge, IL Dubuque, IA Madison, WI New York San Francisco St. Louis Bangkok Bogotá Caracas Kuala Lumpur Lisbon Madrid Mexico City Milan Montreal New Delhi Santiago Seoul Singapore Sydney Taipei Toronto Business Accounting and Finance, Second edition Tony Davies and Tony Boczko ISBN-10: 0-07-710809-4 ISBN-13: 978-0-07-710809-0



Published by McGraw-Hill Education Shoppenhangers Road Maidenhead Berkshire SL6 2QL Telephone: 44 (0) 1628 502 500 Fax: 44 (0) 1628 770 224

Website: www.mcgraw-hill.co.uk

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

Library of Congress Cataloguing in Publication Data

The Library of Congress data for this book has been applied for from the Library of Congress

Acquisitions Editor: Mark Kavanagh Development Editor: Rachel Crookes Senior Marketing Manager: Marca Wosoba Senior Production Editor: Eleanor Hayes

Text Design by Jonathan Coleclough Cover design by Fielding Design Ltd Typeset by Mathematical Composition Setters Ltd, Salisbury, Wiltshire Printed and bound in Great Britain by CPI Bath Press

Published by McGraw-Hill Education (UK) Limited an imprint of The McGraw-Hill Companies, Inc., 1221 Avenue of the Americas, New York, NY 10020. Copyright © 2005 by McGraw-Hill Education (UK) Limited. All rights reserved. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of The McGraw-Hill Companies, Inc., including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

© 2005. Exclusive rights by The McGraw-Hill Companies, Inc. for manufacture and export. This book cannot be re-exported from the country to which it is sold by McGraw-Hill. The right of Tony Davies to be identified as author of this work has been asserted by him in accordance with the Copyright Designs and Patents Act 1988.

Dedication

I dedicate this book with love to my wife Fran and my daughters Joanna and Polly

Preface

Introduction

There were two key aims in writing the first edition of Business Accounting and Finance (BAF). One aim was to provide undergraduates, postgraduates and others with an accounting and finance book in a practical business context that was clear and easy to understand. In BAF we have maintained a rigorous approach and full coverage of all the theoretical and technical aspects of accounting and finance, together with their practical application. At the same time, we have tried to remove the fear and intimidation that sometimes accompany these subjects, by making them more user-friendly and a little more fun to study.

The other aim was to provide a comprehensive and flexible teaching and learning resource, with a wide range of study and assessment material supported by an 'easy to use' accessible website. There are links between each of the chapters, which follow a structure that has been designed to facilitate effective teaching and learning of accounting and finance in a progressive way. Alternatively, each chapter may be used on a standalone basis; chapters may also be excluded if they relate to subjects that are not essential for a specific module. Basic bookkeeping is a topic that may or may not be a requirement of some modules and so it has been placed in an appendix towards the end of the text. Therefore, the text is intended to be suitable for modules of either one or two semesters' duration.

Feedback from lecturers and students, particularly those for whom English may not be their first language, positively confirmed that these aims were largely met. The second edition of BAF has built on that success with its user-friendly approach to the principles and techniques of accounting and finance, its increased linkage with the real business world, and coverage of contemporary issues and topics of growing importance.

Accounting and finance are of critical importance in the support of all business activities. The formal study of accounting and finance is exciting because it introduces a toolkit that enables a better understanding of the performance of businesses, and the decisions and problems they face. These issues are discussed daily by managers and in the media. The second edition of this textbook provides you with the toolkit and shows you how to apply it in practice, utilising a comprehensive range of learning features, illustrative examples and assessment material to support and reinforce your study.

This textbook is aimed primarily at students who are not majoring in accounting or finance, but who are undertaking an introductory-level module as part of their degree or diploma course in business management, economics or any other subject. BAF is a tightly-written, clear and engaging text which distils the core principles of accounting and finance for those students who may not have the luxury of devoting all their time to its study.

Second edition

The structure of the first edition of BAF has been maintained but enhanced in the second edition. The content of the second edition has been expanded and completely updated and now includes six full-length case studies, 35 new chapter-end exercises, and a completely new chapter with eight chapter-end exercises, which are provided with Excel spreadsheet model solutions.

Each topic in BAF has been carefully researched to closely follow the typical current requirements of introductory undergraduate and MBA modules. The text assumes no prior knowledge of the

subject, starting at square one and taking you step-by-step through the concepts and application of techniques, with clear explanations and numerous worked examples.

The second edition has been increased to 16 chapters, structured into three parts. Each part of the book and the component chapters are outlined in the introductory section to each part of the text, and cover the main areas of accounting and finance:

- **Financial accounting** is broadly concerned with the recording and analysis of historical financial data, the presentation of financial information, and compliance with current legislation, and accounting rules and standards.
- Management accounting uses financial and non-financial information and also provides information for the costing of products for the valuation of stocks, the pricing of products and services, and the planning, control, and decision-making functions. It is mainly involved in the support of the management of an organisation in dealing with current problems and in the evaluation of the future outcomes of various different scenarios and decisions.
- Business finance (or financial management) includes the appraisal of decisions relating to investments in capital projects, the ways in which a business and the investment in any new projects may be financed, and the efficient and effective management of the assets of the organisation.

Each of the three parts of the second edition provides some wider coverage of existing topics and many new sections that include, for example:

Part I

- the international approach to the development of a common set of accounting rules to be used by businesses in groups of countries, for example the European Union
- the up-to-date position regarding corporate governance, and the responsibilities of directors, primarily in the UK
- the reporting of corporate social responsibility (CSR) by companies

Part II

- a look at how a company may find its break-even point when it produces many different products
- measurement of the performance of the individual divisions within a business
- lean accounting, which provides the support and motivation for lean thinking businesses are becoming leaner as they endeavour to create greater value from even less resources

Part III

- increased coverage of sources of business funding, including hybrid finance, leasing, and UK Government and European funding
- a new chapter, which looks at the significant impact of information technology on accounting and finance.

The additional new chapter about IT and accounting emphasises how the continuing development of IT has resulted in changes in the role of the accounting and finance function, and a broadening of the range of other business disciplines in which it is now involved. It explains how IT has impacted on every area within a business: design; engineering; manufacturing; human resources management; purchasing; distribution; sales; marketing; and how these operational areas have increasingly become totally integrated with the accounting and finance function. The spreadsheet has now

become an indispensable tool in every aspect of business life. Accounting and finance Excel spreadsheet applications are fully illustrated in worked examples and chapter-end assessment material.

Just as the principles and practice of, for example, genetics or information technology are continually questioned, refined, and improved, so accounting and finance continue to develop, sometimes in exciting ways. This is illustrated in BAF by the introduction of topics not typically covered in some of the more traditional introductory accounting texts, for example corporate governance, and lean accounting. It also includes a number of contemporary issues and areas of increasing importance such as kaizen, target costing, quality costing, balanced scorecard, throughput accounting, and activity based costing.

This text has been written primarily for non-specialist students, and so each chapter aims to help students understand the broader context and relevance of accounting and finance in the business environment, and how accounting and financial statements and non-financial information can be used to improve the quality of management decision-making. Every chapter in the second edition provides completely new examples and commentary on company activity, including at least one press extract. Companies featured include: Microsoft; NTL; Easyjet; Samsung; Marks & Spencer; Corus; Matalan; Shearings; Tyco International; Royal Doulton; Network Rail. In addition, two of the chapters feature extracts and analysis of the Report and Accounts 2004 of Johnson Matthey plc.

Using this book

To support your study and reinforce the topics covered, we have included an enhanced, and comprehensive, range of learning features and assessment material in each chapter, including:

- learning objectives
- introduction
- highlighted key terms
- fully-worked examples
- Excel spreadsheet worked examples
- integrated progress checks
- key points summary
- questions
- discussion points
- exercises
- Excel spreadsheet exercises.

Within each chapter we have also included numerous diagrams and charts that illustrate and reinforce important concepts and ideas. The double-page Guided Tour that follows on pages xxv-xxvi summarises the purpose of these learning features and the chapter-end assessment material. To gain maximum benefit from this text and to help you succeed in your study and exams, you are encouraged to familiarise yourself with these elements now, before you start the first chapter.

Accounting is essentially a 'hands-on' subject; just reading about it is not enough. Believe us, from our own experience we know that repeated practice of examples and exercises is the only way to become proficient in its techniques. You may think that reading through this book or your lecture notes, highlighting the odd sentence and gliding through the worked examples, progress checks and chapter-end questions and exercises, will instill the knowledge and expertise required to pass your exams. This would be a big mistake. Active learning needs to be interactive: if you have not followed a topic or an example, go back and work through it again; try to think of other examples to which

particular topics may be applied. The only way to check you have a comprehensive understanding of things is to attempt all the integrated progress checks and worked examples, and the chapter-end assessment material, and then to compare with the text and answers provided. Full solutions are given for each worked example, and solutions to 45% of the chapter-end exercises (those with their numbers in colour) are provided in Appendix 4. The book's supporting website (www.mcgraw-hill.co.uk/textbooks/davies) provides an extensive range of learning and teaching resources (see below). Additional self-assessment material is available in the student centre of the website.

Case studies

Each of the three main parts of the book includes two case studies that may be tackled either individually or as a team. The case studies are a little more weighty than the chapter-end exercises; in addition, they integrate many of the topics included in the chapters in each part of the text to which they relate, although not exclusively. Each case study therefore gives you an opportunity to apply the knowledge and techniques gained from each part of the book, and to develop these together with the analytical skills and judgement required to deal with real-life business problems. Additional cases are provided on the accompanying website.

We hope that this textbook continues to put the sparkle into your study of accounting and finance to enhance your interest, and increase your understanding and skills. Above all, relax, learn and enjoy!

Online learning centre (OLC)

The website accompanying this text

www.mcgraw-hill.co.uk/textbooks/davies

includes an extensive range of chapter-based student and lecturer resources, and comprises three main sections. See page xxvii for details.

Remember to check the website frequently throughout your studies, as these resources will be regularly updated.

Acknowledgements

Thank you to the following lecturers who were involved in either the initial market research and/or in providing useful review comments and technical checks of the draft chapters during the development phase of this project:

- Graham Ball
- Mike Barker
- Tariq Bashir
- Bruce Bowhill
- Mary Canny
- Giovanni Cozzi
- Cedric McCallum
- Ian Crawford
- Robert Devlin
- Barbara Dexter
- Graham Diggle
- Steve Dungworth
- Steward Hughes
- Carolyn Isaaks
- Chris Knight
- Danny Leiwy

- John Lyons
- Jenny Maynard
- Rona O'Brien
- Gary Owen
- Richard Pike
- Graeme Reid
- Mark Richer
- Clare Roberts
- Zeljko Seviç
- Jon Simon
- Chris Simpson
- John Syer
- Brian Telford
- Tony Wall
- Pauline Willis

Thank you to CIMA (the Chartered Institute of Management Accountants) for their permission to include extracts from their Management Accounting Official Terminology 2000 edition.

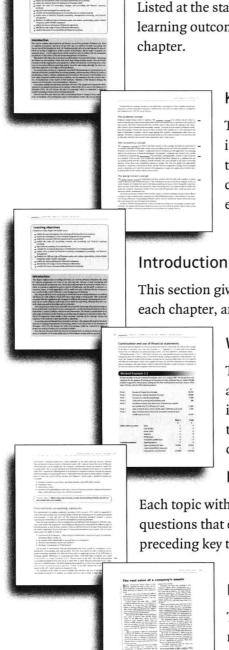
Thank you to Financial Management, Accountancy Age, The Daily Telegraph, The Times, and The Guardian for their permission to use extracts from their publications, and to HSBC Bank Group Archives for their permission to use photographic images.

Thank you to Johnson Matthey plc for permission to use extracts of their Report and Accounts 2004 as an excellent example of the information provided to shareholders by a major UK plc.

Thank you to systems analyst, Norrette Moore, for her invaluable review comments with regard to the chapter about IT and accounting.

Thank you to Mark Kavanagh for his support and encouragement in the writing of this book.

Guided Tour



Learning objectives

Listed at the start of each chapter, these bullet points identify the core learning outcomes you should have acquired after completing each

Key terms

These are colour highlighted the first time they are introduced, alerting you to the core concepts and techniques in each chapter. A full explanation is contained in the glossary of key terms section at the end of the book.

This section gives you a brief overview of the coverage and purpose of each chapter, and how it links to the previous chapter.

Worked examples

The numerous worked examples in each chapter provide an application of the learning points and techniques included within each topic. By following and working through the step-by-step solutions, you have an opportunity to check your knowledge at frequent intervals.

Progress checks

Each topic within each chapter includes one or more of these short questions that enable you to check and apply your understanding of the preceding key topics before you progress to the next one in the chapter.

Press extracts

These topical extracts used in every chapter feature real company examples from the press, including commentary that highlights the practical application of accounting and finance in the business environment.



Summary of key points

Following the final section in each chapter there is a comprehensive summary of the chapter topics. These allow you to check that you understand all the main points covered before moving on to the next chapter.



Questions

These are short narrative-type questions that encourage you to review and check your understanding of all the key topics. There are typically 8 to 11 of these questions at the end of each chapter.



Discussion points

This section typically includes 2 to 4 thought-provoking ideas and questions that encourage you to critically apply your understanding and/or further develop some of the topics introduced in each chapter, either individually or in team discussion.



Exercises

These comprehensive examination-style questions are graded by their level of difficulty, as well as by the time typically required to complete them. Designed to assess your knowledge and application of the principles and techniques covered in a chapter, there are typically 7 to 9 exercises at the end of each chapter. Full solutions to the colour-highlighted exercise numbers are provided in Appendix 4 to allow you to self-assess your progress.



Glossary of key terms

At the end of the book a glossary of key terms in alphabetical order provides full definitions of all main terms that have been introduced throughout each chapter, as identified by the symbol —. The numbers of the pages on which key term definitions appear are colour-highlighted in the index.

Online Learning Centre (OLC)

After completing each chapter, log on to the supporting Online Learning Centre website. Take advantage of the study tools offered to reinforce the material you have read in the text, and to

develop your knowledge of business accounting and finance in a fun and effective way.

Resources for students include:

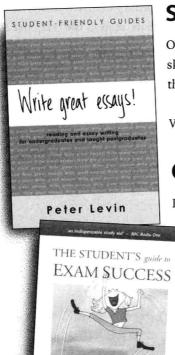
- Additional chapter-based exercises
- Excel spreadsheet solutions to worked examples
- Additional part-based case studies
- Self-testing multiple-choice questions organised by chapter with automatic grading
- Revision notes organised by chapter
- Glossary of key terms
- The press room
- Useful weblinks
- International and UK accounting standards

Additionally available for lecturers:

- Solutions to all chapter-based exercises
- Excel spreadsheet solutions to chapter-based exercises
- Debriefings to all case studies
- Large multiple-choice questions test bank
- PowerPoint lecture slides
- Textbook figures
- PageOut



Visit www.mcgraw-hill.co.uk/textbooks/davies today



Study Skills

Open University Press publishes guides to study, research and exam skills, to help undergraduate and postgraduate students through their university studies.

Visit www.openup.co.uk/ss/ to see the full selection.

Computing Skills

If you'd like to brush up on your computing skills, we have a range of titles covering MS Office applications such as Word, Excel, PowerPoint, Access and more.

Get a £2 discount off these titles by entering the promotional code app when ordering online at www.mcgraw-hill.co.uk/app

Brief Table of Contents

	Detailed Table of Contents	vii		PART II	
	Features	χυ		Management Accounting	287
	Case Studies	χυ		Outline of Part II	287
	Press Extracts	χυ	8	Cost behaviour	289
	Figures	xvi	9	Cost management	315
	Preface	xx	10	Decision-making	363
	Acknowledgements	xxiv		Case Study III	400
	Guided Tour	xxv	11	Planning and budgeting	407
	Online Learning Centre (OLC)	xxvii		Budgetary control	444
1	Underlying principles: the building blocks	1		Case Study IV	476
				PART III	
	PART I Financial Accounting	37		Business Finance	479
	Outline of Part I			Outline of Part III	479
_		37	13	Capital investment decisions	481
	Financial statements of limited companies – balance sheet	39	14	Sources of finance and the cost of capital	516
3	Financial statements of limited companies – profit and loss account			Case Study V	551
		76	15	Management of working capital	553
4	Financial statements of limited companies – cash flow		16	Information technology and accounting, and e-business	595
	statement	114		Case Study VI	635
5	Business performance analysis	147			
	Case Study I	185		Appendices	639
6	Published reports and accounts	194		Outline of appendices	639
7	Corporate governance	248	1	Double entry - the basics	641
	Case Study II	282	2	Present value tables	669
			3	FRSs, SSAPs, IASs, and IFRSs	672
			4	Solutions to selected exercises	675
				Glossary of key terms	730
				Index	757

Detailed Table of Contents

	Features	χυ
	Case Studies	χυ
	Press Extracts	χυ
	Figures	xvi
	Preface	xx
	Acknowledgements	xxiv
	Guided Tour	xxv
	Online Learning Centre (OLC)	xxvii
1	Underlying principles: the building blocks	1
	Learning objectives	2
	Introduction	2
	What is accounting, and its uses and purposes?	3
	The conceptual frameworks of accounting	4
	The Statement of Principles (SOP)	5
	UK accounting concepts	6
	True and fair view	11
	UK accounting and financial reporting standards	11
	International accounting standards	13
	Financial accounting, management accounting and financial management	15
	Accounting and accountancy	19
	Types of business entity: sole traders; partnerships; limited companies; public limited companies	22
	An introduction to financial statement reporting	26
	Users of accounting and financial information	28
	Accountability and financial reporting	30
	Summary of key points	32
	Questions	33
	Discussion points	33
	Exercises	33
	PART I Financial Accounting	37
	Outline of Part I	37
2	Financial statements of limited companies - balance sheet	39
	Learning objectives	40
	Introduction	40

	Capital expenditure and revenue expenditure	41
	Financial statements of limited companies	43
	Construction and use of financial statements	46
	What does the balance sheet tell us?	52
	Structure of the balance sheet	52
	Capital reserves or shareholders' equity	53
	Liabilities	55
	Assets	58
	Balance sheet formats	61
	Valuation of assets	64
	Summary of key points	70
	Questions	71
	Discussion points	71
	Exercises	71
3	Financial statements of limited companies - profit and loss account	76
	Learning objectives	77
	Introduction	77
	What does the profit and loss account tell us?	77
	What is profit?	78
	Structure of the profit and loss account	81
	Profit and loss account formats	87
	Profit and loss and the balance sheet	90
	Depreciation	94
	Cost of sales	98
	Bad and doubtful debts	104
	Profit and loss and cash flow	106
	Summary of key points	108
	Questions	109
	Discussion points	110
	Exercises	110
4	Financial statements of limited companies - cash flow statement	114
	Learning objectives	115
	Introduction	115
	What does the cash flow statement tell us?	115
	Structure of the cash flow statement	117
	Direct and indirect cash flow	121
	Cash flow statement formats	124
	Cash flow links to the balance sheet and profit and loss account	133
	Summary of key points	138
	Questions	139
	Discussion points	139
	Exercises	139

5 Business performance analysis	147
Learning objectives	148
Introduction	148
The performance review process	148
Limitations of the performance review process	152
Economic performance measurement	153
Ratio analysis	153
The best performance measure - cash or profit?	174
Summary of key points	177
Questions	177
Discussion points	178
Exercises	178
Case Study I: Buzzard Ltd	185
6 Published reports and accounts	194
Learning objectives	195
Introduction	195
Why are annual accounts filed and published?	196
Chairman's statement	199
Chief executive's statement	199
Financial review	210
Accounting policies	211
Financial highlights	211
Profit and loss account, balance sheet, and cash flow stater	nent 212
Horizontal analysis	219
Vertical analysis	221
Notes on the accounts	222
Segmental reporting	223
Corporate social responsibility (CSR) reporting	229
Directors' report	230
Inflation and reporting	237
Value added statements	238
Summary of key points	24.
Questions	242
Discussion points	24.
Exercises	24.
7 Corporate governance	24
Learning objectives	249
Introduction	249
Corporate governance code of practice	250
The audit and the role of auditors	26.
Directors' responsibilities	26
Insolvency	27-