

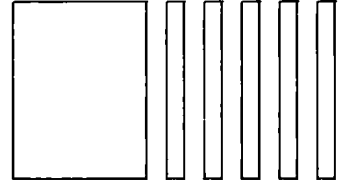
ACCOUNTING
in a
BUSINESS
CONTEXT

AIDAN BERRY
and
ROBIN JARVIS



Chapman and Hall

Accounting in a Business Context



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and
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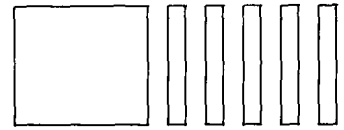
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In memory of Richard Nunns

Series foreword

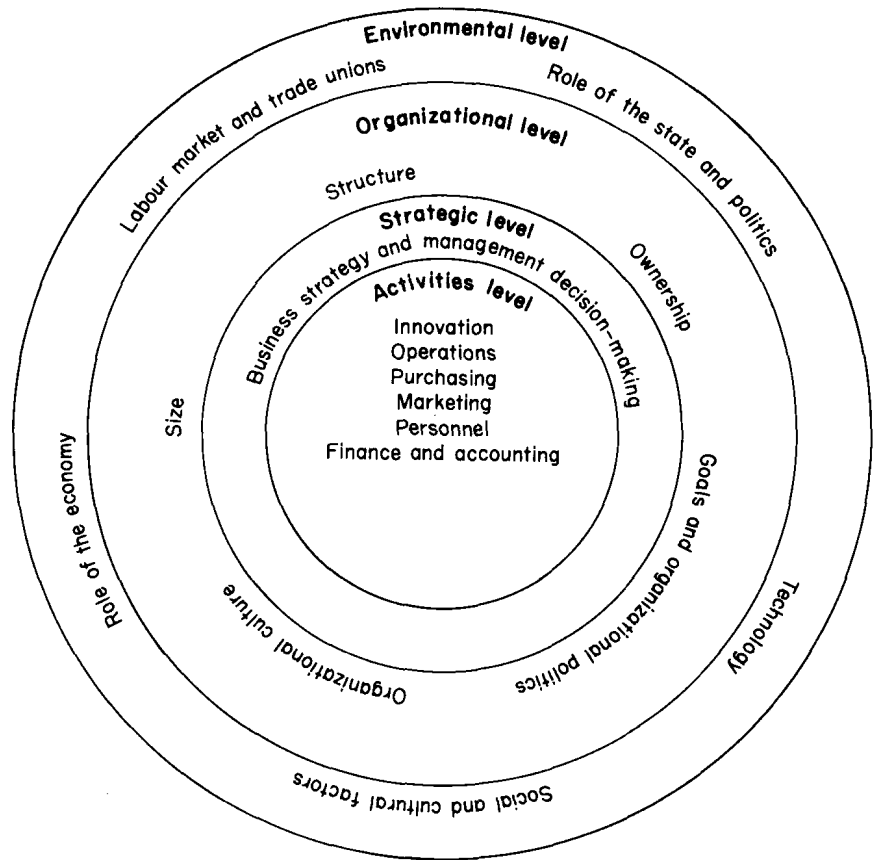


This book is part of the 'Business in Context' series. The books in this series are written by lecturers all with several years' experience of teaching on undergraduate business studies programmes. For a number of years we have been aware that many of the books we were recommending to our students did not cater specifically for business studies courses. Although there are some good books covering the different disciplines found in the business studies curricula, few of these texts are aimed specifically at the business studies student. Many of the best management texts assume a level of managerial experience and the worst take a simplistic and prescriptive view of business life. The interdisciplinary nature of business studies often means presenting students with a range of books dealing with various specialist topics, which can prove both daunting and expensive.

It is certainly not our intention to offer our individual texts as a panacea. Indeed our policy throughout this series is that the books are well referenced and the student is guided to further reading on every topic. However, we do feel that our books provide a focus for the student attempting to seek some meaning in the range of subjects currently offered on business studies programmes.

Business studies has attracted a growing band of students for a number of years and is currently one of the most popular undergraduate courses. Whilst many books have emerged to feed a hungry BTEC market, the undergraduate business studies student has been somewhat neglected. One of the causes of that neglect has undoubtedly been the difficulty of many, academics and members of the business community alike, to define business studies, beyond a list of loosely connected subject headings. With this series we hope to make good some of those missing connections.

With the exception of the text *Business in Context*, which takes the series title as its theme, all our texts take the approach of a particular discipline traditionally associated with business studies and taught across a wide range of business studies programmes. The first books in our series examine business from the perspectives of economics, behavioural science, law, quantitative methods and accounting. However, whereas in traditional texts it is the subject itself that is the focus, our texts make business the focus. All the texts are based upon the same specific model of business illustrated in Figure 1. We have called our model 'Business in Context' and the text of the same name is an explanation and expansion of that model.



The model comprises four distinct levels. At the core are the activities which make up what we know as business and include innovation, operations and production, purchasing, marketing, personnel and finance and accounting. We see these activities operating irrespective of the type of business involved. They are found in both the manufacturing and service industries as well as in the public and private sectors and constitute the first level.

The second level of our model is concerned with strategy and management decision making. It is here that decisions which influence the direction of the business activities at our core are made.

The third level is concerned with organizational factors within which business activities and management decisions take place. The organizational issues we examine are structure, size, goals and organizational politics, patterns of ownership and organizational culture. Clear links can be forged between this and other levels of the model, especially between structure and strategy, goals and management decision making, and how all aspects both contribute to and are influenced by the organizational culture.

The fourth level is concerned with the environment in which businesses operate. The issues here involve social and cultural factors, the role of the state and politics, the role of the economy, and issues relating to both

technology and labour. An important feature of this level is that such elements not only operate as opportunities and constraints for business, but also are shaped by the three other levels.

This brief description of the 'Business in Context' model illustrates the key features of the series. We see business as dynamic. It is constantly being shaped by and in turn shaping those managerial, organizational and environmental contexts within which it operates. Influences go backwards and forwards across the various levels. Moreover, the aspects identified within each level are in constant interaction with one another. Thus the role of the economy cannot be understood without reference to the role of that state; size and structure are inextricably linked; innovation is inseparable from issues of operations, marketing and finance. The understanding of how the model works is what business studies is all about and forms the basis for the series.

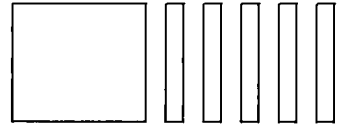
In proposing this model we are proposing a framework for analysis and we hope that it will encourage readers to add to and refine the model and so broaden our understanding of business. Each writer in this series has been encouraged to present their own interpretation of the model. In this way we hope to build up a more complete picture of business initially through the eyes of an economist, a behavioural scientist, a lawyer, a statistician and an accountant.

The series therefore aims for a more integrated and realistic approach to business than has hitherto been the case. The issues are complex but the authors' treatment is not. Each book is built around the 'Business in Context' model and each displays a number of common features that mark out the series. Firstly we aim to present our ideas in a way that students will find easy to understand and we relate those ideas wherever possible to real business situations. Secondly we hope to stimulate further study both by referencing our material and by pointing students towards further reading at the end of each chapter. Thirdly we use the notion of 'Key Concepts' to highlight the most significant aspects of the subject presented in each chapter. Fourthly we use Case Studies to illustrate our material and stimulate further discussion. Fifthly we present at the end of each chapter a series of questions, exercises and discussion topics. To sum up, we feel it most important that each book will stimulate thought and further study and assist the student in developing powers of analysis, a critical awareness and ultimately a point of view about business issues.

We have already indicated that the series has been devised with the undergraduate business studies student uppermost in our minds. We also maintain that these books are of value wherever there is a need to understand business issues and may therefore be used across a range of different courses covering BTEC Higher and some professional and Master degree courses in business and management studies.

David Needle and Professor Eugene McKenna

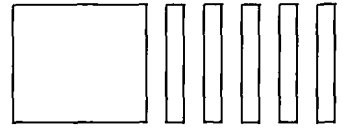
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The ideas underlying the approach to this book have evolved from discussions with colleagues and feedback from students over a number of years. We therefore wish to express our thanks to colleagues and students who have contributed in their support and comments. In particular, we would like to thank Joanna Johnson, Cliff Holland and Terry Murphy for their useful comments on the draft chapters.

Finally, we would like to thank our wives, Gill (Berry) and Moira (Jarvis), for putting up with the continuing dialogue regarding the book, often in situations where it was inappropriate.

Preface



The book has been written specifically with the needs of business studies students in mind. Although it is written as an introductory text covering financial accounting, financial analysis and management accounting, it does not attempt to introduce sophisticated accounting techniques or unnecessary technical terminology. Instead it builds from definitions through to a clear understanding of accounting statements, their uses and their limitations. Unlike other books in this field the examples and case studies have been tailor-made for the students' needs rather than being simply an amalgamation of material, some of which may be more suited to the needs of students on professional accounting courses such as accounting technicians' courses.

The book is broadly based round the needs of users of accounting information. This provides a structure for looking at the financial accounting statements, financial analysis and the specific information requirements of management and the ways in which those requirements are satisfied by various forms of report.

To introduce accounting techniques and such principles as duality the basic format used is that of a worksheet. This allows students to build their own accounting models using the various spreadsheet packages currently available. We have deliberately avoided the trap of building computer-based spreadsheet models for students to work with. It is our opinion that the learning process is related to the exercise of building the spreadsheet model as that encompasses the basic logic and understanding underpinning double-entry principles. We do not believe that the use of spreadsheets *per se* provides this understanding. Instead we see the use of spreadsheets for sensitivity analysis etc. as a second stage which requires the basic building blocks that our approach provides.

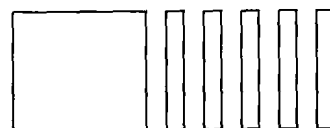
The approach that we have adopted is to look initially at a simple cash-based business and then to build from this solid foundation to a more sophisticated model based upon accrual accounting principles. The approach has proved to be very successful with students on both business studies undergraduate degrees and Higher National Diploma courses at Brighton and Kingston Polytechnics. It has also been used successfully to provide the basic understanding from which more sophisticated techniques can be explored in, for example, undergraduate accounting degrees.

From this firm foundation the student is introduced to the problems of

financial analysis and the way in which the approach to this differs between various user groups. The limitations of financial statements prepared for external purposes are examined in the context both of external and of internal users. The needs of internal users are examined in more detail in terms of the alternative information sources available to them. The extent to which these internal statements are used to satisfy the requirements of external users is also discussed with particular reference to its importance when raising finance from outside the organization.

The needs of internal users are then dealt with in more detail with particular reference to the types of information needed for decision making, planning and control. Once again the approach is to identify the needs of the users of the information and then to look in more detail at how the information is assembled, its usefulness and its limitations. In this section of the book as in previous sections the role of accounting information is set clearly within the context of the particular organization, its strategic environment and the economic environment generally, having clear regard to the costs and benefits of information to different sizes and types of business. Unlike many other texts we have set out to find examples from both manufacturing and service sector organizations to illustrate the concepts being introduced, and wherever appropriate to illustrate these concepts through real-world case studies.

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Introduction to accounting

1

This chapter will introduce you to the role of accounting, its uses and its users. It will also give you an appreciation of the role of accounting both within a business organization and in its external impacts. We shall introduce some ideas about the ways in which accounting assists managers in meeting business objectives through, for example, providing the information necessary to make a decision about buying or renting premises. The impacts of the size and type of organization on accounting will be discussed. For example, in very small organizations such as a window cleaning business the accounting requirements are likely to be less complex than is the case with a larger business such as British Rail. Another factor that both affects and is affected by accounting is the environment. The effects of the environment on accounting can be through the impact of government legislation as happens every time we adopt a new Companies Act or when a new EC Directive on accounting is added to the United Kingdom's statute book. Apart from government action, accounting can be affected at this level by changes in technology. For instance the move towards greater use of flexible manufacturing systems poses a major challenge to accountancy whilst the introduction of information technology has allowed accounting information to be provided more quickly and efficiently, thus enabling different decisions to be taken than would otherwise have been the case. From this brief résumé we can see that the accounting activity interacts with all levels of the 'Business in Context' model as explained in the Series foreword.

In order to understand the role and importance of accounting in the context of business organizations it is first necessary to decide what the word 'accounting' means. If you were to look up the word 'account' in *Roget's Thesaurus* you would be directed to words such as report and narration. Further investigation would reveal that it is also referred to as commercial arithmetic, double-entry book-keeping etc. These alternatives imply totally different things: a report is something that conveys information for a particular purpose, whereas commercial arithmetic implies a mechanical exercise following agreed rules or principles.

In practice, although accounting is normally seen as a series of figures, which may give the impression that it is only a form of commercial arithmetic, these are, in fact, merely a convenient way of summarizing and reporting information that would be indigestible in narrative form. For

example, if you were asked to provide a report giving details of the value of everything you own, it would be simpler to use figures to represent the value rather than words. However, there are certain things that do not lend themselves to summaries in numerical terms. An example may be the value of good health, the value of lead-free petrol, or even the value of a qualification such as a degree, an HND or whatever.

Apart from problems concerned with what can be reported and what should be reported, other problems need to be considered, for example whether it can be reported in a numerical format and whether that is the best format. We also need to consider whom the report is for and what it is to be used for. For instance, you may give totally different accounts of your car's capabilities to a prospective buyer and to a mechanic to whom you had taken it for repairs. So we can see that the question of defining accounting has many facets, such as what you report, how you report, and who you report to and for what purpose you report. We shall look at these issues in more detail later in this chapter. Prior to that, in order to get a better idea of what accounting is generally understood to be about, let us examine some definitions contained in the accounting literature.

A definition that is commonly quoted is that produced by the American Institute of Certified and Public Accountants (AICPA) in 1941:

Accounting:

... 'is the art of recording, classifying, and summarising, in a significant manner and in terms of money, transactions and events which are in part at least, of a financial character, and interpreting the results thereof.'

This definition implies that accounting has a number of components – some technical (such as recording of data), some more analytical (such as interpreting the results) and some that beg further questions (such as 'in a significant manner': significant to whom and for what?).

Let us consider another definition offered by the same professional body:

Accounting:

... 'is the collection, measurement, recording, classification and communication of economic data relating to an enterprise, for purposes of reporting, decision making and control.'

This gives us a clue to the fact that accounting is closely related to other disciplines (we are recording economic data) and it also gives us some clue as to the uses of accounting information, i.e. for reporting on what has happened and as an aid to decision making and control of the enterprise.

Another part of the same document sees accounting as

... a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organization.

This suggests that the role of accounting information within an organization is at the very core of running a successful organization. Thus, as we have already noted, accounting can be seen as a multifaceted activity which