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part I

the world of accounting and finance

nature and purpose of accounting

Learning objectives

When you have studied this chapter, you should be able to:

- Explain the purpose of accounting in a business context
- Distinguish between financial accounting and management accounting
- Compare different types of business entity
- Explain the importance of financial information to management
- Identify the main users of published financial statements.

1.1 introduction

This book focuses on accounting in a business context and everyone knows that business is about trying to make money. An accounting system can be used to record what has happened to the money in the business over time and provide financial information on the performance and position of a business. Financial information is needed by the owners and managers of the business, as well as others outside. Precisely who the users are depends to a large extent on the type and size of the business. For example, financial information relating to a small convenience store is likely to be used only by the owner and the tax authorities. However, financial information relating to a large, global company will have a much wider range of users. A user's level of interest depends on the purpose for which the financial information is needed. For example, a manager working in a division of a large company is likely to require detailed information in order to run the department; a bank lending officer contemplating lending £1m to a business is likely to need information for assessing the risk that the business will not be able to repay the loan with interest when it falls due.

Whether you decide to start your own business when you complete your studies, or become an employee, you will need a basic understanding of accounting so that you can make the best use of the financial information that the accountants provide. In this chapter we introduce you to the purpose of accounting. We provide an overview of the work involved in the two main branches of accounting and the accountancy profession. We also describe the different types of business organization and the principal sources of financial information about a business, before going on to consider the potential users of the information.

1.2 purpose of accounting

Even if you have not studied business or management before, you are likely to be familiar with some of the terminology associated with this subject. The phrase *accounting and finance* is often used to describe the subject you are studying. In general terms, finance refers to sources and management of money and we shall look this more closely in Chapter 3. In this chapter we will focus on what we mean by the term *accounting*. In everyday language, accounting for something means giving an explanation or report on something, and this lies at the heart of the subject, as the following brief history shows.

history of accounting

'The earliest records of financial information, in Mesopotamia and later in Egypt, date from the fourth millennium BC. Records are more abundant from Greek and Roman times. They are often merely lists of expenditure on major projects or lists of income from taxation. However, even before sophisticated accounting had been invented, some of the functions of accountants had become well established. "Keeping account" has always been part of

ordered society. “Giving account” has always been the duty of chancellors and stewards to whom responsibility has been delegated. From time to time, the kings or lords would *audit*, or hear the accounts. Sometimes the lord was illiterate and innumerate and relied considerably on the skills of his steward, or accountant.

The essential purpose of accounting is still to communicate relevant financial information to interested persons. Today, the owners of companies (the shareholders) expect to see an account from their stewards (the directors) which has already been audited by independent accountants (the auditors). The original purpose of accounting was to explain what had been going on – how the stewards had collected and used their lord’s money. This accountability or stewardship role still applies, though there are now additional roles for accounting information.’

Source: Nobes and Kellas, 1990, p. 10.

In its broadest form, we might say that accounting is a service that is provided for those who need financial information about the business. However, we need a more authoritative explanation. The following definition is taken from the *Oxford Dictionary of Accounting* (Hussey, 1999):

KEY DEFINITION

Accounting is the process of identifying, measuring, recording and communicating economic transactions.

In a business context, the term *economic transactions* refers to the commercial dealings of the organization that are concerned with creating wealth for the owner(s); in other words, money-making activities. We shall now consider each of the activities in the accounting process separately:

- *Identifying* economic transactions in most cases is fairly straightforward. Examples include selling goods or services to customers, paying wages, purchasing stock and buying machinery or equipment. It is also important to distinguish between the personal economic transactions of the owner(s) and/or managers and the economic transactions of the business, and focus solely on the latter.
- *Measuring* economic transactions is done in monetary terms. This convention began when more people learned to read and write and society moved from a bartering system where goods and services were exchanged without using money. For example, a farmer might exchange 10 pigs for 1 cow and measure the transaction in those very simple quantitative terms. Using money, the transaction might be 10 pigs sold at £10 each, and the sale recorded as £100; 1 cow purchased at £100 and the purchase recorded as £100. Measuring transactions in monetary terms makes it easier to aggregate, summarize and compare similar types of transaction.

- *Recording* economic transactions is essential. Traditionally they were recorded in handwritten books of accounts known as ledgers, but today most businesses keep computerized records.
- *Communicating* economic transactions is done by producing a variety of different financial statements. These are drawn from the records and set out in a particular format that summarizes a particular financial aspect of the business. The three main forms of financial statement are the cash flow statement, profit and loss account and balance sheet. We shall be looking at each of these financial statements in more detail in Part II.

The following activity allows you to carry out the basic accounting procedures of identifying, measuring and recording the economic transactions involved in building some office shelves:

activity

A business buys 5 litres of paint, 20 metres of timber and employs a carpenter for two days to build shelves in an office. Paint costs £4 per litre, timber costs £2.50 per metre and the carpenter charges £50 per day. What is the total cost of the shelves?

The cost can be calculated in a number of stages. You need to multiply the cost of paint per litre by the amount used. You also need to multiply the cost of timber per metre by the amount used. Finally, you need to calculate the cost of employing the carpenter by multiplying his daily rate by the number of days. The order in which you work out the figures does not matter, as long as you arrive at three figures which, when added together, make up the total cost of the job:

	£
Cost of paint (£4 × 5 litres)	20
Cost of timber (£2.50 × 20 metres)	50
Cost of labour (£50 × 2 days)	<u>100</u>
Total cost of the shelves	<u>170</u>

In more complex examples it is not so easy to identify and measure the economic events in monetary terms. We shall be looking at some of these problems in subsequent chapters.

1.3 main branches of accounting

The 18th century saw the start of an industrialization process in Europe that began to change many countries from rural to urban economies. During the 19th century new technologies were developed for commercial and industrial purposes, such as engineering and applied science, and industrialization spread to other continents through the colonialist policies pursued by the more powerful European countries as they competed for raw materials, new markets and diplomatic advantage (*Oxford Paperback Encyclopedia*, 1998). Another dramatic change took place during the 1970s and 80s, when the reduced cost of electronic hardware helped bring about a revolution in the commercial and personal use of informa-

tion technology that has transformed the storage and processing of data and electronic communication systems. By the mid-1990s many commercial and public organizations had their own websites on the internet for publicity, sales and publishing. Thus, the internet has created a global market place for many businesses.

The formation of the European Union (EU), which has its roots in the Treaties of Rome (1957), has been another significant influence on the internationalization of business, together with the development of international markets for raising finance. Such changes have meant that instead of operating in local or national markets, businesses in many countries around the world operate in a global economy. Indeed, some businesses have become huge conglomerates with complex activities and international operations that were unimaginable in the days when transactions were based on simple bartering.

Not surprisingly, accounting has had to develop in response to these changes in the business environment and the subject can now be divided into many specialist areas. However, there are two main branches: *financial accounting* and *management accounting*, as shown in Figure 1.1.

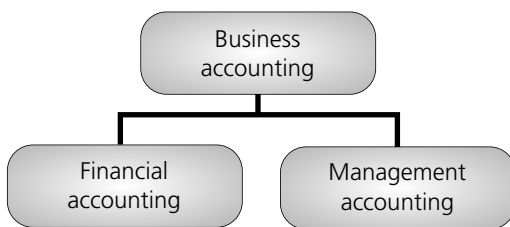


FIGURE 1.1 Main branches of accounting

We are going to start by looking at a definition of financial accounting.

KEY DEFINITION

Financial accounting is the branch of accounting concerned with classifying, measuring and recording the economic transactions of an entity in accordance with established principles, legal requirements and accounting standards. It is primarily concerned with communicating a true and fair view of the financial performance and financial position of an entity to external parties.

From this definition you can see that the purpose of financial accounting is to provide financial information to meet the needs of *external users*. The term ‘true and fair view’ implies that the financial statements produced at the end of a financial period (usually a year, but sometimes less) are a faithful representation of the economic activities of the organization. The financial statements are drawn up within a regulatory framework, which is very important for businesses that have been formed as limited liability entities. Therefore, the organization must prepare the financial statements according to legislation and other regulations. In addition, the financial statements are prepared using a number of

accounting assumptions which have been established as general principles. We shall be looking at these assumptions in the next chapter. Generally, an organization's financial statements are considered to give a true and fair view if they comply with the regulatory framework and normal accounting principles. However, in a very small number of cases, the organization may have to ignore specific rules to ensure that the financial statements give a true and fair view so that the users of the financial statements are not misled.

Financial accounting can be divided into a number of specific activities, such as the following:

- bookkeeping, which focuses on the recording of business transactions
- auditing, which is the thorough examination of the financial systems and records to confirm that the financial statements give a true and fair view (an audit is a legal requirement for all large companies and for some small and medium-sized companies that are not eligible for exemption)
- corporate recovery, which is concerned with the provision of insolvency services and advice to businesses in financial difficulties
- taxation advice, which is governed by legislation.

activity

A financial accountant can give advice on the following matters (tick the appropriate box):

	True	False
(a) How to arrange financial affairs so that the least amount of tax is incurred	<input type="checkbox"/>	<input type="checkbox"/>
(b) The best way to borrow money for a specific project	<input type="checkbox"/>	<input type="checkbox"/>
(c) The likely profit to be made on a music festival	<input type="checkbox"/>	<input type="checkbox"/>
(d) Carrying out financial transactions in foreign currencies	<input type="checkbox"/>	<input type="checkbox"/>
(e) Deciding on the best way to provide for a pension	<input type="checkbox"/>	<input type="checkbox"/>
(f) Calculating VAT payments	<input type="checkbox"/>	<input type="checkbox"/>
(g) Trading in stocks and shares	<input type="checkbox"/>	<input type="checkbox"/>

You may have been puzzled by some of these statements, but you would be right if you said that they are all the concern of the financial accountant. However, as in other professions, there are specialists who may concentrate on specific areas within financial accounting.

We will now look at a definition of management accounting.

KEY DEFINITION

Management accounting is a branch of accounting concerned with collecting, analysing and interpreting quantitative and financial information. It is primarily concerned with communicating information to management for planning, controlling and decision making.

Whereas financial accounting is concerned with providing financial information to external users, the above definition indicates that management accounting focuses on providing financial information to *internal users*: those responsible for managing the business. We shall be looking at management accounting in some detail in Part III of this book. A management accountant is concerned with identifying why the information is required so that the most appropriate technique can be used to supply information to managers. The managers of the business need this information to enable them to plan the progress of the business, control the activities and understand the financial implications of any decisions they may take. Unlike financial accounting, management accounting is not governed by legislation or regulations and the emphasis is on providing information for decisions that will help the business achieve its financial targets.

Cost accounting is an important part of management accounting and incorporates techniques for planning, control and decision making. Large organizations may employ a specialist cost accountant whose job it is to ascertain the cost of operating the various cost centres in a business and the cost of products, services and other cost units. This allows management to make important decisions, such as setting selling prices, production and/or sales targets, and deciding which products or services are the most profitable to produce or supply. Another important aspect of cost accounting is establishing budgets and standard costs, and comparing them with the actual costs incurred.

To illustrate the difference between financial accounting and management accounting we can look at the example of the office shelves again:

- A financial accountant would be interested in the total cost of £170 so that it can be recorded as the economic transaction.
- A management accountant would be more concerned with informing managers how much the individual elements cost, such as the paint, the timber and the labour. A management accountant would also want to calculate how much the shelves actually cost and compare it with the planned or budgeted figure (what it was estimated they would cost).

Classify the following activities (tick the appropriate box):

	<i>Financial accounting</i>	<i>Management accounting</i>
(a) Auditing the books of an organization	<input type="checkbox"/>	<input type="checkbox"/>
(b) Managing the tax affairs of a business	<input type="checkbox"/>	<input type="checkbox"/>
(c) Analysing the financial implications of management decisions	<input type="checkbox"/>	<input type="checkbox"/>
(d) Preparing financial statements at the end of the year	<input type="checkbox"/>	<input type="checkbox"/>
(e) Ensuring compliance with legal and other regulations	<input type="checkbox"/>	<input type="checkbox"/>
(f) Providing financial information for managers	<input type="checkbox"/>	<input type="checkbox"/>
(g) Keeping the financial records of the organization	<input type="checkbox"/>	<input type="checkbox"/>

By now you are probably more confident about deciding which activities involve financial accounting and which can be classified as management accounting. With the exception of (c) and (f), all the above activities are concerned with financial accounting.

The purpose of management accounting is to provide managers with financial and other quantitative information to help them carry out their responsibilities. The responsibilities of managers in any organization can be classified as planning, controlling and decision making. Therefore the financial information they require should help them to control the resources for which they are responsible, plan how those resources can be most effectively used and decide what course of action they should take when a number of options are open.

activity

Imagine you are a manager and decide whether you would require the following information for planning, controlling or decision making:

- (a) The amount claimed for taxi fares by staff last month
- (b) The prices charged by a new supplier for services or materials
- (c) The cost of running the office photocopier
- (d) The cost of employing subcontracted staff, compared with your own employees
- (e) The cost of making a component, compared with buying it from a supplier

Items (d) and (e) should be easy to define because in both circumstances you are choosing between alternatives and therefore you are making decisions. With items (a) and (c) you are mainly concerned with controlling costs, although you might want the information to make plans for future expenditure. Item (b) could be concerned with planning future costs or you may be about to decide whether to change to another supplier. This decision may have arisen because you are trying to control costs. Although the boundaries between planning, controlling and decision making are blurred, financial and statistical information has a very important role to play and it is the management accountant who provides this information.

As management accounting is concerned with providing information that is useful to managers, it offers a number of general advantages, such as helping a business become more profitable (or ensuring that a not-for-profit organization provides value for money).

activity

What other advantages do you consider management accounting information offers to managers? Draw up a list of the ways in which management accounting information can be used by managers under the headings of planning, controlling and decision making.

Your list may include some of the following advantages:

Planning

- the price of products or services
- the number of employees and what they should be paid

- the quantity of each product or service that must be sold to achieve a desired level of profit.

Controlling

- unnecessary expense and waste
- the amount of investment in machinery or equipment
- the cost of running different departments.

Decision making

- whether to make or buy a particular component
- whether it is worth investing in new technology
- which products or services to offer if there is a shortage of skilled labour.

1.4 accountancy and the profession

Although accounting can be divided into financial and management accounting, you should not be misled into thinking that there is no relationship between these two activities, since they both draw on the same data sources and both generate financial information. However, there are some important differences, which relate to the accuracy, level of detail and timing of the information produced. Financial accounting operates on the basis of an annual reporting cycle. As you will see in the next section, for some businesses (limited liability entities) it is strictly regulated because the information must be as accurate as possible. For most businesses, it is often some months after the end of the financial year before the financial statements are issued. The financial statements are drawn up for the entire business and contain aggregated information that is presented in the way required by legislation. By contrast, management accounting is not regulated and the aim is to present the information to managers when they want it and in the form they want it. In most management accounting systems, reports for each activity in each part of the organization are produced on a monthly or more frequent basis. Consequently they are very detailed. Because the reports are produced frequently, some figures may be based on estimates.

In a large business where the accounting systems are well designed and operate efficiently, if the periodic management accounts for the different parts of the business were aggregated, the resulting totals would be very similar to the figures in the financial accounts. However, there would be some differences. For example, the financial accounts would contain details of interest payments, dividends paid to shareholders and tax payments. There may also be minor differences due to some figures in the management accounts being estimated. If there were any significant differences, they would be investigated by the firm's accountant.

Another difference is that a large business is likely to employ specialists to deal with different aspects of accounting and finance, whereas a medium-sized business may have one qualified accountant who carries out both financial and management accounting functions, perhaps with the help of other staff, such as a credit controller and bookkeeper. In a small business, it may be more cost effective for all the accountancy work, except some simple record keeping, to be carried by an external accountant. However, this does not mean that smaller businesses do not make use of management accounting information. Although the most widely used sources of financial information in smaller businesses relate to cash (bank statements and cash flow information), the large majority use monthly or quarterly management accounts and budgets (Collis and Jarvis, 2002).

In the UK, a qualified accountant must have passed a number of rigorous examinations set by one of the recognized accountancy bodies. He or she then pays an annual subscription to become a member of that particular institution, and thus joins the accountancy profession. Table 1.1 shows the qualified membership of the six British chartered accountancy bodies in 2002:

TABLE 1.1 Qualified membership of the British accountancy bodies 2002

	No. of members	%
Institute of Chartered Accountants in England and Wales (ICAEW)	123,719	38
Association of Chartered Certified Accountants (ACCA)	95,416	30
Chartered Institute of Management Accountants (CIMA)	59,896	19
Institute of Chartered Accountants in Scotland (ICAS)	15,166	5
Chartered Institute of Public Finance and Accountancy (CIPFA)	13,471	4
Institute of Chartered Accountants in Ireland (ICAI)	12,932	4
	320,600	100

Source: Adapted from Edwards, 2003, p. 59.

Membership of the ICAEW rose by about 10% between 1998 and 2002, but the ACCA grew by almost 40% in the same five-year period (Fisher, 2003). The ACCA is unusual because approximately half its members are based outside Britain. It also has the highest proportion of female members (36%). Although all the accountancy bodies have shown steady increases in the number of qualified female members, women are outnumbered by men in the accountancy profession.

Accountants can work in professional practice (for a firm of accountants or in their own practice), in commerce and industry or in the public sector. A qualified accountant is not necessarily restricted to one area of work. However, an accountant in a professional practice is likely to be a member of ICAEW, ACCA, ICAS or ICAI. Membership of CIMA would be most appropriate for a management accountant in industry. Membership of ACCA or CIPFA would be appropriate for a treasurer in a local authority, or an accountant in the National Health Service or other public sector organization with funding from national or local government.

1.5 classifying businesses

Accounting provides important information that is used in all kinds of organizations, regardless of the nature of their activities, their financial objectives or their size. This is because accounting information helps organizations to achieve their economic objectives. All entities strive to ensure that the revenue generated and the costs incurred are at acceptable levels, but what is an acceptable level varies. In the profit-making sector the economic objective of some business owners is to maximize wealth and they pursue what we call *profit maximization* strategies. Others place limitations on the amount of wealth they want to create and follow strategies they hope will give them sufficient profit to maintain a certain lifestyle and no

more. Recent research shows that 53% of small and medium-sized entities (SMEs) (defined as those with up to 250 employees) do not intend to grow (SBS (Small Business Service), 2004). This type of economic rationality can be called *satisficing* (Simon, 1960). Although we are looking at accounting in a business context, you should be aware that in the not-for-profit sector the economic objective is to break even. This means that managers working in organizations in the public sector and in social organizations, such as clubs, will be concerned with generating enough revenue to cover costs rather than making a profit.

The size of business entities ranges from very small, such as a florist's shop with one owner and no employees, to a large multinational company with thousands of owners (the shareholders) and thousands of employees. Government statistics show that of the estimated 4.3 million business enterprises in the UK in 2004, 99% were small (a small enterprise is defined as having 0–49 employees) (SBS, 2005). However, Britain is not the only country where small firms dominate to such a large extent. In continental Europe, 99% of the 19.3 million enterprises in the European Economic Area and Switzerland are small (European Communities, 2004).

As well as providing a living for their owners, small firms make a significant contribution to the economy. In the UK they provide 47% of employment, despite the fact that 73% consist solely of the self-employed owner-manager(s) (SBS, 2005). Comparing these to the European statistics, we find that the small firms account for 56% of employment (European Communities, 2004). With an average size of 5 employees, European enterprises are smaller than in the USA, for example, where the average number is 20. This is because in Europe approximately 50% of firms with fewer than 10 employees are sole proprietorships, compared to 80% in the USA. Regardless of their global position, most countries recognize the significant contribution to economic growth made by smaller entities.

The majority of smaller entities are owner-managed and family-owned (Collis, 2003; SBS, 2004). In larger businesses, ownership and control tends to be separated, as the owners appoint managers to run the business on their behalf. Businesses also differ in terms of their legal status and in the groups of people who are likely to be interested in financial information about them. Before we look at the users and uses of financial information, we need to consider the three main types of enterprise in the UK:

- sole proprietorships
- partnerships
- companies and corporations.

Figure 1.2 shows how the four million UK enterprises are dispersed among these categories.

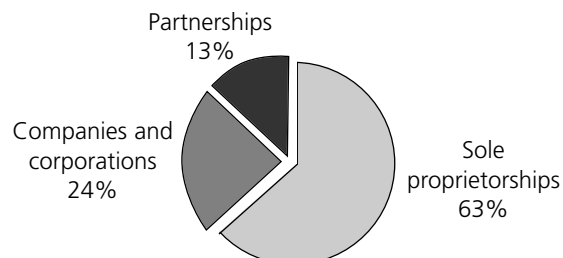


FIGURE 1.2 UK enterprises by legal status

Source: Adapted from SBS, 2005, Table 2.

As you can see, the majority of enterprises are *sole proprietorships*. A sole proprietorship is an unincorporated entity because it has not gone through a process of incorporation by which it is registered as a limited liability entity. It is owned by one person, who is in business with a view to making a profit. A sole proprietor may be providing a service (for example a window cleaner, hairdresser or business consultant), trading goods (for example a newsagent, florist or grocer) or making goods (for example a cabinet maker, potter or dress designer). Alternatively, the business may have activities in the primary sector (agriculture, forestry or fishing). A sole proprietor may run the business alone or employ full-time or part-time staff. The owner of this type of business may experience difficulty in obtaining the finance to start the enterprise, as the capital is restricted to what he or she has available to invest plus any loans. However, there are no legal formalities to set up this type of business and no obligation to disclose financial information to the public. One key characteristic is that a sole proprietor has *unlimited liability*, which means that the owner is personally liable for any debts the business may incur. This liability extends beyond any original investment and could mean the loss of personal assets.

A *partnership* is an entity in which two or more people join together in business with a view to making a profit. Examples range as widely as those cited for sole traders but partnerships are a popular form of business for professional firms such as accountants, doctors, dentists and solicitors. The maximum number of partners in a firm used to be restricted to 20, but this limit was removed in 2002. In a general partnership the partners have 'joint and several' liability. This means that the partners have *unlimited liability* for each other's acts in terms of any debts the business may incur. The capital invested in the business is restricted to what the partners have to invest, supplemented by what they can borrow. The partners may run the business alone or employ full-time or part-time staff. The Business Names Act 1985 requires the names of the partners to be shown on business stationery, but they need not be used in the business name. The partners must keep accounting records and in the absence of a written or verbal *partnership agreement*, the Partnership Act 1890 applies. A written partnership agreement is a deed of contract that relates to the agreement to form a partnership.

activity

What sort of financial matters do you think partners ought to agree on before starting the business?

The most obvious matters to agree are as follows:

- How to divide the profit
- How much money (capital) each partner will invest in the business
- Whether any of the partners will be entitled to a salary
- Whether any interest will be payable on the capital invested by the partners
- Whether any interest will be payable on any loan made to the partnership by any of the partners.

If the partners are in dispute and there is no partnership agreement, the Partnership Act 1890 provides rules on the relationship between the partners. We will be looking at partnership law in more detail in Chapter 2.

To help you identify the similarities and differences between the two types of business organization, decide whether the following characteristics apply to a sole proprietor, a simple partnership, or both:

	<i>Sole proprietorship</i>	<i>Partnership</i>
(a) The entity is an unincorporated business	<input type="checkbox"/>	<input type="checkbox"/>
(b) There is only one owner	<input type="checkbox"/>	<input type="checkbox"/>
(c) There is no maximum number of owners	<input type="checkbox"/>	<input type="checkbox"/>
(d) There are no formalities involved when starting the business	<input type="checkbox"/>	<input type="checkbox"/>
(e) There should be a contract of agreement	<input type="checkbox"/>	<input type="checkbox"/>

What they have in common is that they are both unincorporated businesses. The first important difference to note is that a sole proprietor is the sole owner of the business, whereas a partnership has at least two owners with no maximum. Another important difference is that there are no formalities involved in setting up a business as a sole proprietor, whereas the relationship between partners in a partnership must be formalized in a contract of agreement. You might argue that partners do not need a contract of agreement, because in the absence of such a deed the Partnership Act 1890 sets out the relationship. This means that a standard agreement is applied, although this may not be appropriate in all circumstances. You may have thought of some other differences such as:

- A partnership can raise more capital than a sole proprietorship to start the business because there is more than one owner.
- For the same reason, a greater range of skills is likely to be available in a partnership.
- The pressures of managing the business are shared in a partnership, whereas a sole trader must bear them alone.
- Any loss made by a partnership is shared among the partners, whereas a sole trader suffers the whole of any loss the business incurs.
- In a partnership, responsibility for debts incurred by individual partners, or the business as a whole, is shared; a sole trader must carry responsibility for debts incurred by the business alone.
- The individual partners are responsible for the actions of the others in a partnership, whereas a sole trader has none of these worries.

Perhaps the most important characteristic these two types of business have in common is that the owners have unlimited liability, which is the case for all unincorporated businesses.

We will now move on to look at two types of business that have *limited liability*: a *limited liability partnership (LLP)* and a *limited company*. A limited liability entity is a business that, through the process of legal incorporation, is considered to have a legal identity that is separate from its owners, who are known as members. The capital invested in the business is raised by selling shares to members (hence the term *shareholder*) and can be supplemented by loans and other forms of debt finance. Members have limited liability, which means that

even if the business fails owing significant amounts, the owners' liability for those debts is limited to the capital they have invested.

the concept of limited liability

'The Limited Liability Act 1855 was the first to establish the principle of limited liability subject to certain safeguards, but it was only in force a few months before the Joint Stock Companies Act 1856 superseded it and became the first in the line of statutes which culminated in the concept of limited liability as we know it today.

The concept of limited liability relates to the members of a company being liable to contribute towards payment of its debts only to a limited extent. The amount of members' liability is determined by the liability clause contained in a company's memorandum of association, and differs in its nature according to whether the company is one which is limited by shares, limited by guarantee, or unlimited.

The vast majority of companies registered under the Companies Act are companies "limited by shares". This means that the shareholders or members have a limited liability to pay the debts of the company. When new shares are issued by a company, the person who takes the shares must agree to pay for them. Usually payment will be made immediately but sometimes shares will be issued "unpaid" or "partly paid", in which case payment must be made later. If the company goes into liquidation and is insolvent, the members are liable to pay for their shares in full if they have not already done so ...

Complementary to the concept of limitation of the members' liability is the notion that the company is a separate "legal person" distinct from the members and the directors. It is the company that buys and sells, owns land, employs workers, makes profits or losses, and not the individuals who make up the company. The company itself is owned by the members, and its directors act on its behalf, but the debts are the debts of the company and the only assets which can be used to satisfy those debts are the assets owned by the company ... These complementary rules of limited liability and legal personality, therefore, combine to confer enormous advantages on the sole proprietor who turns his [or her] business into a company.'

Source: Mallett and Brumwell, 1994, pp. 6–7.

LLPs were introduced by the Limited Liability Partnership Act 2000 and the Limited Liability Partnership Regulations 2001 (after the above article was written). In the first two

years 4,442 of this new type of partnership were registered, many of which are professional firms offering services, such as accountants, doctors and solicitors. LLPs are allowed to organize themselves internally in the same way as a general partnership. However, in their external relations, most of the requirements that apply to limited companies (modified as appropriate) apply.

Limited companies and LLPs are more closely regulated than sole proprietors and general partnerships. On formation they must file two documents with the Registrar of Companies at Companies House, which is part of the Department of Trade and Industry (DTI):

- *Memorandum of association*, which gives details about the constitution of the business and its objects.
- *Articles of association*, which gives details about its internal regulation, including the voting rights of shareholders, how shareholders' and directors' meetings will be conducted and the powers of management.

Under the Companies Act 1985 all limited liability entities are required to make public disclosure of financial information. They are obliged to keep accounting records and prepare an *annual report and accounts* which must be filed with the Registrar of Companies and distributed to every shareholder. The annual report and accounts is a comprehensive source of financial information on a limited liability entity and includes the annual financial statements (with some simplifications and disclosure concessions for qualifying smaller entities). We will be looking at the annual report and accounts in more detail in Chapter 2.

Companies can be divided into *private companies* and *public companies*. Most public companies are converted from private companies under the re-registration procedure in the Companies Act 1985. Of the 1.6 million companies on the register in 2003, only 0.7% were public limited companies, 99% were private limited companies and 0.3% were unlimited private companies (DTI, 2003). The main differences between a private company and a public company are:

- A public company must state in its memorandum of association that it is a public company.
- A public limited company's name must end with the words 'public limited company' or the abbreviation 'Plc' or 'Ccc' the Welsh equivalent; a private limited company's name must end with the word 'limited' or the abbreviation 'Ltd'.
- A public limited company can advertise its shares and invite the public to buy them, and its shares can then be freely bought and sold; a private limited company's shares are only available privately.

The shares of a UK public limited company are listed on the London Stock Exchange (LSE) and may also be listed on any of the international stock exchanges. Investors can buy and sell shares in person through a broker, a bank, a share shop or on the internet. Most financial institutions try to keep the process as informal and fast as possible. When shares are issued, an advertisement is placed in the newspapers in the form of a prospectus and application coupon. It is best to obtain professional advice before buying shares, since every investment carries some risk as well as the chance of making a gain. Because limited companies are so important to the economy, information about them, particularly public limited companies, is readily available. We will look at this in more detail in Chapter 2.

Figure 1.3 summarizes the different types of business entity we have described.

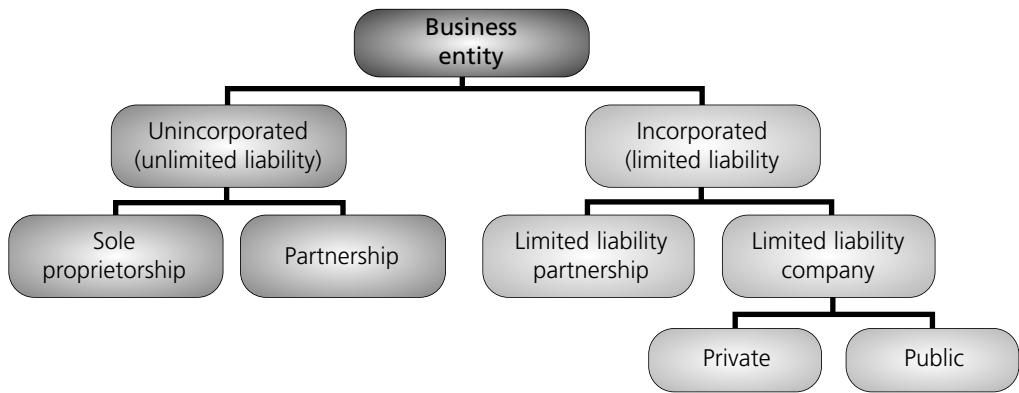


FIGURE 1.3 Types of business entity

activity

What do you think are the main advantages of an LLP or limited company over a general partnership?

One of the main advantages is that the members of an LLP or limited company have their liability limited to the amount they have agreed to invest, even if the company goes into liquidation. With a general partnership, the partners are liable for the debts of the business, even if they were not personally responsible for incurring them. There are two main exceptions to this restriction on liability that apply to LLPs:

- If the member of an LLP was personally at fault, he or she may have unlimited liability if he or she accepted a personal duty of care or a personal contractual obligation.
- If an LLP becomes insolvent, the members can be required to repay any property withdrawn from the LLP, including profits and interest, in the two years prior to insolvency. This is only applicable where it is reasonable that the member could not have concluded that insolvency was likely.

A limited liability entity usually finds it easier to raise finance than a general partnership. Public limited companies raise finance by issuing shares on a stock exchange. Private limited companies cannot do this and can only raise capital from selling shares privately. Once they are established, limited liability entities find it relatively easy to raise loans because the financial regulations imposed on them give lenders some confidence in the financial information they provide, which they use to assess and monitor the lending risk. Limited liability entities have an unlimited life, whereas a general partnership has a finite life. When a member of a limited liability entity dies, his or her shares can be transferred to someone else and the company or LLP continues; when a partner in a general partnership dies, the old partnership ceases. Of course, the remaining partners are free to reform the business as a new partnership, with or without additional partners.

1.6 importance of financial information to management

Before looking at the potential uses of financial information, we need to establish what we mean by *financial information*. For our purposes, financial information can be considered to be information about something expressed in terms of money. We are confronted with financial information at home and at work. We may be so used to reading and hearing it that we do not think about what messages we are being given and why. For example, if you have gone shopping today, you may have compared prices and been given receipts which itemize and total your purchases. At home you may have received your bank statement or a telephone bill and decided that you must cut back on your spending. At work you may have received a quotation that you intend to use to help you decide which supplier to order from. These are examples of financial information that have a direct impact on your activities. Other items may have less direct impact. For example, if you have read the newspaper or looked at news programmes on television or the internet, you will probably have heard about how much a particular celebrity earns, the state of the economy, changes in interest rates or record profits made by a particular company. If you have no association with that company, you may simply conclude that it indicates the state of a prosperous economy which may bring you some indirect benefits. If you are a shareholder or an employee of the company concerned, you will probably have a much greater interest.

To understand how financial information can be helpful, we need to identify the uses to which it can be put. One way of doing this is to define the responsibilities involved in any job or activity.

activity

Sally Lunn is the manager of a small coffee shop. Here is a list of her responsibilities:

- ordering and controlling stock
- supervising two full-time and two part-time staff
- ensuring the security of the premises
- keeping cash records and daily banking
- general display and maintenance of the shop
- serving customers
- resolving customers' complaints.

Think of a job you have held in the past or present and jot down a list of your responsibilities. If you have not had any work experience, think about any voluntary job you may have done, such as helping in a charity or organizing a student event.

No matter what work you are describing, it is likely that your responsibilities can be classified under one of the following major activities:

- *Planning* – Without plans and policies a business has no sense of direction or purpose. Financial information allows plans and policies to be formulated and helps people in the organization understand the targets and standards it intends to achieve. For

example, a manager needs to know what profit it is hoped the business will make; on a personal level you need information in order to plan holidays, whether you need to take a weekend job, and so on.

- *Controlling* – A large number of responsibilities at work are concerned with ensuring that the organization makes progress towards its set objectives. For control to be effectively maintained, financial information is required on such matters as the various costs of products and processes, monitoring labour efficiency and identifying the sources and purpose of all expenditure. Similarly for social activities, such as organizing a student ball, information is needed to ensure that a loss is not made.
- *Decision making* – In establishing plans, it is necessary to decide which of the various courses of action should be taken. We need to know the financial implications of our actions in order to select the most appropriate plan. In business, a manager may need to make a decision between using machinery and labour on an activity; on a personal level we may need to make a decision between buying a car and using public transport.

activity

Consider any financial information you currently receive and classify it according to whether it helps you in controlling, planning or decision making. The information can be financial information you receive at work or at home, such as your bank statement or household bills. You may find that some types of information help with more than one activity.

Once you have completed your list, compare it with the one you drew up for the previous activity. The information should match. For example, if you decided that most of your responsibilities are concerned with controlling, then most of the information you receive will be ticked under that heading in your list. On the other hand, you may have identified financial information that you require but do not currently receive, or financial information you receive but cannot use because you do not understand it. In later chapters we shall be looking at different types of financial information and identifying those that are most relevant to your responsibilities.

1.7 users of financial statements

We are now ready to consider the main users of financial information produced by different types of business entity.

activity

List the various groups of people who might find financial information about a business useful and give some examples of how they might use it.

The contents of your list will depend to a large extent on the type of organization you had in mind. It is easy to appreciate that management will have an interest in financial informa-

tion about the business, as we have already discussed that they need it in order to run the business and carry out their responsibilities of planning, controlling and decision making. In general, financial information about a business is important to its owners, lenders, suppliers, employees and customers to assess the financial strength of the business. It is also important to the government to evaluate its economic and fiscal policies and to government agencies, such as those responsible for collecting taxes, regulation or keeping statistical records. Financial information about the business may also be used by competitors, potential purchasers, pressure groups and members of the public who are interested in its activities.

Whether financial information is readily available depends upon on the type of business and, to some extent, its size. Since sole proprietorships and general partnerships are not required to make public disclosure of financial information, the main user of their financial statements is management. In other words, their financial statements are prepared for those responsible for running the business.

On the other hand, limited liability entities have a statutory obligation to publish annual financial statements by sending a copy to shareholders and filing them at Companies House. The communication of the financial statements to external parties in this way is known as *financial reporting*. The following list summarizes the main users of the financial statements published by limited liability entities (ASB, 1999):

- Present and potential investors for assessing investment risk and return
- Employees for assessing job security, job opportunities and for pay bargaining
- Lenders for assessing and monitoring lending risk
- Suppliers and other trade creditors for assessing and monitoring credit risk
- Customers for evaluating continuity of supply, after sales service/warranties
- Governments and their agencies for allocating resources, taxation, regulation, national statistics and so on
- The public for evaluating such things as the impact of the entity's activities on the local economy, the community and the environment.

Because of the importance of financial reporting, we shall be examining the needs of the users of the financial statements in more detail in the next chapters.

1.8 conclusions

In this first chapter of the book we have described the two main branches of accounting and looked at the roles of financial and management accountants. We have examined and contrasted the main characteristics of two types of unincorporated business (sole proprietorships and general partnerships) and two types of incorporated business (limited liability partnerships and limited liability companies). We have also compared a private limited company with a public limited company. This has allowed us to draw out the financial implications resulting from the choice of business type, with a particular focus on raising capital and disclosure of financial information.

Our discussion of the importance of accounting in providing financial information to internal users allowed us to draw the general conclusion that it is useful because it aids management in their responsibilities for planning, controlling and decision making. Finally, we have examined the users of the financial statements of limited liability entities.

practice questions

1. Explain why students studying business or management subjects should learn about accounting.
2. Define accounting and explain the difference between the two main branches of accounting.
3. Compare the advantages and disadvantages of sole proprietors, general partnerships and limited liability entities.
4. Explain the concept of limited liability.
5. Identify the seven main users of the financial statements of limited liability entities and briefly describe their information needs.

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