

INTRODUCTION TO ACCOUNTING

Part 1

This book is divided into four main parts, as shown below. Part 1 contains two chapters. In Chapter 1 we provide some background about accounting, the accountancy profession, and the organizations that accountants work for. In Chapter 2 we outline the rules and regulations that accountants are expected to follow when preparing accounting statements.



As others see us . . .

But we are cool, insist accountants

It's one of the most enduring stereotypes in the business world: ever since the days of Monty Python's Lion Tamer sketch, accountancy has become a byword for dull, straight-laced stuffiness. But now the grey men are fighting back: an indignant survey reports that accountants are actually a lot more dynamic, tech-savvy and generally 'down with the kids' than everyone makes them out to be. And if you don't believe them, they've got the spreadsheets to prove it...

The report, from tax and accountancy information provider CCH, 'exposes the gulf' between people's perception of accountants and the reality – or at least, the reality according to accountants. Take technology, just 28% of the public surveyed thought accountancy was a dynamic profession embracing new technologies, whereas 53% of accountants think their profession is the height of tech-saviness. Indeed, so achingly hip are accountants that a staggering 74% can use an iPod – miles more than the public's guess of just 59%!

What's more, accountants are also 'down' with social networking sites: 58% are apparently regular users (compared to the public perception of 44%). CCH reckons accountants are 50% more likely to have a Facebook profile than the average punter – 60% of those under 35 have a page, compared to the

national average of 23%. Even if we ignore the inevitable socio-economic bias in that statistic, we're not totally sure whether this proves that they're cool, or the direct opposite (although it does go a long way towards explaining the existence of a 12,000-strong Facebook group called 'Accountants are Sexy').

According to CCH, this marvellous embrace of new technologies is proof positive of a new, dynamic younger generation of accountants, who are 'breathing new life into the profession'. And as such, their enduring reputation for terminal tediousness is wholly undeserved. 'Even in these hyper PC times, it seems that accountants are still unfairly viewed as being behind the times,' laments CCH executive director Martin Casimir.

On the other hand, we can't help feeling that life could be a lot worse for these poor accountants – after all, they could be bankers, in the Monty Python sketch, accountant Michael Palin initially jumps at the idea of working his way up to lion taming via banking: 'That's a man's life, isn't it?' he exclaims, 'Travel, excitement, adventure, thrills, decisions affecting people's lives...' Prophetic words – and it explains exactly why bankers are currently a hell of a lot more unpopular than accountants have ever been...

Management Today, 27 October 2008.

Source: Reproduced from *MT* magazine with the permission of the copyright owner, Haymarket Business Publications Limited.

Questions relating to this news story can be found on page 20 ➡

About this chapter

This chapter sets the scene for the rest of the book.

The chapter begins with an explanation of why it is important for you as a non-accountant to study accounting. It then gives a brief explanation of the nature and purpose of accounting and of its historical development. This is followed by an outline of the main branches of accounting and a description of the accountancy profession. The last main section of the chapter gives a brief overview of the economic structure of the United Kingdom (UK).

Learning objectives

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

- summarize the nature and purpose of accounting;
- outline its history;
- explain why you need to know something about it;
- identify the main branches;
- list the principal UK accountancy bodies;
- describe the most important types of public and private entities in the UK.



Why accounting is important

News clip

Financial meltdown

According to the Deputy President of the Association of Chartered Certified Accountants the failure to tackle financial illiteracy could be as devastating as global warming. She urges financial professionals to help with financial education in schools 'to put something back'. How is not clear but perhaps this book is a step in that direction.

Source: Adapted from *Accountancy Magazine*, January 2007, p. 10.

You've probably got hold of this book because you're a student. You may be doing a certificate, diploma or degree course in perhaps business, engineering, languages, law, management or one of the sciences. And then you find to your horror that you have to do some accounting. Why?

OK, we'll try to explain. You probably have a vague idea that accounting has something to do with balance sheets and profits and tax and, er, *stuff* but you are certainly not sure what that has to do with the subject you're studying. And you resent it.

Right. Now accounting is basically about collecting information and letting people who need it have it, like shareholders and managers. Perhaps just like you hope to be. 'So what?' you might well ask. 'If I need it or want it I'll just ask the accountants to get it for me.' That's fine, but if you were a manager would you really be quite happy to accept *all* that the accountants gave you? Would you know what it meant, how reliable it was and what you were supposed to do with it? We suspect that if you really think about the repercussions of *not* questioning what your accountants gave you, you would

be (to say the least) a little unhappy. Maybe even a bit worried, especially if you were legally responsible for it all.

The point we are making is that accountants provide a service for other people. Most accountants are probably highly qualified, experienced and good at their job, but as accountants they should not take the *decisions*. That is the manager's job – it could be your job and you will know much more about your business than any accountant. Rest assured that there is no doubt that you will be able to make even *better* decisions (a) if you have some knowledge and some understanding of the nature of accounting information; and (b) what it can and what it cannot do in helping you plan and control your business.

So in a sentence – if you know something about accounting you will become a *better* manager. By the end of this book you will be well on the way to becoming one.

This first chapter sets the scene for what follows. It is important because it provides you with the necessary background information to enable you to become a better manager.

Nature and purpose

We begin our accounting studies by giving a brief explanation of what accounting is and what it *does*. We will then tell you something of what it *doesn't* do. For our purposes we will use the following definition of accounting:

Accounting is a service provided for those who need information about an entity's financial performance, its assets and its liabilities.

This definition contains a number of features that require some explanation.

- *Service*. Accounting is of assistance to other people – if nobody wanted the service there would be no such thing as accounting.
- *Information*. The information traditionally collected by accountants is restricted to what can be quantified and translated into monetary terms.
- *Entity*. An entity is a jargon term used by accountants to describe any type of organization, e.g. a person running his (or her) own business or a company.
- *Financial performance*. The financial performance is usually judged by matching incomes received with expenditure incurred over a period of time (usually one year).
- *Assets*. In accounting an asset is regarded as being something that will result in a future economic benefit as a result of a past event. For example, the purchase of plant and machinery will provide a benefit over very many years and thereby help the entity generate income in those years.
- *Liabilities*. A liability in accounting is defined as an obligation arising from a past event. For example, you may have bought some furniture but you don't have to start paying for it until next year. So for the time being, what you owe is a debt or an obligation, i.e. a liability.

The above summary shows that accounting information is somewhat restricted:

- It relates to only one entity.
- It has to be quantifiable.
- It must be capable of being converted into monetary terms.
- It relates to an arbitrary period of time.

- A distinction is made between economic benefits that relate to past, current and future periods.

Non-accountants are often surprised when they realize that accounting information is restricted in such ways. This gives rise to what is sometimes called the *expectations gap*, i.e. when users expect accounting to do more than it can.

The expectations gap often causes considerable misunderstanding between accountants and the public, especially when an ‘accounting scandal’ erupts from time to time. Such scandals are often the result of genuine accounting problems but the public tend to think that they can all be put down to fraud. This was especially so in the early 2000s when there was a great many accounting scandals. The best known one in recent times involved an American company called Enron. Its problems were caused mainly by fraud but some questionable accounting practices probably made it easier to perpetrate the fraud.

We now move on to give you a review of the historical development of accounting. We do so in the next section.

Activity 1.1

Look up the definition of accounting in three different dictionaries. Copy the definitions into your notebook. Then frame your own definition based on the information that you have extracted from your dictionaries.

Historical development

The word *account* in everyday language is often used as a substitute for an *explanation* or a *report* of certain actions or events. If you are an employee, for example, you may have to explain to your employer just how you have been spending your time, or if you are a manager you may have to report to the owner on how the business is doing. In order to explain or to report, you will, of course, have to remember what you were doing or what happened. As it is not always easy to remember, you may need to keep some written record. In effect, such records can be said to provide the basis of a rudimentary accounting system.

In a primitive sense, man has always been involved in some form of accounting. It may have gone no further than a farmer measuring his worth simply by counting the number of cows or sheep that he owned. However, the growth of a monetary system enabled a more sophisticated method to be developed. It then became possible to calculate the increase or decrease in individual wealth over a period of time, and to assess whether a farmer with perhaps ten cows and fifty sheep was wealthier than one who had sixty pigs. Figure 1.1 illustrates just how difficult it would be to assess the wealth of a farmer in a non-monetary system.

Even with the growth of a monetary system, it took a very long time for formal documentary systems to become commonplace, although it is possible to trace the origins of modern book-keeping back to at least the twelfth century. We know that from about that time, traders began to adopt a system of recording information called *double-entry book-keeping*. By the end of the fifteenth century, double-entry book-keeping was widely used in Venice and the surrounding areas (the first-known book on the subject was published in 1494 by an Italian mathematician called Pacioli). Modern book-keeping systems are still based on principles established in the fifteenth century, although they have had to be adapted to suit modern conditions.

His possessions	A year ago	Now	Change
Cows	●●●●●●●●●●	●●●●●●●●●●●●●●	+5
Hens [● = 10]	●●●●●●●●●●	●●●●●●●●	-30
Pigs	●●●●●●	●●●●	-2
Sheep [● = 10]	●●●●●	●●●●●●●●	+20
Land [● = 1 acre]	●●●●	●●●●	no change
Cottage	●	●	no change
Carts	●●●	●	-2
Ploughs	●	●●	+1

Figure 1.1 Accounting for a farmer's wealth

There are two main reasons why a recording system devised in medieval times has lasted for so long:

- It provides an accurate record of what has happened to a business over a given period of time.
- Information extracted from the system can help the owner or the manager to operate the business much more effectively.

In essence, the system provides the answers to three basic questions that both owners and managers want to know. They are as follows.

- What profit has the business made?
- How much does the business owe?
- How much is owed to it?

These three questions are illustrated in pictorial form in Figure 1.2.

The medieval system dealt largely with simple agricultural and trading entities. In the eighteenth century, however, the UK underwent an *Industrial Revolution*. Economic activity gradually moved away from growing things to making or manufacturing them. In the early days of the Industrial Revolution managers had to depend upon the type of information supplied to the owners. The owners' need was for *financial* purposes, i.e. to calculate how much profit they had made and how much they owed and what was owed to them. Financial information was prepared infrequently (perhaps only once a year) and then not in any great detail. Managers needed information largely for *costing* purposes, so they could work out the cost of making individual products. The information required needed to be in much more detail and prepared much more frequently.

As a result of the different information needs of owners and managers, separate accounting systems were developed. However, as much of the basic data were common to both systems they were gradually brought together. It would be rare now to find any entity that had a separate financial accounting system and a separate costing system.

Another change in more recent years is that it is possible to identify more than two user groups. Besides owners and managers, information may also now be required by other users such as creditors, employees, the government and investors.

While accounting gradually evolved into two main branches in the late nineteenth century (financial accounting and cost accounting), there were additional developments in the twentieth century. We examine the structure of accounting as it is today in the next section.

Owed/ owned	A year ago	Now	Better or worse off now?
Animals owned	1 cow	2 cows	Better
Owed to jim	50 kilos of barley	100 kilos of barley	Worse
Due from Hetty	4 gross eggs	3 gross eggs	Worse
Taking everything into account			?

Figure 1.2 An owner's vital questions

Activity 1.2

Complete the following sentences:

- The word _____ in everyday language means an explanation or a report.
- Traders in the fifteenth century began to adopt a system of _____ to record information.
- The owners of a business want to know how much _____ a business has made.
- An _____ is a term used to describe any type of organization.
- In the eighteenth century the United Kingdom underwent an _____.

Branches

News clip

Among the top 100

A new survey shows that more than half the chief executives of companies in the FTSE 100 share index have a strong financial background in accounting, banking or finance. It appears that a strong background in such sectors is the best way to 'fast track' to the top jobs in UK business.

Source: Adapted from Robert Half International, 26 March 2009.

The work that accountants now undertake ranges far beyond that of simply preparing financial and cost statements. It is possible to identify at least six main branches of accounting and a number of important sub-branches. We will deal with each of them broadly in the order that they have developed over the last 100 years, i.e. financial accounting, management accounting, auditing, taxation, financial management, and bankruptcy and liquidation. You will see from Figure 1.3 how they all fit together.

Financial accounting

Until about the middle of the nineteenth century the nature, purpose and development of accounting described in the last two sections was mainly about the type of accounting that we would now describe as *financial* accounting. We do not, therefore, need to add much more to our outline except to give you a more formal definition of financial accounting. We will adopt that used by the Chartered Institute of Management Accountants (CIMA). It is as follows:

Classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation, by means of income statements, balance sheets and cash flow statements, during and at the end of an accounting period. (CIMA, Official Terminology, 2005)

‘Concepts, principles, accounting standards and legal requirements’ are the rules and regulations that govern accounting. We shall be dealing with them in Chapter 2. ‘Income statements, balance sheets and cash flow statements’ are dealt with in Part 2 of this book. But in brief, an income statement is a summary of what profit or loss you might have made over a period of time. A balance sheet is a summary of what you own and what you are owed at the end of that time, and a cash flow statement is a summary of what cash you have received and what cash you have paid in that particular period. Income statements (or profit and loss accounts), balance sheets and cash flow statements are known collectively as the *financial statements*.

A distinction is sometimes made between *financial accounting* and *financial reporting*. We do so in this book mainly for practical reasons in order to break the information down into manageable parts. *Financial accounting* may be regarded as being the accounting process that ends with the preparation of the financial statements. *Financial reporting* is the process of analysing, communicating and supplementing the information included in the financial statements to those users who either need it or want it.

Book-keeping

An important sub-branch of financial accounting is *book-keeping*. Indeed, book-keeping may be regarded as the foundation on which the entire discipline of accounting is built. It is a mechanical task involving the collection of basic financial data. The data are entered in special records known as *books of account* and they are then extracted in the form of a *trial balance*. The trial balance enables the financial statements to be prepared. The CIMA definition of book-keeping is:

Recording of monetary transactions, appropriately classified, in the financial records of an entity. (CIMA, Official Terminology, 2005)

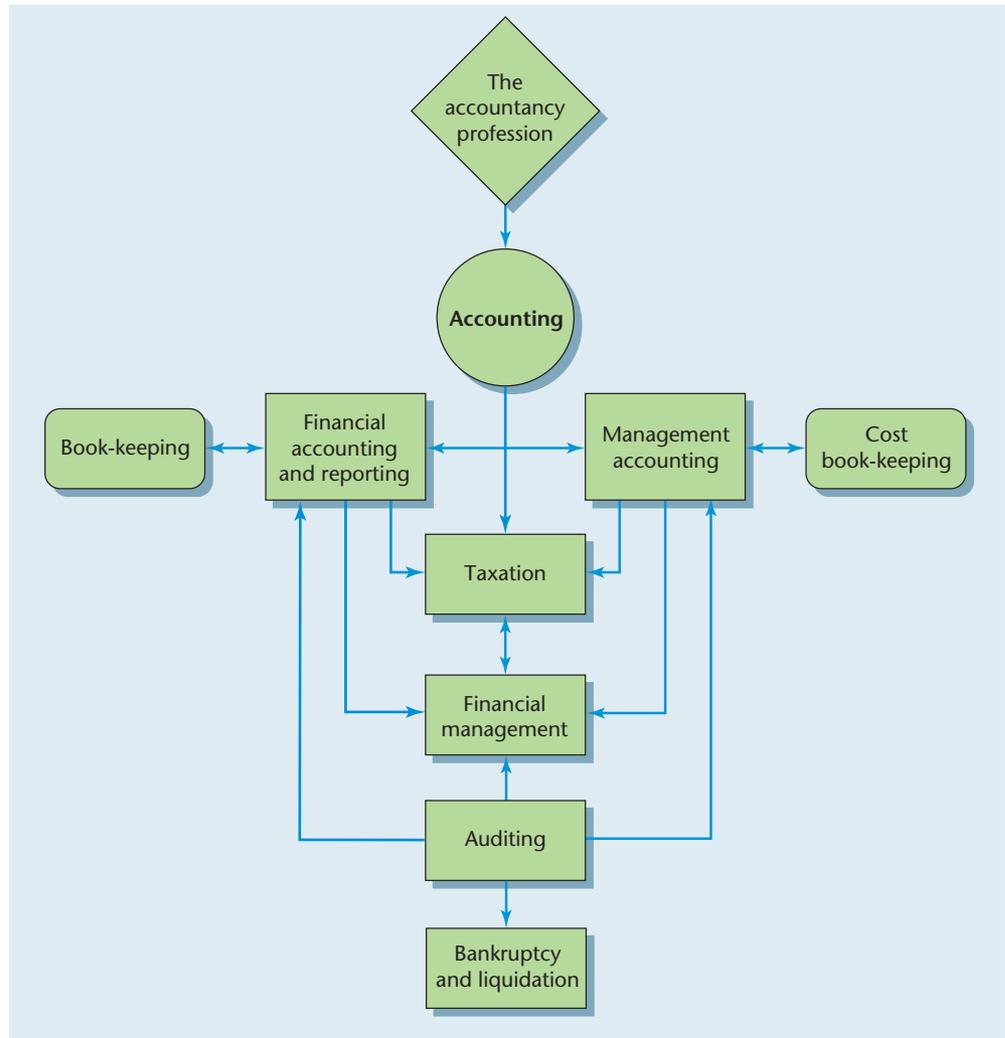


Figure 1.3 The main branches of accounting

Management accounting

Management accounting has grown out of nineteenth century financial accounting. The CIMA definition is:

The application of the principles of accounting and financial management to create, protect, preserve and increase value for the stakeholders of for-profit and not-for-profit enterprises in the public and private sectors. (CIMA, Official Terminology, 2005)

This definition is accompanied by a statement explaining that:

Management accounting is an integral part of management. It requires the identification, generation, presentation, interpretation and use of relevant information to:

There then follows a list of various functions of management accounting. The list includes strategy development, planning, control, funding, governance, and information supply.

Cost book-keeping

CIMA does not give a specific definition of cost book-keeping but it does define the verb 'to cost':

To ascertain the cost of a specified thing or activity. (CIMA, Official Terminology, 2005)

So by combining this definition of 'cost' with the definition of 'book-keeping' given earlier, we can arrive at a suitable working definition of cost book-keeping:

The recording of monetary transactions, appropriately classified, in the financial records of an entity in order to ascertain the cost of a specified thing or activity.

Auditing

News clip

Help somebody

Auditors are apparently easy scapegoats when there is a financial scandal. This is put down to what stakeholders expect and what auditors are actually paid to do. Steps taken in recent years to make the

position clear do not appear to have been successful. The author of this article appears to think that it may not be possible to do much about people who make 'ill-informed comments'.

Source: Adapted from *Accountancy Age*, 13 November 2008, p. 3.

CIMA defines an audit as being:

Systematic examination of the activities and status of an entity, based primarily on investigation and analysis of its systems, controls and records. (CIMA, Official Terminology, 2005)

So auditing is the process of carrying out that investigation.

Not all entities have their accounts audited but it is a legal requirement for some entities, e.g. large limited liability companies.

Auditors are usually trained accountants who specialize in checking whether the accounts are credible, i.e. whether they can be believed. There are two main types of auditor.

- 1 **External auditors.** External auditors are entirely independent. They come from outside the entity, they are not employees of it and they do not answer to its managers. When they have finished their work they present their findings to the owners. They do not report to any of its managers.

External auditors formally report to the owners on whether the financial accounts represent what is called ‘a true and fair view’ of the entity’s affairs. They may do some detailed checking of its records in order to be able to come to such a view but normally they would be selective. If they are then satisfied they will be able to report their findings to the owners. The public often believe that the job of an auditor is to discover whether any fraud has taken place. This is not so. This misconceived perception forms part of the expectations gap discussed earlier in the chapter.

- 2 *Internal auditors.* Some entities employ internal auditors. Internal auditors are appointed by the managers of the entity; they are employees of the entity and they answer to its management. Internal auditors perform routine tasks and undertake some detailed checking of the entity’s accounting procedures. Their task may also go beyond the financial accounts e.g. they may examine the planning and control procedures and conduct ‘value-for-money’ tests.

External auditors and internal auditors usually work together very closely. Nevertheless, they do have separate roles and responsibilities. External auditors have always to remember that internal auditors are employees of the entity and they may be subject to the same pressures as other employees such as job security, pay and promotion prospects. But even external auditors are not completely independent. In the case of a public company, for example, the directors *recommend* the appointment of the company’s auditors to the shareholders. As the shareholders usually accept whom the directors suggest, the directors are in a strong position if they want to dismiss the auditors. The auditors can then appeal directly to the shareholders but the shareholders usually back the directors.

Taxation

Taxation is a highly complex and technical branch of accounting. Those accountants who are involved in tax work are responsible for calculating the amount of tax payable both by business entities and by individuals. It is not necessary for anybody or any entity to pay more tax than is required by the law. It is, therefore, perfectly legitimate to search out all legal means of minimizing the amount of tax that might be demanded by the government. This is known as *tax avoidance*. The non-declaration of sources of income on which tax might be payable is known as *tax evasion*. Tax evasion is a very serious offence and it could lead to a long prison sentence. The borderline between tax avoidance and tax evasion is a narrow one and tax accountants have to steer a fine line between what is lawful and what is not.

Financial management

Financial management is a relatively new branch of accounting that has grown rapidly over the last 30 years. Financial managers are responsible for setting financial objectives, making plans based on those objectives, obtaining the finance needed to achieve the plans and generally safeguarding all the financial resources of the entity. They are much more likely to be involved in the general management of an entity than are other types of accountant. Their responsibilities involve them in drawing on a much wider range of disciplines (such as economics and mathematics) than is traditional in other branches of accounting and they use more non-financial and more qualitative data.

Bankruptcy and liquidation

One other highly specialist branch of accounting that you may sometimes read about is that connected with *insolvency*, i.e. bankruptcies and liquidation. This branch of accounting is extremely specialized. It has a long history but it is not one that most accountants will have had either anything to do with or indeed know much about.

Bankruptcy is a formal legal procedure. The term is applied to individuals when their financial affairs are so serious that they have to be given some form of legal protection from their creditors. The term *liquidation* is usually applied to a company when it gets into serious financial difficulties and its affairs have to be ‘wound up’, i.e. arrangements made for it to go out of existence in an orderly fashion.

Companies do not necessarily go immediately into liquidation if they get into financial difficulties. An attempt will usually be made either to rescue them or to protect certain types of creditors. In these situations, accountants sometimes act as *administrators*. Their appointment freezes creditors’ rights. This prevents the company from being put into liquidation during a period when the administrators are attempting to manage the company. By contrast, *receivers* may be appointed on behalf of loan creditors. The creditors’ loans may be secured on certain property. The receivers will try to obtain the income from that property or they may attempt to sell it.

We hope that you never come into contact with insolvency practitioners and so we will move on swiftly to have a look at another topic, namely the structure of the accountancy profession.

Activity 1.3

State whether each of the following statements is true or false:

- | | |
|--|-------------------|
| (a) An auditor’s job is to find out whether a fraud has taken place. | <i>True/false</i> |
| (b) Management accounts are required by law. | <i>True/false</i> |
| (c) Tax avoidance is lawful. | <i>True/false</i> |
| (d) A balance sheet is a list of assets and liabilities. | <i>True/false</i> |
| (e) Companies have to go into liquidation if they get into financial difficulties. | <i>True/false</i> |

The accountancy profession

News clip

Not up to standard

The President of the Association of Chartered Certified Accountants believes that there are a number of people out there who call themselves accountants even though they are not professionally qualified. They are perfectly entitled to do so but he argues that an awful lot of them do not measure up to the sort of standards that clients would reasonably expect from an ‘accountant’.

Source: Adapted from *Accountancy Age*, 31 July 2007.

There are six major accountancy bodies operating in the United Kingdom. They are:

- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants in Ireland (ICAI)
- Institute of Chartered Accountants of Scotland (ICAS)
- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Management Accountants (CIMA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)

The Irish Institute (ICAI) is included in the UK list because it has a strong influence in Northern Ireland.

Although all six major professional accountancy bodies now have a Royal Charter, it is still customary to refer only to members of ICAEW, ICAI, and ICAS as *chartered accountants* (CAs). Such chartered accountants have usually had to undergo a period of training in a practising office, i.e. one that offers accounting services directly to the public. This distinguishes them from members of the other three bodies because their auditing experience enables them to become approved (in the legal sense) auditors. Much practice work is involved, not just in auditing but also in tax. After qualifying, many CAs go to work in commerce or industry. ACCA members may also obtain their training in practice but relevant experience elsewhere counts towards their qualification (apart from in auditing). CIMA members usually train and work in industry, while CIPFA members specialize almost exclusively in central and local government.

Apart from the six major bodies, there are a number of important (although far less well-known) smaller accountancy associations and societies, e.g. the Association of Certified Public Accountants, the Institute of Cost and Executive Accountants and the Institute of Financial Accountants. Such bodies offer some form of accountancy qualification but they have not yet managed to achieve the status or the prestige of the six major bodies. They are usually referred to as *secondary bodies*.

There is also another very important accountancy body, the Association of Accounting Technicians (AAT). The association was formed in 1980 as a professional organization especially for those accountants who *assist* qualified accountants in preparing accounting information. In order to become an accounting technician, it is necessary to take (or be exempt from) the association's examinations. The AAT's examinations are less technical and perhaps more practical than those of the six major bodies but they are not easy.

The overall organization of the accountancy profession is shown in Figure 1.4.

Activity 1.4

Which is the odd one out among the following professional accountancy bodies? Give your reasons.

- (a) AAT
- (b) CIMA
- (c) CIPFA
- (d) ICAEW

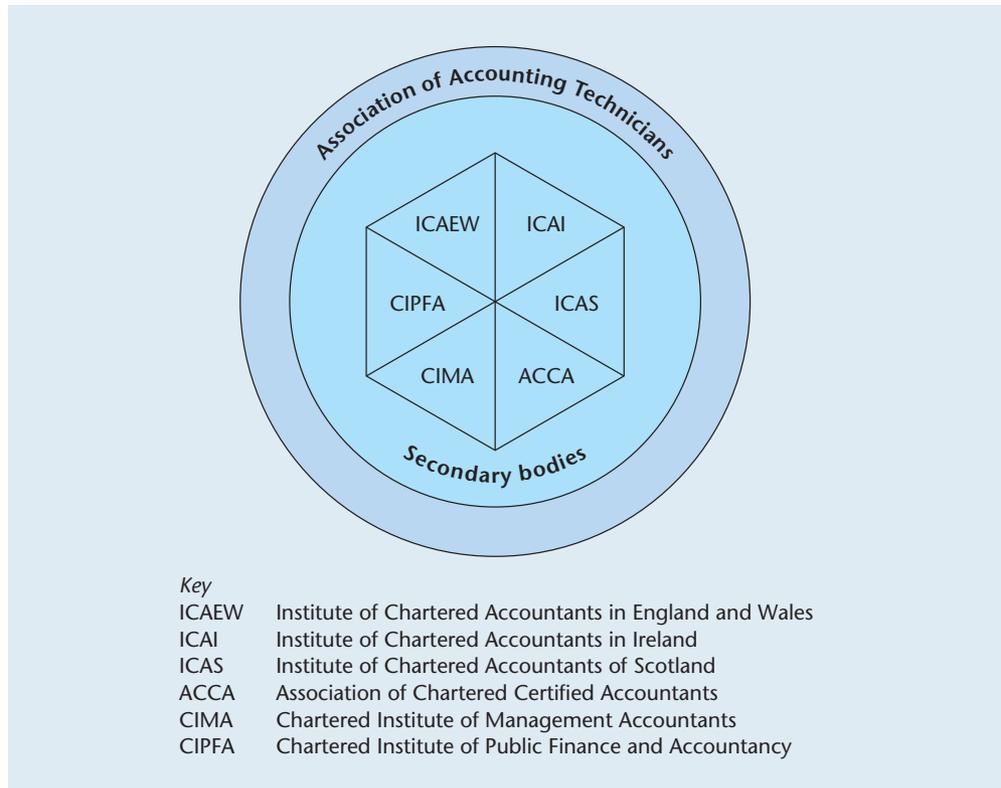


Figure 1.4 Organization of the UK accountancy profession

Public and private entities

The main aim of this section is to introduce you to the two main types of entities with which we shall be primarily concerned in this book – *sole traders* and *companies*. Before we can do this we need to explain a little bit about the economic structure of the United Kingdom.

In order to simplify our analysis, we will classify the UK economy into two broad groupings – the *profit-making sector* and the *not-for-profit sector*. Within each of these sectors it is then possible to distinguish a number of different types of entities (see Figure 1.5). We begin by examining the profit-making sector.

The profit-making sector

The profit-making sector is extremely diverse, but it is possible to recognize three major subdivisions. These are the manufacturing sector, the trading sector and the service sector.

The *manufacturing sector* is involved in purchasing raw materials and component parts, converting (or incorporating) them into finished goods and then selling them to customers. Examples of manufacturing enterprises include the chemicals, glass, iron and steel, and textile industries.

The *trading sector* purchases finished goods and then sells them to their customers without any further major conversion work normally being done on them. Trading

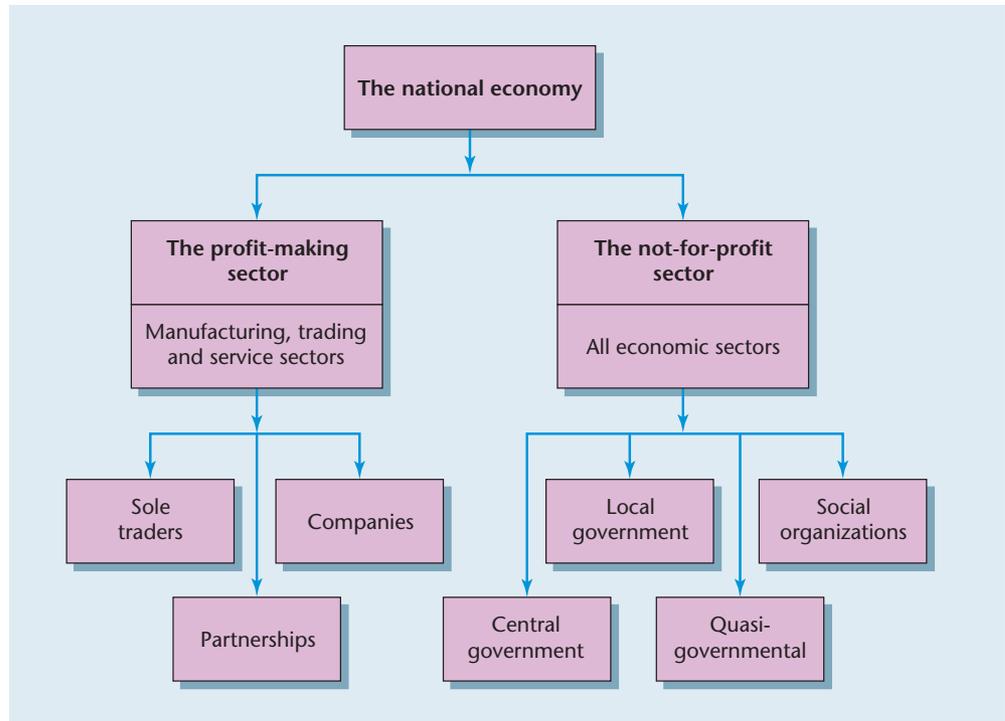


Figure 1.5 Public and private entities

enterprises are found in the retailing and wholesaling sectors. The sector includes entities such as builders' merchants, shops and supermarkets.

The *service sector* provides advice or assistance to customers or clients, e.g. hairdressing, legal and travel services. Unlike the manufacturing and trading sectors, the service sector does not usually deal in physical or tangible goods. There are some exceptions: the hotel and restaurant trade, for example, is normally classed as part of the service sector even though it provides major tangible services such as accommodation, food and drink.

The accounting systems required of manufacturing, trading and service sector entities are all slightly different, although they are based on similar principles and procedures. Manufacturing entity accounts are the most complex, trading entity accounts are fairly straightforward, while service entity accounts are usually quite simple.

Until about 30 years ago the manufacturing sector was of major significance in the UK. It is now much less important and the service sector has largely taken its place.

The products or the services offered by the manufacturing, trading or service sectors may be different but the way that they are organized is still very similar. Within each sector you will find three main types of entities: *sole traders*, *partnerships* and *companies*. The basic distinction between them reflects their ownership, how they are financed and what the law requires of them.

Sole traders

The term 'sole trader' is rather misleading for two reasons:

- 'sole' does not necessarily mean that only one person is involved in the entity;
- manufacturing and service entities may also be organized as sole traders.

The term really reflects the *ownership* of the entity; the main requirement is that only one individual should own it. The owner would normally also be the main source of finance and he would be expected to play a reasonably active part in its management.

Sole trader entities usually operate on a very informal basis and some private matters relating to the owner are often indistinguishable from those of the business. Sole trader accounts are fairly straightforward and there is no specific legislation that covers the accounting arrangements. We shall be using sole trader accounts in Chapters 3 and 4 in order to demonstrate some basic accounting techniques.

Partnerships

A partnership entity is very similar to a sole trader entity except that there must be at least *two owners* of the business. Partnerships often grow out of a sole trader entity, perhaps because more money needs to be put into the business or because the sole trader needs some help. But it is also quite common for a new business to begin as a partnership, e.g. when some friends get together to start a home-decorating service or to form a car-repair business.

The partners should agree among themselves how much money they will each put into the business, what jobs they will do, how many hours they will work, and how the profits and losses will be shared. In the absence of any agreement (whether formal or informal), partnerships in the United Kingdom are covered by the Partnership Act 1890.

Since 2001 there has been a new type of partnership called a *Limited Liability Partnership* (LLP). An LLP has a separate legal personality from that of its owners (like a company) and so it protects the partners from personal bankruptcy.

Partnership accounts are very similar to those of sole traders and we shall not be dealing with them in this book.

Companies

A company is another different type of business organization. There are many different forms of companies but basically a company is an entity that has a separate existence from that of its owners. We are going to be primarily concerned with *limited liability companies*. The term 'limited liability' means that the owners of such companies are required to finance the business only up to an agreed amount. Once they have contributed that amount they cannot be called on to contribute any more, even if the company gets into financial difficulties.

Activity 1.5

Insert in the following table one advantage and one disadvantage of operating a business as (a) a sole trader, (b) a partnership, and (c) a limited liability company.

Type of entity	Advantage	Disadvantage
(a) Sole trader		
(b) Partnership		
(c) Limited liability company		

As there is a risk that limited liability companies may not be able to pay what they owe, Parliament has had to give some legal protection to those parties who may become involved with them. The details are contained within the Companies Act 2006. We will be dealing with company accounts in some detail in Chapters 5 to 9.

The not-for-profit sector

By 'not-for-profit' we mean those entities whose primary purpose is to provide a service to the public rather than to make a profit. We will consider this sector under four main headings: central government, local government, quasi-governmental bodies and social organizations.

Within the three governmental groups, there is a wide variety of different types of entity. Governmental accounting is extremely specialized and it would require a book of its own to deal with it. We shall not be covering it in any depth.

Central government

Central government is responsible for services such as macro-economic policy, education, defence, foreign affairs, health and social security. These responsibilities are directly controlled by Cabinet ministers who answer to Parliament at Westminster for their actions. In 1999, some of these central government responsibilities were 'devolved', i.e. they became the direct responsibility of elected bodies in Northern Ireland, Scotland and Wales.

Local government

Devolution is not new in the UK. For well over a century central government has also devolved many of its responsibilities to local authorities, i.e. smaller units of authority that have some geographical and community coherence. Councillors are elected by the local community. They have responsibility for those services that central government has delegated or devolved, e.g. the local administration of education, housing, the police and social services.

Quasi-governmental bodies

Central government also operates indirectly through quasi-governmental bodies such as colleges and universities and the British Broadcasting Corporation (BBC). Such bodies are nominally independent of central government, even though their main funds normally come from central government and their senior managers may be appointed by government ministers.

Activity 1.6

Into which category may the following functions/services best be placed? Tick the appropriate column.

Function/service	Central government	Local government	Quasi-governmental	Social organization
1 Broadcasting				
2 Famine relief				
3 Postal deliveries				
4 Social services				
5 Work and pensions				

Social organizations

This category covers a wide range of cultural, educational, recreational and social bodies. Some are formally constituted and professionally managed, such as national and international charities, while others are local organizations run by volunteers on a part-time basis, e.g. bridge and rugby clubs.



Questions you should ask

This is an introductory chapter so at this stage there are not many technical questions that you might want to ask. Your questions are more likely to be about the accountants themselves and the organization of the accounting function. The following is a sample of the types of general question that as a non-accountant you might like to put to your own entity's accountants.

- How many accountants do we employ?
- How many are members of each of the six main professional accounting bodies?
- How is the accounting function organized?
- What can the accountants do to help me do a better job?
- What information do the accountants want from me?
- When is it wanted?
- What is it to be used for?
- What do I get back in return?
- What am I supposed to do with it?
- In future how can managers and accountants become a better team?

Conclusion

The main aim of this chapter has been to introduce non-accountants to the world of accounting. The chapter has stressed that the main purpose of accounting is to provide financial information to those parties that need it.

Information must be useful if it is to have any purpose but as a non-accountant you may feel reluctant to question any accounting information that lands on your desk. You may also not understand why the accountant is always asking you irrelevant questions and so you respond with any old nonsense. You then perhaps feel a bit guilty and a little frustrated; you would like to know more but you dare not ask. We hope that by the time you have worked your way through this book, you will have the confidence to ask and, furthermore, that you will understand the answer. Good luck!

Now that the world of accounting has been outlined, we can turn to more detailed subject matter. The first task is to learn the basic rules and regulations governing accounting. These are covered in the next chapter.

Key points

- 1 To account for something means to give an explanation or to report on it.
- 2 Owners of an entity want to know (a) how well it is doing, (b) what it owes, and (c) how much is owed to it.
- 3 Accounting is important for non-accountants because (a) they must make sure their own entity complies with any legal requirements, and (b) an accounting system can provide them with information that will help them do a better job.
- 4 There are seven main user groups: investors, lenders, suppliers and other trade creditors, employees, customers, governments and their agencies, and the public.
- 5 The six main branches of accounting are auditing, financial accounting and reporting, financial management, management accounting, taxation, and bankruptcy and liquidation.
- 6 Sub-branches of accounting include book-keeping (a function of financial accounting) and cost book-keeping (a function of management accounting).
- 7 There are six major professional accountancy bodies in the UK: the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Ireland, the Institute of Chartered Accountants of Scotland, the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants and the Chartered Institute of Public Finance and Accountancy.
- 8 The Association of Accounting Technicians is an important secondary accountancy body. Its members primarily provide technical assistance to professionally qualified accountants although they themselves are often in senior positions.
- 9 There are two economic sectors within the UK economy: the profit-making sector and the not-for-profit sector. Within each sector business operations can be classified into manufacturing, trading or service entities. Individual entities may then be organized as sole traders, partnerships or companies.
- 10 The not-for-profit sector includes central government and local government operations, quasi-governmental bodies and social organizations. Governmental operations are extremely complex and the accounting requirements are highly specialized. Social organizations are also diverse. They include various associations, charities, clubs, societies and sundry voluntary organizations. Their accounting requirements are similar to those in the profit-making sector.

Check your learning

The answers to these questions can be found within the text.

- 1 What is accounting?
- 2 What is meant by an 'entity'?
- 3 Give three reasons why accounting is an important subject for non-accountants to study.
- 4 What is meant by the word 'account'?
- 5 What name is given to the system that accountants use to record information?
- 6 What are the three basic questions that the owner of a business might ask?
- 7 What economic event happened in the UK during the eighteenth century?
- 8 What happened to the ownership and management of businesses during the nineteenth century?
- 9 Why did managers in nineteenth century industrial entities require more detailed information?
- 10 List three user groups of accounting information.
- 11 What are the six main branches of accounting?
- 12 Of which main branch of accounting does cost accounting form a part?
- 13 What is the difference between 'book-keeping' and 'cost book-keeping'?
- 14 Explain the difference between 'bankruptcy' and 'liquidation'.
- 15 List the six major UK professional accountancy bodies.
- 16 What function does the *Association of Accounting Technicians* fill?
- 17 Name three types of entity that fall within the profit-making sector of the UK.
- 18 What is meant by 'limited liability'?
- 19 What role do local authorities play in the not-for-profit sector?
- 20 Name one quasi-governmental body.

News story quiz

Remember the news story at the beginning of this chapter? Go back to that story and re-read it before answering the following questions.

In a sense this is an old story: our perceptions of ourselves are quite different from what other people think of us. It is often quite a shock to find that out. In this case the story is specifically about accountants, and it is no surprise to find that there is quite a big perception gap.

Questions

- 1 Have you seen the *Monty Python* 'Lion Tamer' sketch?
- 2 What is your perception of an accountant?
- 3 Where does your perception of an accountant come from?

- 4 Do you think that the accountancy profession is a dynamic one?
- 5 What immediately springs to mind when/if you think of the accountancy profession?

Tutorial questions

The answers to questions marked with an asterisk can be found in Appendix 4.

- 1.1 'Accountants stifle managerial initiative and enterprise.' Discuss.
- 1.2 Do you think that auditors should be responsible for detecting fraud?
- 1.3 The following statement was made by a student: 'I cannot understand why accountants have such a high status and why they have so much influence.' How would you respond to such assertions?
- 1.4* Why should a non-accountant study accounting?
- 1.5* Describe two main purposes of accounting.
- 1.6* What statutory obligations require a public limited company to prepare management accounts?
- 1.7 State briefly the main reasons why a company may employ a team of accountants.
- 1.8* What statutory obligations require limited liability companies to prepare financial accounts?
- 1.9 Why does a limited liability company have to engage a firm of external auditors?
- 1.10 Assume that you are a personnel officer in a manufacturing company, and that one of your employees is a young engineering manager called Joseph Sykes. Joseph has been chosen to attend the local university's business school to study for a diploma in management. Joseph is reluctant to attend the course because he will have to study accounting. As an engineer he thinks that it will be a waste of time for him to study such a subject.
Required:
Draft an internal memorandum addressed to Joseph explaining why it would be of benefit to him to study accounting.
- 1.11 Clare Wong spends a lot of her time working for a large local charity. The charity has grown enormously in recent years and the trustees have been advised to overhaul their accounting procedures. This would involve its workers (most of whom are voluntary) in more book-keeping and there is a great deal of resistance to this move. The staff have said that they are there to help the needy and not to get involved in book-keeping.
Required:
As the financial consultant to the charity, prepare some notes that you could use in speaking to the voluntary workers in order to try to persuade them to accept the new proposals.

Further practice questions, study material and links to relevant sites on the World Wide Web can be found on the website that accompanies this book. The site can be found at www.pearsoned.co.uk/dyson