

**Eighth
edition**

Accounting and Finance

An Introduction

**Eddie McLaney
and
Peter Atrill**

PEARSON

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney
Auckland • Singapore • Hong Kong • Tokyo • Seoul • Taipei • New Delhi
Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

Brief contents

Preface	xxi
How to use this book	xxiii
Acknowledgements	xxv
1 Introduction to accounting and finance	1
Part 1 Financial accounting	37
2 Measuring and reporting financial position	39
3 Measuring and reporting financial performance	77
4 Accounting for limited companies (1)	121
5 Accounting for limited companies (2)	159
6 Measuring and reporting cash flows	201
7 Analysing and interpreting financial statements	233
Part 2 Management accounting	293
8 Making management decisions	295
9 Cost–volume–profit analysis	319
10 Full costing	361
11 Costing and performance evaluation in a competitive environment	408
12 Budgeting	457
13 Accounting for control	501
Part 3 Financial management	545
14 Making capital investment decisions	547
15 Financing a business	596
16 Managing working capital	653 →

Part 4	Supplementary information	707
Appendix A	Recording financial transactions	709
Appendix B	Glossary of key terms	728
Appendix C	Solutions to self-assessment questions	745
Appendix D	Solutions to review questions	766
Appendix E	Solutions to selected exercises	781
Appendix F	Present value table	830
Index		833

Contents

Preface	xxi
How to use this book	xxiii
Acknowledgements	xxv
1 Introduction to accounting and finance	1
<i>Introduction</i>	1
<i>Learning outcomes</i>	1
What are accounting and finance?	2
Who are the users of accounting information?	2
The conflicting interests of users	4
How useful is accounting information?	5
Evidence on the usefulness of accounting	6
Providing a service	7
Further qualities	8
Weighing up the costs and benefits	9
Accounting as an information system	11
Management accounting and financial accounting	13
Scope of this book	15
The changing face of accounting	16
Why do I need to know anything about accounting and finance?	17
Accounting for business	18
What is the purpose of a business?	18
What kinds of business ownership exist?	19
Sole proprietorship	19
Partnership	20
Limited company	21
How are businesses organised?	22
How are businesses managed?	25
The quest for wealth creation	27
Meeting the needs of other stakeholders	27
Balancing risk and return	29
Reasons to be ethical	31
Not-for-profit organisations	32
<i>Summary</i>	33
<i>Key terms</i>	35
<i>References</i>	35
<i>Further reading</i>	35
<i>Review questions</i>	36

Part 1 Financial accounting

2	Measuring and reporting financial position	39
	<i>Introduction</i>	39
	<i>Learning outcomes</i>	39
	The major financial statements – an overview	40
	The statement of financial position	44
	Assets	44
	Claims	47
	The effect of trading transactions	50
	Classifying assets	52
	Current assets	53
	Non-current assets	53
	Classifying claims	55
	Current liabilities	55
	Non-current liabilities	55
	Statement layouts	56
	Capturing a moment in time	58
	The role of accounting conventions	58
	Business entity convention	58
	Historic cost convention	59
	Prudence convention	60
	Going concern convention	60
	Dual aspect convention	61
	Money measurement	62
	Goodwill and brands	62
	Human resources	63
	Monetary stability	64
	Valuing assets	64
	Non-current assets	65
	Non-current assets with finite lives	65
	Non-current assets with indefinite useful lives	65
	Fair values	66
	The impairment of non-current assets	67
	Inventories	69
	Meeting user needs	70
	<i>Self-assessment question 2.1</i>	71
	<i>Summary</i>	71
	<i>Key terms</i>	73
	<i>Further reading</i>	73
	<i>Review questions</i>	74
	<i>Exercises</i>	74
3	Measuring and reporting financial performance	77
	<i>Introduction</i>	77
	<i>Learning outcomes</i>	77

The income statement	78
Different roles	79
Income statement layout	80
Gross profit	81
Operating profit	81
Profit for the period	81
Further issues	82
Cost of sales	82
Classifying expenses	83
Recognising revenue	85
Long-term contracts	86
Continuous and non-continuous services	88
Recognising expenses	88
When the expense for the period is more than the cash paid during the period	89
When the amount paid during the period is more than the full expense for the period	91
Profit, cash and accruals accounting	93
Depreciation	94
Calculating the depreciation expense	94
Depreciation method	96
Impairment and depreciation	100
Depreciation and asset replacement	101
Depreciation and judgement	101
Costing inventories	103
Inventories – some further issues	107
Trade receivables problems	108
Doubtful debts	110
Uses and usefulness of the income statement	112
<i>Self-assessment question 3.1</i>	113
<i>Summary</i>	114
<i>Key terms</i>	115
<i>Further reading</i>	116
<i>Review questions</i>	117
<i>Exercises</i>	117
4 Accounting for limited companies (1)	121
<i>Introduction</i>	121
<i>Learning outcomes</i>	121
The main features of limited companies	122
Legal nature	122
Perpetual life	122
Limited liability	124
Legal safeguards	125
Public and private companies	125
Taxation	127
The role of the Stock Exchange	128

Managing a company	128
Financing limited companies	129
Equity (the owners' claim)	129
The basic division	129
Share capital	130
Reserves	132
Bonus shares	134
Share capital jargon	136
Borrowings	137
Raising share capital	138
Withdrawing equity	139
The main financial statements	142
The income statement	143
The statement of financial position	145
Dividends	145
Accounting for groups of companies	146
<i>Self-assessment question 4.1</i>	150
<i>Summary</i>	151
<i>Key terms</i>	153
<i>Further reading</i>	153
<i>Review questions</i>	154
<i>Exercises</i>	154
5 Accounting for limited companies (2)	159
<i>Introduction</i>	159
<i>Learning outcomes</i>	159
The framework of annual financial reports	160
The directors' duty to account	161
The need for accounting rules	161
Sources of accounting rules	164
The growing authority of the IASB	164
Adopting IFRSs	165
Presenting the financial statements	167
Fair representation	167
Statement of financial position	168
Statement of comprehensive income	169
Statement of changes in equity	171
Statement of cash flows	172
Notes	173
General points	173
The need for a conceptual framework	173
The IASB framework	174
The auditors' role	175
Segmental financial reports	176
Segmental reporting rules	177
Segmental disclosure	178
Segmental reporting problems	179

Corporate governance	180
Strengthening the framework of rules	181
The UK Corporate Governance Code	182
Management commentary	184
Directors' report	184
Strategic report	185
Creative accounting	187
Creative accounting methods	188
Checking for creative accounting	193
Creative accounting and economic growth	194
<i>Self-assessment question 5.1</i>	195
<i>Summary</i>	195
<i>Key terms</i>	197
<i>References</i>	197
<i>Further reading</i>	198
<i>Review questions</i>	199
<i>Exercises</i>	199

6 Measuring and reporting cash flows **201**

<i>Introduction</i>	201
<i>Learning outcomes</i>	201
The statement of cash flows	202
Why is cash so important?	203
The main features of the statement of cash flows	205
A definition of cash and cash equivalents	205
The relationship between the main financial statements	206
The layout of the statement of cash flows	207
Cash flows from operating activities	207
Cash flows from investing activities	208
Cash flows from financing activities	208
Net increase or decrease in cash and cash equivalents	209
The normal direction of cash flows	209
Preparing the statement of cash flows	211
Deducing net cash flows from operating activities	211
Deducing the other areas of the statement of cash flows	216
Reconciliation of liabilities from financing activities	219
What does the statement of cash flows tell us?	219
Problems with IAS 7	222
<i>Self-assessment question 6.1</i>	222
<i>Summary</i>	224
<i>Key terms</i>	225
<i>Reference</i>	225
<i>Further reading</i>	225
<i>Review questions</i>	226
<i>Exercises</i>	226

7	Analysing and interpreting financial statements	233
	<i>Introduction</i>	233
	<i>Learning outcomes</i>	233
	Financial ratios	234
	Financial ratio classifications	234
	The need for comparison	236
	Past periods	236
	Similar businesses	237
	Planned performance	237
	Calculating the ratios	237
	A brief overview	240
	Profitability	241
	Return on ordinary shareholders' funds (ROSF)	241
	Return on capital employed (ROCE)	242
	Operating profit margin	244
	Gross profit margin	245
	Efficiency	247
	Average inventories turnover period	247
	Average settlement period for trade receivables	248
	Average settlement period for trade payables	249
	Sales revenue to capital employed ratio	251
	Sales revenue per employee	251
	Relationship between profitability and efficiency	253
	Liquidity	254
	Current ratio	255
	Acid test ratio	255
	Cash generated from operations to maturing obligations ratio	256
	Financial gearing	257
	Gearing ratio	260
	Interest cover ratio	261
	Investment ratios	262
	Dividend payout ratio	262
	Dividend yield ratio	263
	Earnings per share	264
	Cash generated from operations per share	266
	Price/earnings (P/E) ratio	266
	Financial ratios and the problem of overtrading	270
	Trend analysis	272
	Using ratios to predict financial failure	272
	Using single ratios	273
	Using combinations of ratios	274
	Z-score models	276
	Limitations of ratio analysis	278
	Quality of financial statements	278
	Inflation	279
	The restricted view given by ratios	279

The basis for comparison	280
Statement of financial position ratios	280
<i>Self-assessment question 7.1</i>	281
<i>Summary</i>	282
<i>Key terms</i>	283
<i>References</i>	284
<i>Further reading</i>	284
<i>Review questions</i>	285
<i>Exercises</i>	285

Part 2 Management accounting

8	Making management decisions	295
	<i>Introduction</i>	295
	<i>Learning outcomes</i>	295
	Cost–benefit analysis	296
	What is meant by ‘cost’?	297
	Relevant costs: opportunity and outlay costs	299
	Sunk costs and committed costs	304
	Non-measurable costs and benefits	306
	Risk	307
	Sensitivity analysis	308
	<i>Self-assessment question 8.1</i>	311
	<i>Summary</i>	312
	<i>Key terms</i>	313
	<i>Further reading</i>	313
	<i>Review questions</i>	314
	<i>Exercises</i>	314
9	Cost–volume–profit analysis	319
	<i>Introduction</i>	319
	<i>Learning outcomes</i>	319
	Cost behaviour	320
	Fixed cost	320
	Variable cost	322
	Semi-fixed (semi-variable) cost	323
	Analysing semi-fixed (semi-variable) costs	324
	Finding the break-even point	325
	Contribution	332
	Contribution margin ratio	332
	Margin of safety	333
	Achieving a target profit	335
	Operating gearing	336
	Operating gearing and its effect on profit	337

Profit–volume charts	338
The economist's view of the break-even chart	339
Failing to break even	341
Weaknesses of break-even analysis	341
Using contribution to make decisions: marginal analysis	344
Pricing/assessing opportunities to enter contracts	345
The most efficient use of scarce resources	347
Make-or-buy decisions	349
Closing or continuation decisions	351
<i>Self-assessment question 9.1</i>	353
<i>Summary</i>	354
<i>Key terms</i>	355
<i>Further reading</i>	355
<i>Review questions</i>	356
<i>Exercises</i>	356
10 Full costing	361
<i>Introduction</i>	361
<i>Learning outcomes</i>	361
What is full costing?	362
Why do managers want to know the full cost?	362
Single-product businesses	364
Multi-product businesses	365
Direct and indirect cost	366
Job costing	367
Full (absorption) costing and the behaviour of cost	368
The problem of indirect cost	370
Overheads as service renderers	370
Job costing: a worked example	370
Selecting a basis for charging overheads	374
Segmenting the overheads	377
Dealing with overheads on a cost centre basis	377
Batch costing	387
Non-manufacturing overheads	388
Full (absorption) costing and estimation errors	389
Using full (absorption) cost information	391
Full cost (cost-plus) pricing	393
Price makers and price takers	393
Use of cost-plus information by price takers	394
Criticisms of full (absorption) costing	396
Full (absorption) costing versus variable costing	396
Which method is better?	398
<i>Self-assessment question 10.1</i>	400
<i>Summary</i>	401
<i>Key terms</i>	402
<i>Reference</i>	403
<i>Further reading</i>	403

<i>Review questions</i>	404
<i>Exercises</i>	404

11 Costing and performance evaluation in a competitive environment **408**

<i>Introduction</i>	408
<i>Learning outcomes</i>	408
Cost determination in the changed business environment	409
Costing and pricing: the traditional way	409
Costing and pricing: the new environment	410
Cost management systems	410
The problem of overheads	411
Taking a closer look	411
Activity-based costing	412
Attributing overheads	413
Benefits of ABC	414
ABC versus the traditional approach	414
ABC and service industries	414
Criticisms of ABC	419
Other costing approaches in the modern environment	421
Total life-cycle costing	421
Total quality management	424
Costing quality procedures	426
Target costing	427
Kaizen costing	428
Value chain analysis	429
Benchmarking	431
Non-financial measures of performance	433
The balanced scorecard	434
Scorecard problems	440
Measuring shareholder value	440
The quest for shareholder value	441
How can shareholder value be created?	441
The need for new measures	442
Economic value added (EVA®)	443
<i>Self-assessment question 11.1</i>	448
<i>Summary</i>	450
<i>Key terms</i>	451
<i>Reference</i>	451
<i>Further reading</i>	451
<i>Review questions</i>	452
<i>Exercises</i>	452

12 Budgeting **457**

<i>Introduction</i>	457
<i>Learning outcomes</i>	457

How budgets link with strategic plans and objectives	458
Time horizon of plans and budgets	460
How budgets help managers	461
Budgets and forecasts	463
Limiting factors	464
Periodic and continual budgets	464
How budgets link to one another	465
The budget-setting process	468
Using budgets in practice	471
Incremental and zero-base budgeting	473
Preparing budgets	476
The cash budget	476
Preparing other budgets	480
Activity-based budgeting	483
Non-financial measures in budgeting	485
Budgets and management behaviour	485
Who needs budgets?	485
Beyond conventional budgeting	487
Long live budgets!	489
<i>Self-assessment question 12.1</i>	492
<i>Summary</i>	493
<i>Key terms</i>	494
<i>References</i>	494
<i>Further reading</i>	494
<i>Review questions</i>	495
<i>Exercises</i>	495

13	Accounting for control	501
	<i>Introduction</i>	501
	<i>Learning outcomes</i>	501
	Budgeting for control	502
	Types of control	503
	Variances from budget	505
	Flexing the budget	506
	Sales volume variance	507
	Sales price variance	509
	Materials variances	511
	Labour variances	512
	Fixed overhead variance	513
	Reasons for adverse variances	518
	Variance analysis in service industries	520
	Non-operating profit variances	520
	Investigating variances	520
	Variance analysis in practice	523
	Compensating variances	523
	Standard quantities and costs	524
	Setting standards	525

What kind of standards should be used?	525
Who sets the standards?	525
How is information gathered?	525
The learning-curve effect	526
Keeping standards relevant	527
Other uses for standard costing	528
Making budgetary control effective	528
Some problems . . .	529
The new business environment	530
Behavioural issues	532
The impact of management style	533
Failing to meet the budget	535
Budgets and innovation	536
<i>Self-assessment question 13.1</i>	537
<i>Summary</i>	537
<i>Key terms</i>	539
<i>Reference</i>	539
<i>Further reading</i>	539
<i>Review questions</i>	540
<i>Exercises</i>	540

Part 3 Financial management

14 Making capital investment decisions	547
<i>Introduction</i>	547
<i>Learning outcomes</i>	547
The nature of investment decisions	548
Investment appraisal methods	549
Accounting rate of return (ARR)	551
ARR and ROCE	552
Problems with ARR	553
Payback period (PP)	555
Problems with PP	557
Net present value (NPV)	559
Interest lost	560
Risk	560
Inflation	561
What will logical investors do?	562
Using present value tables	565
The discount rate and the cost of capital	566
Why NPV is better	567
NPV's wider application	568
Internal rate of return (IRR)	568
Problems with IRR	572
Some practical points	573
Investment appraisal in practice	577

Investment appraisal and strategic planning	580
Risk and investment	580
Managing investment projects	581
Stage 1: Determine investment funds available	582
Stage 2: Identify profitable project opportunities	583
Stage 3: Evaluate the proposed project	583
Stage 4: Approve the project	584
Stage 5: Monitor and control the project	584
<i>Self-assessment question 14.1</i>	586
<i>Summary</i>	587
<i>Key terms</i>	589
<i>Reference</i>	589
<i>Further reading</i>	589
<i>Review questions</i>	590
<i>Exercises</i>	590
15 Financing a business	596
<i>Introduction</i>	596
<i>Learning outcomes</i>	596
The main objective of financing policy	597
Sources of finance	597
Internal sources of finance	597
Internal sources of long-term finance	598
Retained earnings	598
Dividend policy	599
Internal sources of short-term finance	600
Tighter credit control	600
Reducing inventories levels	600
Delaying payment to trade payables	600
Some further points	601
External sources of finance	602
External sources of long-term finance	602
Ordinary shares	603
Preference shares	603
Borrowing	604
Forms of borrowing	608
Finance leases	612
Sale-and-leaseback arrangements	615
Hire purchase	616
Securitisation	617
External sources of short-term finance	619
Bank overdrafts	619
Debt factoring	619
Invoice discounting	621
Long-term versus short-term borrowing	623
Gearing and the financing decision	624
Raising long-term finance	628

Share issues	628
Rights issues	629
Offers for sale and public issues	632
Setting a share price	632
Private placings	633
Bonus issues	633
The role of the Stock Exchange	634
Advantages of a listing	634
Disadvantages of a listing	636
Going private	638
The Alternative Investment Market	638
Providing long-term finance for the small business	639
Venture capital	639
Business angels	641
Government assistance	641
Islamic finance	642
<i>Self-assessment question 15.1</i>	642
<i>Summary</i>	644
<i>Key terms</i>	646
<i>References</i>	646
<i>Further reading</i>	647
<i>Review questions</i>	648
<i>Exercises</i>	648
16 Managing working capital	653
<i>Introduction</i>	653
<i>Learning outcomes</i>	653
What is working capital?	654
Managing working capital	655
The scale of working capital	655
Managing inventories	658
Budgeting future demand	661
Financial ratios	661
Recording and reordering systems	661
Levels of control	663
Inventories management models	665
Managing trade receivables	669
Which customers should receive credit and how much should they be offered?	670
Length of credit period	672
Cash discounts	675
Debt factoring and invoice discounting	676
Credit insurance	676
Collection policies	676
Managing cash	680
Why hold cash?	680
How much cash should be held?	681

Controlling the cash balance	682
Cash budgets and managing cash	683
The operating cash cycle	683
Cash transmission	688
Bank overdrafts	689
Managing trade payables	690
Taking advantage of cash discounts	692
Controlling trade payables	693
<i>Self-assessment question 16.1</i>	695
<i>Summary</i>	696
<i>Key terms</i>	698
<i>Further reading</i>	699
<i>Review questions</i>	700
<i>Exercises</i>	700

Part 4 Supplementary information

Appendix A Recording financial transactions	709
<i>Introduction</i>	709
<i>Learning outcomes</i>	709
The basics of double-entry bookkeeping	710
Recording trading transactions	712
Balancing accounts and the trial balance	715
Preparing the financial statements (final accounts)	719
The ledger and its division	722
<i>Summary</i>	723
<i>Key terms</i>	724
<i>Further reading</i>	724
<i>Exercises</i>	725
Appendix B Glossary of key terms	728
Appendix C Solutions to self-assessment questions	745
Appendix D Solutions to review questions	766
Appendix E Solutions to selected exercises	781
Appendix F Present value table	830
Index	833