

fifth edition

BUSINESS ACCOUNTING AND FINANCE

CATHERINE GOWTHORPE



 CENGAGE

Australia • Brazil • Canada • Mexico • Singapore • United Kingdom • United States

Brief contents

- 1 The role of accounting in business 1

SECTION I Financial Accounting and Reporting 27

- 2 The statement of financial position 28
- 3 The statement of profit or loss 48
- 4 Applying accounting conventions 68
- 5 Depreciation and amortization 94
- 6 The statement of cash flows 112
- 7 Financial reporting by limited companies 138
- 8 Understanding financial reports: trend analysis 164
- 9 Understanding financial reports: using accounting ratios 181

SECTION II Management Accounting 211

- 10 Management and cost accounting information 212
- 11 Costing: overview and basic techniques 221
- 12 Costing: accounting for overheads 236
- 13 Pricing 257
- 14 Marginal costing and decision making 272
- 15 Capital investment decisions 297
- 16 Budgets 319
- 17 Accounting for control 342
- 18 Performance measurement 364

SECTION III Financial Management 383

- 19 The management of working capital 384
- 20 Financing the business 403

Answers to self-test questions 420

Answers to exercises 441

Glossary 505

Index 511

Contents

Figures xi

Preface to the fifth edition xiii

1 The role of accounting in business 1

Aim of the chapter 1

Learning outcomes 1

Introduction 1

1.0.1 Special Notes for the Suspicious 1

1.0.2 Legal and Reporting Requirements 2

Content of this Chapter 2

1.1 Forms of Business Organization 2

1.1.1 Sole Trader Businesses 3

1.1.2 Partnerships 3

1.1.3 Limited Companies 4

1.2 Sole Traders, Partnerships and Limited Companies

Contrasted 5

1.2.1 Sole Trader – Advantages 5

1.2.2 Sole Trader – Drawbacks 6

1.2.3 Partnership – Advantages 6

1.2.4 Partnership – Drawbacks 6

1.2.5 Limited Company – Advantages 6

1.2.6 Limited Company – Drawbacks 6

1.3 Finance for Business 7

1.3.1 Existing Resources 7

1.3.2 Retained Profits 8

1.3.3 Borrowing Money 8

1.3.4 Leasing and Hire Purchase 8

1.3.5 Grant Finance 9

1.3.6 Financing Companies: Share Issues 9

1.3.7 Financing Companies: Venture Capital 9

1.4 Short-, Medium- and Long-term Finance 9

1.5 Fundamentals of Taxation 10

1.5.1 Income Taxes (Personal Taxation) 10

1.5.2 Corporation Tax 10

1.5.3 Capital Gains Tax 10

1.5.4 Value Added Tax 10

1.6 The Need for Accounting Information 11

1.6.1 Sole Trader 11

1.6.2 Partnership 12

1.6.3 Limited Company 13

1.7 Users of Accounting Information 15

1.7.1 Access to Information 16

1.8 Characteristics of Useful Financial Information 16

1.9 Financial Accounting and Management Accounting 16

1.10 The Role of the Accountant in Business

Organizations 18

1.10.1 The Accounting Profession 18

1.11 Accounting Ethics 18

1.11.1 Ethical Responsibilities for Accountants 18

1.11.2 The Ethical Code: Ethical Principles 19

1.11.3 The Ethical Code: Threats to the Ethical Principles 19

1.11.4 Consequences of Ethical Failures 20

1.11.5 Ethics and Law 21

1.11.6 Business Ethics 21

1.12 Organization of the Remainder of this Book 21

Chapter Summary 22

Internet Resources 22

Exercises: Answers at the End of the Book 23

Exercises: Answers Available on the Instructors' Section of the Book's Website 25

SECTION I Financial Accounting and Reporting 27

2 The statement of financial position 28

Aim of the chapter 28

Learning outcomes 28

Introduction 28

2.1 Basics of Business Accounting: The Three Principal Financial Statements 28

2.2 The Statement of Financial Position: Definitions of Elements 31

2.2.1 Assets 31

2.2.2 Liabilities 31

2.2.3 Capital 31

2.2.4 Terminology 31

2.3 The Accounting Equation	32
2.3.1 The Statement of Financial Position Format	32
2.4 Drawing up a Statement of Financial Position	34
2.4.1 Changing the Value of Capital	37
2.5 More Practice with Statements of Financial Position	37
2.6 Communicating Meaning: What does the Statement of Financial Position Say?	39
2.6.1 Characteristics of Useful Financial Information	40
2.7 Financial Reporting by Large Companies	40
Chapter Summary	41
Internet Resources	41
Exercises: Answers at the End of the Book	42
Exercises: Answers Available on the Instructors' Section of the Book's Website	45

3 The statement of profit or loss 48

Aim of the chapter	48
Learning outcomes	48
Introduction	48
3.1 The Statement of Profit or Loss: Terminology	49
3.2 Categories of Commercial Activity	49
3.3 Statement of Profit or Loss for a Sole Trader	49
3.4 Movements in Inventory	51
3.5 Calculating Cost of Sales	52
3.6 Calculating Net Profit	53
3.6.1 Typical Business Expenses	53
3.7 What does the Statement of Profit or Loss Mean?	54
3.7.1 Gross Profit Analysis	55
3.7.2 Net Profit Analysis	56
3.8 Analyzing Financial Information in Large Companies	56
3.9 Statement of Profit or Loss Accounting in a Service Business	57
3.10 Preparing both the Statement of Profit or Loss and the Statement of Financial Position	58
Chapter Summary	62
Internet Resources	62
Exercises: Answers at the End of the Book	63
Exercises: Answers Available on the Instructors' Section of the Book's Website	66

4 Applying accounting conventions 68

Aim of the chapter	68
Learning outcomes	68
Introduction	68
4.1 Returns of Goods, Discounts and Delivery Charges	68

4.1.1 Returns	69
4.1.2 Discounts	69
4.1.3 Delivery Charges	70
4.1.4 Relevance for Service Businesses	70
4.2 Accounting Conventions	74
4.2.1 Going Concern	74
4.2.2 Recognition	74
4.2.3 Accruals (Matching)	75
4.3 Comprehensive Example: Accruals	76
4.4 Current Asset Measurement: Inventory and Trade Receivables	79
4.4.1 Inventory	79
4.4.2 Trade Receivables	81
Chapter Summary	84
Internet Resources	85
Exercises: Answers at the End of the Book	85
Exercises: Answers Available on the Instructors' Section of the Book's Website	90

5 Depreciation and amortization 94

Aim of the chapter	94
Learning outcomes	94
Introduction	94
5.1 Accounting for the Use of Non-current Assets	94
5.2 Impact of Depreciation on the Financial Statements	96
5.3 Intangible Assets and Amortization	97
5.3.1 What about the Staff?	98
5.4 Accounting for Amortization	99
5.5 Another Method of Depreciation	100
5.6 Land and Buildings	102
5.7 The Role of Judgement in Estimating Depreciation	102
5.8 Sale of a Non-current Asset	103
5.9 Buying and Selling Assets During the Year	104
Chapter Summary	104
Internet Resources	105
Exercises: Answers at the End of the Book	105
Exercises: Answers Available on the Instructors' Section of the Book's Website	109

6 The statement of cash flows 112

Aim of the chapter	112
Learning outcomes	112
Introduction	112
6.1 The Distinction Between Profit and Cash	112

6.2 Preparing a Statement of Cash Flows	114
6.2.1 Preparing a Statement of Cash Flows: A Business Start-up	114
6.3 Direct and Indirect Approaches to Cash Flow	119
6.4 Statements of Cash Flow in an Established Business	120
6.5 The High Profit/No Cash Paradox	125
6.6 Statements of Cash Flow in Large Businesses	128
Chapter Summary	129
Internet Resources	129
Exercises: Answers at the End of the Book	130
Exercises: Answers Available on the Instructors' Section of the Book's Website	133

7 Financial reporting by limited companies 138

Aim of the chapter	138
Learning outcomes	138
Introduction	138
7.1 The Limited Company	138
7.2 Limited Liability	139
7.3 Information Needs of Company Creditors	141
7.4 Information Needs of Company Shareholders	141
7.5 Information Needs of People Other than Shareholders and Creditors	141
7.6 Regulation of Company Accounting and Other Issues	141
7.6.1 Companies Acts	141
7.6.2 Company Formation and Types of Company	142
7.6.3 Company Constitutional Arrangements Including the Issue of Shares	142
7.6.4 Shares	142
7.6.5 Role of Directors	144
7.6.6 Publication and Presentation of Accounting Information	145
7.6.7 The Audit of Companies	146
7.6.8 Accounting Standards	146
7.6.9 International Financial Reporting Standards	146
7.7 Accounting for Limited Companies	147
7.7.1 Components of a Set of Limited Company Accounts	147
7.7.2 Presentation of Accounting Information	148
7.8 Accounting for Listed Companies: Additional Requirements	151
7.8.1 Regulations for Listed Companies	151
7.8.2 The Annual Report for a Listed Company	151
7.9 Accounting for Listed Companies: Non-financial Information	152
7.9.1 Advantages of Publishing Non-financial Information	152

7.9.2 Drawbacks of Publishing Non-financial Information	152
7.9.3 The Strategic Report	152
7.10 Corporate Reporting on the Internet	153
7.11 Corporate Governance	153
7.11.1 What are the Important Issues in Corporate Governance?	154
7.11.2 How Can Good Corporate Governance be Assured?	154
7.11.3 Board Leadership and Company Purpose	155
7.11.4 Division of Responsibilities	155
7.11.5 Composition, Success and Evaluation	156
7.11.6 Audit, Risk and Internal Control	156
7.11.7 Remuneration	156
7.11.8 Reporting	156
7.11.9 Conclusion on Corporate Governance	156
Chapter Summary	157
Internet Resources	157
Exercises: Answers at the End of the Book	158
Exercises: Answers Available on the Instructors' Section of the Book's Website	161

8 Understanding financial reports: trend analysis 164

Aim of the chapter	164
Learning outcomes	164
Introduction	164
8.1 Usefulness of Financial Reports to Various Interest Groups	165
8.1.1 Owners and Investors	165
8.1.2 Potential Investors in a Business	165
8.1.3 Creditors	166
8.2 Analytical Techniques: Changes in Figures	166
8.3 Analytical Techniques: Horizontal and Trend Analysis	167
8.3.1 Some Problems with Horizontal Analysis	168
8.4 Analytical Techniques: Vertical Analysis and Common Size Analysis	169
8.5 Comparing Businesses with each Other	171
8.5.1 Problems in Comparison	171
8.6 Segment Analysis	174
Chapter Summary	175
Internet Resources	176
Exercises: Answers at the End of the Book	176
Exercises: Answers Available on the Instructors' Section of the Book's Website	178

9 Understanding financial reports: using accounting ratios 181

- Aim of the chapter 181
- Learning outcomes 181
- Introduction 181
- 9.1 Financial Ratio Analysis Techniques 181
 - 9.1.1 A Word of Caution about Financial Ratio Analysis 182
- 9.2 Performance Ratios 182
 - 9.2.1 Return on Capital Employed (ROCE) 182
- 9.3 Liquidity Ratios 185
- 9.4 Efficiency Ratios 186
- 9.5 Investor Ratios 190
 - 9.5.1 Market Capitalization 192
- 9.6 Lending Ratios 193
 - 9.6.1 Gearing 193
 - 9.6.2 Interest Cover 193
- 9.7 The Effects of Gearing 194
 - 9.7.1 Why are Ordinary Shareholders Interested in Gearing? 194
- 9.8 Preparing an Analysis of Financial Statements 196
 - 9.8.1 Collecting the Data 196
 - 9.8.2 The Focus of the Analysis 196
 - 9.8.3 The Analysis 197
 - 9.8.4 Limitations of the Analysis 197
- Chapter Summary 198
- Internet Resources 199
- Exercises: Answers at the End of the Book 200
- Exercises: Answers Available on the Instructors' Section of the Book's Website 206

SECTION II

Management Accounting 211

10 Management and cost accounting information 212

- Aim of the chapter 212
- Learning outcomes 212
- Introduction 212
- 10.1 What is Management and Cost Accounting? 212
 - 10.1.1 Characteristics of Management Accounting Information 213
 - 10.1.2 Some Useful Features of Cost and Management Accounting Information 214
- 10.2 Definitions of Management Accounting and Cost Accounting 215

- 10.3 The Management Accounting Process 215
 - 10.3.1 The Objectives of the Organization 216
 - 10.3.2 The Effect of Uncertainty 216
- 10.4 Organization of the Rest of the Book 217
- Chapter Summary 218
- Internet Resources 218
- Exercises: Answers at the End of the Book 218
- Exercises: Answers Available on the Instructors' Section of the Book's Website 219

11 Costing: overview and basic techniques 221

- Aim of the chapter 221
- Learning outcomes 221
- Introduction 221
- 11.1 Costing in Business 221
- 11.2 Product Costing 222
 - 11.2.1 Cost Classification: Product and Period Costs 225
- 11.3 Approaches to Costing 225
 - 11.3.1 Materials Costs 227
 - 11.3.2 Labour Costs 229
- Chapter Summary 231
- Internet Resources 231
- Exercises: Answers at the End of the Book 232
- Exercises: Answers Available on the Instructors' Section of the Book's Website 233

12 Costing: accounting for overheads 236

- Aim of the chapter 236
- Learning outcomes 236
- Introduction 236
- 12.1 Production Overheads: Allocation and Apportionment 237
 - 12.1.1 Allocation to Cost Centres 237
 - 12.1.2 Apportionment to Cost Centres 237
- 12.2 Overhead Absorption 240
 - 12.2.1 Overhead Absorption Rates: Some Other Approaches 242
- 12.3 Costing of Services 243
- 12.4 Costing of Public Sector Services 245
- 12.5 Activity-based Costing (ABC) 245
 - 12.5.1 Principles of ABC 246
 - 12.5.2 Applying ABC in a Manufacturing Business 246
 - 12.5.3 Applying ABC in a Service Industry 249
 - 12.5.4 ABC: Benefits and Problems 249
- Chapter Summary 250
- Internet Resources 250

Exercises: Answers at the End of the Book 250

Exercises: Answers Available on the Instructors' Section
of the Book's Website 253

13 Pricing 257

Aim of the chapter 257

Learning outcomes 257

Introduction 257

13.1 The Relationship Between Price and Quantity 257

13.1.1 Elasticity and Inelasticity 258

13.1.2 Problems in Applying the Economic Model
to the Real World 258

13.2 Competition in the Market 259

13.2.1 Price Setters and Price Takers 260

13.3 How do Producers Decide on Prices? 260

13.3.1 Market-based Pricing 260

13.3.2 Cost-based Pricing 261

13.4 Special Cases 263

13.4.1 Tendering 263

13.4.2 Highly Restricted Supply of Unique
Products 263

13.4.3 Target Pricing and Costing 264

13.4.4 Discounting 264

13.4.5 Auction 265

13.5 More Issues in Pricing Decisions 265

13.5.1 Product Life Cycle 265

13.5.2 Product Life Cycle Issues 266

13.6 Pricing in Context 266

13.6.1 Building Contractor 266

13.6.2 Toothpaste Manufacturer 267

13.6.3 Writer 267

13.6.4 Solicitors 267

Chapter Summary 269

Internet Resources 269

Exercises: Answers at the End of the Book 269

Exercises: Answers Available on the Instructors' Section
of the Book's Website 270

14 Marginal costing and decision making 272

Aim of the chapter 272

Learning outcomes 272

Introduction 272

14.1 Issues in Decision Making 273

14.1.1 Relevant Costs and Revenues 273

14.2 Cost Variability 274

14.2.1 Variable Costs 274

14.2.2 Fixed Costs 275

14.2.3 Stepped Costs 276

14.2.4 Semi-variable Costs 277

14.2.5 Typical Cost Behaviour in Different Business
Sectors 278

14.3 Marginal Costing for Decision Making 280

14.3.1 Contribution 280

14.3.2 Break-even 281

14.4 Cost–Volume–Profit Analysis 281

14.4.1 Break-even Charts 281

14.4.2 Break-even Analysis Using Formulae 283

14.5 Further Applications of Break-even in Practice 284

14.5.1 Target Profit 284

14.5.2 Margin of Safety 285

14.6 Special Decisions 286

14.6.1 Accepting Contracts 286

14.6.2 Major Increases in Activity Levels 287

14.6.3 Limiting Factors 287

14.7 Limitations of Analysis Based on Marginal Costing 289

Chapter Summary 289

Internet Resources 290

Exercises: Answers at the End of the Book 290

Exercises: Answers Available on the Instructors' Section
of the Book's Website 294

15 Capital investment decisions 297

Aim of the chapter 297

Learning outcomes 297

Introduction 297

15.1 Capital Investment in Context 298

15.1.1 Capital Rationing 298

15.2 Simple Appraisal Techniques 299

15.2.1 Accounting Rate of Return 301

15.2.2 Payback 302

15.3 More Complex Appraisal Techniques 304

15.3.1 The Time Value of Money 304

15.3.2 Net Present Value (NPV) 306

15.3.3 Machine A 307

15.3.4 Machine B 307

15.3.5 Machine A 308

15.3.6 Machine B 308

15.3.7 Internal Rate of Return (IRR) 308

15.4 Choosing Between Projects 311

15.5 Strengths and Weaknesses of the Common
Investment Appraisal Techniques 311

15.5.1 Accounting Rate of Return (ARR) 312

15.5.2 Payback 312

15.5.3 Net Present Value (NPV) 312

15.5.4 Internal Rate of Return (IRR) 312

15.5.5 The Best Technique? 313

Chapter Summary 313

Internet Resources 313

Exercises: Answers at the End of the Book 314

Exercises: Answers Available on the Instructors' Section
of the Book's Website 316

16 Budgets 319

Aim of the chapter 319

Learning outcomes 319

Introduction 319

16.1 The Relationship Between Strategy and Budget
Setting 320

16.2 Principal Types of Budget 321

16.2.1 Approaches to Budgeting 321

16.3 The Budget Process 322

16.3.1 Who Sets the Budget? 322

16.3.2 Imposition of Budgets 323

16.3.3 Participative Approach 323

16.3.4 Stages Involved in Setting a Budget 324

16.4 Setting the Budget: A Practical Example 325

16.5 Monitoring Outcomes 332

16.6 Budgeting: Its Benefits and Drawbacks 332

16.6.1 Benefits 332

16.6.2 Drawbacks 333

16.7 A Radical Alternative 334

16.7.1 Beyond Budgeting 334

Chapter Summary 335

Internet Resources 335

Exercises: Answers at the end of the book 336

Exercises: Answers Available on the Instructors' Section
of the Book's Website 338

17 Accounting for control 342

Aim of the chapter 342

Learning outcomes 342

Introduction 342

17.1 Standard Costing, Flexible Budgeting and Variance
Analysis 342

17.2 Standard Costing 343

17.2.1 Establishing Standard Costs 344

17.3 Overhead Variances 351

17.4 Investigating the Reasons for Variances 355

17.4.1 Deciding which Variances Merit
Investigation 355

17.4.2 Principal Reasons for the Occurrence
of Variances 355

17.5 Standard Costing: Issues and Problems 356

Chapter Summary 357

Internet Resources 357

Exercises: Answers at the End of the Book 357

Exercises: Answers Available on the Instructors' Section
of the Book's Website 361

18 Performance measurement 364

Aim of the chapter 364

Learning outcomes 364

Introduction 364

18.1 Performance Reporting and Organizational
Objectives 365

18.2 Divisional Responsibility in Large Business
Organizations 366

18.2.1 Centralization and Decentralization 367

18.3 Assessing Divisional Performance 367

18.3.1 Cost/Revenue Centre 368

18.3.2 Profit Centre 368

18.3.3 Investment Centre 370

18.3.4 Determining Investment in Net Assets 370

18.3.5 Determining Divisional Net Profit 372

18.3.6 Residual Income 373

18.4 Non-financial Performance Measures 373

18.5 The Balanced Scorecard 375

18.5.1 The Four Key Perspectives of the Balanced
Scorecard 376

18.5.2 The Balanced Scorecard in Practice 377

18.5.3 Is the Balanced Scorecard Successful? 378

Chapter Summary 378

Internet Resources 378

Exercises: Answers at the End of the Book 378

Exercises: Answers Available on the Instructors' Section
of the Book's Website 380

SECTION III

Financial Management 383

19 The management of working capital 384

Aim of the chapter 384

Learning outcomes 384

Introduction 384

19.1 Elements of Working Capital 385

19.1.1 Management and Mismanagement of
Working Capital 385

19.2 Asset and Liability Components in
Practice 386

19.3 The Management of Inventories 386

19.3.1 Holding Costs 388

19.3.2 Economic Order Quantity 389

19.3.3 Other Approaches to the Management of Inventories	390	20.2 Stages in Business Growth and Expansion	406
19.4 The Management of Trade Receivables	391	20.2.1 Employing People	407
19.4.1 Addressing the Risks of Offering Credit to Customers	391	20.2.2 Developing the Business Organization	408
19.4.2 The Credit Control Function	392	20.2.3 Sources of Finance for the Growing Business	409
19.5 The Management of Cash, Overdrafts and Trade Payables	394	20.3 Sources of Finance for Large Businesses	410
19.5.1 The Operating Cycle	394	20.3.1 Issue of Shares	410
19.5.2 Managing Cash and Overdrafts	396	20.3.2 Rights of Shareholders	410
19.5.3 Managing Trade Payables	396	20.3.3 Benefits of Limited Companies	410
Chapter Summary	396	20.3.4 The London Stock Exchange (LSE)	411
Internet Resources	396	20.3.5 Organization and Operation of the LSE	411
Exercises: Answers at the End of the Book	397	20.3.6 Flotation and Other Types of Share Issue	413
Exercises: Answers Available on the Instructors' Section of the Book's Website	399	20.3.7 To List or Not to List?	415
20 Financing the business	403	Chapter Summary	415
Aim of the chapter	403	Internet Resources	416
Learning outcomes	403	Exercises: Answers at the End of the Book	416
Introduction	403	Exercises: Answers Available on the Instructors' Section of the Book's Website	418
20.1 Financing the Small Business	403	Answers to self-test questions	420
20.1.1 Sources of Finance for a New Business Start-up	404	Answers to exercises	441
20.1.2 The Business Plan	406	Glossary	505
20.1.3 Why Do Businesses Fail (and Why Do Some of Them Succeed)?	406	Index	511