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1 Introduction

Learning Objectives

After studying this chapter, you should be able to explain the following:
→ Who needs to know about accounting
→ How accounting can be used to keep score
→ How accounting can be used for attention directing
→ How accounting can be used to support decisions

1.1 Accounting: Who Needs It?

The answer is that just about every manager needs it. This book will show why managers need to know about accounting and will explain the language of accounting and some of the basic techniques. This book is not intended to cover the entire spectrum of accounting, nor is it intended to make accountants out of non-accountants. Its aim, rather, is to bridge the gap between accountants and other managers so that they can intelligently discuss topics of mutual importance. Consider the following three situations.

1.1.1 *The Marketing Manager's Proposal*

The marketing manager of a medium-sized company is in a meeting with the other managers of the company. He is proposing a marketing campaign to substantially increase product awareness. He is offering his audience the choice of several different ways of implementing the campaign. He is well into his presentation when one of the product managers asks,

> "How will this appear in the financial statements?"

His answer may be along the following lines:

> "Proposal *A* involves us buying a number of advertising trucks that would drive around the city with illuminated billboards. These purchases would appear in the balance sheet initially, and their depreciation would appear in the income statement as expense. Proposal *B* involves buying advertising space on instagram, which would appear as an expense in the income statement, as incurred. Proposal *A* would initially reduce our liquidity ratios, and this may be a problem for investors, who will perceive us as a riskier investment. Proposal *B* would have minimal effect on liquidity ratios but would, initially, reduce profits more. Both proposals are expected to increase profitability ratios in the medium term."

Alternatively, he may say,

> "Sorry, but I don't know enough about financial statements to answer you now. I will have to get back to you on that."

The first answer indicates that the marketing manager is familiar with the main financial statements, understands that different types of spending might get treated in different ways, and understands the implications for the users of financial statements. The second answer indicates that he does not fully understand the financial implications of the proposals he is making.

1.1.2 The Human Resources Manager's Situation

The human resources manager is called into her vice-president's office. The human resources department budget is overspent by 12% for the year 2020. The VP wants to know what went wrong. Her response might be along these lines:

> "When I submitted the budget in October 2019, I did so based on the information received from the budget team that sales and production activities in 2020 would be no more than 10% higher than in 2019. In early 2020, we were faced with the COVID-19 pandemic, and suddenly everything changed. Sales dropped by 25%, and production was cut back accordingly. We had to make a sudden downward adjustment to our production and sales workforce. Although that reduced expenses in those areas, it actually increased our work, and we had to hire additional staff to deal with the layoffs. Then, when the economy opened up again later in the year, we had to call employees back and replace those who had found alternative work. Again, this represented additional, unexpected work for the Human Resources Department, work over which we had no control. Given this increase in workload, it is to our credit that we have been able to get by with only two additional staff members and an increase in spending of only 12%."

Alternatively, she may have to give some vague answer, such as

> "Well, we needed the extra staff because we were overworked."

or

> "My assistant prepared the budget; I'll have to ask him and get back to you."

The first answer shows that she understands the way a budget is prepared and how it should be used as a control system. The second and third answers show that she knows neither.

1.1.3 The Production Manager's Dilemma

The production manager is proposing the purchase of a new packaging machine. The existing packaging machine is reaching the end of its useful life and needs to be replaced because it is prone to breaking down. Additionally, more modern machines can do more sophisticated packaging, such as integrated full-colour printing and shrink-wrapping. He proposes to spend $100,000 on a state-of-the-art packaging machine that will serve the company's needs for the next 10 to 20 years. The discussion is going well until someone asks if it is possible to lease the machine instead of buying it. His response may be along these lines:

> "Yes, leasing is a possibility. We have a leasing quotation from the supplier. Based on an expected useful life of 10 years, the present value of the lease payments would be $120,000. If we assumed a longer life, the present value of the lease costs would be even higher. So, outright purchase is a better economic alternative. Additionally, the VP of finance informed me that we have adequate cash available for capital investment at this time, and the machine purchase will not strain liquidity."

Alternatively, he may explain that although leasing is a possibility, he has no basis for comparing a capital investment with a series of lease payments, so he cannot decide which is better.

The first answer shows that he is able to deal with the financial implications of his decisions, including consideration of the effect of his proposals on other areas (in this instance, finance and cash flow). The second answer indicates that he is not in command of the appropriate bases for making business decisions, even those within his area of direct control and supposed expertise.

The above three scenarios show that managers need to have a basic understanding of accounting reports and accounting-oriented decision processes. They need this so that they can appear as intelligent, well-informed members of the management team (general background), and so they can plan and control their own operating areas (budgetary control). Furthermore, they can deal with the financial implications of proposals they put forward (decision making).

Given the above hypothetical situations, as a manager, do you want to present yourself as informed and capable of making decisions appropriately? Or do you want to come across as a narrow specialist who understands his or her own discipline well but has no knowledge of the wider issues of business? Today's business environment suggests that the role of the narrow specialist is decreasing; instead, managers are expected to be able to "talk" accounting as the universal language of business.

This book sets out to deal with situations like the ones faced by the managers above. Section 1 starts out with a description of the main financial statements that are used in external company reporting. It does not generally go into the detail of recording financial transactions or the minutiae of calculating the results. Section 1 does, however, show how the information flows through the system and deals with the valuation and presentation of the amounts involved. Within each of the chapters in this section, financial ratios are used to explain the relationships between the accounting numbers. These ratios enable the interpretation of accounting data in ways that are meaningful to a wide variety of users. Readers who wish to explore the mechanics of financial accounting will find an introductory guide in a series of appendices devoted to the traditional conventional accounting model based on debits and credits.

Section 2 deals with the preparation of budgets and their use as controls. This is partially a number-crunching activity, but we also recognize that budgetary control has serious behavioural implications.

In Section 3, we look at accounting data as the basis for decision making. It covers both short-term operating decisions and longer-term capital budgeting decisions. Section 4 deals with special topics in accounting, such as accounting for not-for-profit organizations, accounting and personal finance, and elements of taxation for individuals and small businesses.

The first three sections conform to one popular classification of accounting that divides accounting into scorekeeping, attention-directing, and decision-making roles.

Although each chapter in the book is self-contained, appendices are used to provide illustrative materials and more advanced aspects at the end of some chapters.

1.2 Scorekeeping

When a company publishes its income statement and its balance sheet, it is engaged in scorekeeping. That is, the company is reporting to shareholders and other interested parties how well (or how badly) it has performed. These reports are about the past. The income statement covers a period of time that is now completed (the previous fiscal year). The balance sheet is a snapshot of the company at a point in time (usually the last day of the fiscal year).

Scorekeeping is an exercise in stewardship. Investors (and, to a lesser extent, creditors) have allowed the company the use of their resources. The company must, in return, report on what it did with those resources, and how well the investment has performed. With this information, existing investors and creditors can make informed judgments about how advisable it is to continue to be investors or creditors or whether they should liquidate their holdings in this company and invest or lend elsewhere. In a similar fashion, potential investors and creditors will use the published financial statements to make judgments about whether they should invest or lend and thus become actual investors or creditors of the company.

By *investor*, we mean the holder of the shares of a company. So, implicitly, we are referring to a limited liability company, the shares of which are listed on a stock exchange. These shares can be bought or sold at market prices by anyone who wants them. North America (particularly the United States and, to a lesser extent, Canada) is a world leader in individual investment in company shares. In other economies, it is more common for people to deposit surplus cash in a bank or buy government securities.

By *creditor*, we mean the holder of a company's debt, such as notes or debentures. These are lower risk than shares and usually yield a lower return. Like shares, however, they can be bought and sold in a public market, generally a specialized section of the stock market.

The limited liability corporation with shares listed and traded on a stock exchange is the obvious focus of a book such as this because most large organizations are formed with limited liability. There are also a number of large companies that are "private". Shares of private companies are not listed on any

Forms of Business Organization

When a business is established, whoever starts it up has to make some decisions about the form of organization. The choices include the following:

- Sole proprietorship
- Partnership
- Private limited liability company
- Public limited liability company

Sole Proprietorship

The simplest situation is an individual trading as what is called a sole proprietorship. In Canada, anyone is allowed to go into business on their own account; no formalities are necessary. They can trade in their own name — for example, the author of this text could set up in business as an author and call himself "John Parkinson". It is equally permissible for the sole proprietor to register a business name that is different from his own name, such as "JP Authors".

The ease of doing this is very attractive, but there are downsides. One issue is that the owner is exposed to a high level of risk. If the business fails, not only will the owner lose the business assets, but the owner's personal assets may also be used to satisfy any unpaid business creditors. In addition, an individual may not have enough capital to start the business or may not have expertise in a key area.

Partnership

Often two or more people may agree to work together in partnership. In the simplest partnerships, each partner will provide an equal share of the start-up capital, each will contribute an equal share of expertise and labour, and each will share equally in the partnership profits. Partnership can overcome some of the problematical issues facing a sole proprietor.

Again, like the sole proprietorship, no formalities are strictly necessary. Whether people are working in partnership is a matter of agreement and of fact. A partnership situation can be deduced from the actions of the partners. As with a sole proprietorship, the partnership could be referred to by the names of the partners. For example, the four authors of this text could form a partnership called "Fayerman, Draimin, Parkinson, and Tekathen". Alternatively, by registering the name, they could call the partnership "FDP&T Authors".

Well-run partnerships will be governed by a partnership agreement, which all the partners sign. This will establish the existence of the partnership, the obligations of each partner (such as how much capital each will provide), and the benefits each will receive (such as the % share of any profits).

In term of risk, partnerships are actually slightly riskier than are sole proprietorships. When the partnership is profitable, there is no unusual level of risk. If the partnership fails, first the partnership assets are used to pay off the creditors. If the partnership assets are insufficient, then the individual partners are required to make

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Forms of Business Organization (continued)

up the deficiency out of their own assets, either equally or in whatever proportions the partnership agreement dictates. And here is the additional risk: if any of the partners has insufficient personal assets to satisfy his or her obligations, then the other partners have to make up the deficiency. Ouch!

Private Limited Liability Company

A solution to the problem of putting personal assets at risk is to set up the business as a limited liability company (LLC). This is a formal corporation governed by company law, and shares in the company represent its ownership. An individual or a number of individuals setting up the business invest in the company by buying shares, so the amount of investment may not be different from that for a sole proprietorship or a partnership. However, the amount paid to the company for the shares is the only thing at risk. No claim may be made on the shareholders' personal assets.

Company law requires that LLCs prepare financial statements annually and that these statements are given to the shareholders. There are also requirements about holding regular meetings to deal with some administrative and management matters.

A private LLC is one where the shares are subject to restrictions in respect of how they may be bought and sold. It is an excellent way of organizing a business that might otherwise have been set up as a sole proprietorship or as a partnership.

In a private LLC, the shareholders may or may not be the day-to-day managers of the business; it varies.

Public Limited Liability Company

A public LLC is one where the trading of shares is not restricted. The shares are typically listed on a public stock exchange, and an open market system governs their price. Anyone who wants to can buy them or sell them at the going market price.

Public LLCs have a more onerous set of rules that they have to observe. Their financial statements are expected to be audited to ensure their correctness, and they are much more of a public document — that is, anyone can get access to them. Public LLCs also have to observe the rules of whichever stock exchange has listed their shares.

An LLC, whether private or public, is, in legal terms, a separate entity from its owners. If the business fails, the assets of the company will be used to pay the creditors, but that is where it stops. If there is a shortfall, the creditors bear the loss. All a shareholder can lose is the amount invested in buying the shares.

The public LLC is an ideal way of establishing a really large organization, where the investing resources of many individuals are needed to finance large operations.

In public LLCs, there is generally a clear separation between the shareholders (who are officially the owners) and the people who run the company. A board of directors appoints and supervises senior management, who in turn appoint other managers and staff, and these managers, not the shareholders, carry out the day-to-day operations of the company. There is what is called a divorce of ownership and control.

stock exchange. Other forms of business organization include sole proprietor, partnership, not-for-profit, and (in Canada) Crown corporation. Although there are no opportunities for buying and selling shares of such organizations, the idea of accounting as the language of business is just as relevant to them as to any publicly listed company. They also have to report their results to someone (owners, members, the government, etc.). Likewise, the following attention-directing and decision-making sections apply to their problems as well.

1.3 Attention Directing

The second role of accounting is to help managers direct attention to areas that are most in need for corrective actions so that the company will still achieve its established objectives. For this, the management concept called "management by exception" helps. In this approach, a company will go through a series of logically related steps to achieve its objectives:

Step 1: Define the objectives.
Step 2: Make plans that would, if achieved, accomplish the objectives.
Step 3: Carry out the business operations in the plan.
Step 4: Measure the results of operations.
Step 5: Compare the results to the plans and the objectives.
Step 6a: If the objectives have been achieved, move on to the next iteration.
Step 6b: If the objectives have not been achieved, instigate corrective action, then move on to the next iteration.

Using this method, corrective action becomes necessary only when things have gone wrong — that is, when there is an exception. Routine activities that are carried out according to plan require no intervention. This cuts down on the amount of purely routine management and enables management resources to be focused on areas where their use can achieve some improvement. Accounting has a major role in the process of defining what will be considered an exception and in reporting exceptions as they occur. For example, the company sold in the first weeks of a new quarter much less than it had planned to sell. Hence, the company faces an unfavourable exception that warrants attention. If the company had sold as much as planned, it would have faced no exception. Everything would have gone as planned, with no need for management attention.

A major part of organizational planning takes place through budget-setting and budget-approval processes. Only if the budget is capable of achieving the stated objectives and is accepted by all parties should it be approved.

Comparison between the budget and actual results reveals any gaps and should draw management's attention. Depending on the amount and the causes, management can then initiate informed corrective action.

1.4 Decision Making

The third role of accounting is to support decision making or problem solving. Decisions are the essence of business. When made correctly, they will ensure survival of the company and improve profitability. Conversely, when decisions are made incorrectly, they will lead, sooner or later, to corporate failure.

As a general rule, decision making should incorporate the following steps:

Step 1: Specify the problem or decision as precisely as possible.
Step 2: Choose an appropriate decision technique.
Step 3: Gather information.
Step 4: Use the information and the technique to make the decision.
Step 5: Implement the decision.
Step 6: Evaluate the outcome.

The basis upon which decisions should be made is not as clear-cut as it may seem. Non-accountants will refer casually to an idea such as "cost" as if it were unambiguous. To the accountant, however, there are as many definitions of *cost* as there are decision situations in which the term would be used. Should the cost be planned or actual? Should it be short-run or long-run? Should it be full cost or variable cost? Do the costs arise in the same time period, or do we need to incorporate the time value of money?

With respect to short-term decision making, we will start by examining the causes of costs, and in particular we shall focus on the modern idea of the "cost driver" — the underlying activities that cause costs to happen. Moreover, we will look at more established models, such as the cost-volume-profit model, and at longer-term decision making through the "net present value" model.

1.5 Financial Accounting, Management Accounting, and Auditing

Accounting is so large a subject that a number of specialisms have developed within it. The scorekeeping activities are referred to as financial accounting. Financial accountants are responsible for recording transactions, for measuring, and for disclosing.

Recording transactions is increasingly a routinized, automated activity. When a customer orders food online, when the utility employee zaps a wand at a meter, and in a hundred and one other situations, the transaction data are automatically recorded, and the accounting records on the computer are updated. It may not be long before manual entry of transactions is as outdated as using leather-bound ledgers and quill pens to keep records. However, as of this writing, a number of smaller businesses will still be entering data into the accounting software manually.

Once the data are recorded, the next step is measurement. Judgment is called for to decide the effect of a transaction. Is the activity to which the transaction refers completed, or is there some residual effect that needs to be recognized as an asset/liability in the balance sheet? To answer these questions, the professional financial accountant has been trained to make appropriate value judgments based on generally accepted accounting principles (GAAP).

Finally, the information has to be communicated. The financial accountants will choose the most appropriate way of disclosing the information so as to comply with the law and with GAAP and to meet the needs of external users of financial statements.

Once the financial accountant has prepared the financial statements, an external auditor will review them and the records that support them. The auditor is formally employed on behalf of the shareholders to safeguard their interests. Although the auditor is paid by the company, the shareholders have the right to appoint/reappoint the auditor at the company's annual general meeting. If the shareholders are dissatisfied with the auditor's work, they may vote against the appointment. In practice, this shareholders' right is more illusory than real; when the chips are down, management probably has more influence on the decision than the shareholders do.

The auditor of a company listed on a public stock exchange is required to be an appropriately experienced "Chartered Professional Accountant", or CPA.

The activities of financial accounting described above are rather intended for external users, such as shareholders, creditors, or financial analysts, and have a more general information purpose. In comparison, the work of management accounting is directed toward internal users — predominantly managers — and is prepared for their specific managerial problem, such as explaining the overspent HR budget or deciding on the purchase of a new packaging machine. As we can see from these introductory examples, management accounting assists them in their managerial activities, including the planning and control of their area of responsibility (see "The Human Resources Manager's Situation"), and also supports them in decision making (see "The Production Manager's Dilemma"). Management accounting thus refers to the role of accounting to direct attention and support internal decision making to run a successful company.

1.6 Personal Financial Planning

All of the above refers in general to management and managers in organizations. There are also equally important uses for accounting information and accounting techniques in personal lives. In particular, personal financial planning uses accounting information extensively. For example, when making a personal financial plan for the first time, one of the things you have to do is make a complete list of all your assets and liabilities — that is, a personal balance sheet. The difference between your assets and your liabilities is your personal wealth or equity. Also, when making choices about how much to invest in your savings so that you can afford to retire, the decisions are based on personal budgets and net present value techniques.

1.7 Summary

Accounting is the common language of business and is essential for communication in today's market-driven economy. It is necessary that all managers are familiar with the terminology, with the benefits of useful accounting information, and with some of the problem areas where accounting information is less helpful or less clear than it could be.

Accounting has a role in scorekeeping (how well the company has performed), in attention directing (what the managers should be paying attention to), and in decision making (the financial implications of business choices). Accounting is carried out by financial accountants and management accountants within the company and by external auditors on behalf of shareholders.

Discussion Questions and Problems

Discussion Questions

1. Who needs to know about accounting?
2. Why is accounting called the language of business?
3. What are the main uses of accounting information for managers?
4. Why does an investor need scorekeeping information?
5. What role does accounting have in the planning process?
6. How is control made possible by accounting?
7. What steps should be involved in decision making?
8. Why might the outcome of a decision be different from its expected outcome?
9. What are the main distinctions between financial accounting and management accounting?
10. What is the role of the auditor?

Problems

1. Royson Co. carried out the following action in January this year:
   (a) Paid rent for the month of January on its office premises: $25,000.
   (b) Issued invoices to its customers for goods delivered in January: $1,500,000.
   (c) Calculated how much cash came in during January and how much cash went out during January to evaluate its liquidity position.
   (d) In view of the liquidity position shown in (c) above, asked its bank to increase the line of credit by $20,000.
   (e) At a meeting of the managers, the chief financial officer told the other managers that, although the company was adequately profitable, it had a liquidity issue.
   (f) As a result of (e) above, the chief operating officer told all production units to reduce their inventory holdings by 10%.
   (g) The company circulated its financial statements for the previous fiscal year to the shareholders.

   Required
   In each case, identify whether the action is oriented to scorekeeping, attention directing, or decision making.

2. Royson Co. is a manufacturing company.

   Required
   For each of the following situations, state whether the Royson Company, or the member of the Royson family, is an investor, a creditor, or neither:
   (a) Reg Royson, who is the founder of the company, owns 90% of the common shares.
   (b) Rhonda Royson is Reg's only daughter. She is employed as manager of human resources at the company but at present owns

no shares. According to Reg's will, she will inherit his shares after his death.

(c) The company owes Rhonda Royson \$25,000, being last year's performance bonus, which has not yet been paid.
(d) Royson Co. owes General Concrete Co. \$100,000 for materials supplied in the previous month.
(e) Royson Co. uses Scotiabank for all its banking business. On January 31, the balance on the chequing account was \$12,000, and Scotiabank also held \$25,000 in short-term deposits owned by Royson Co.
(f) Royson Co. rents its office premises from Capital Property Inc. for \$5,000 per month.
(g) Royson Co. has a rental agreement with Capital Property Inc., which calls for a deposit of one month's rent.
(h) Royson Co. owns its production plant. The plant had cost \$1,000,000 10 years ago; there is an outstanding mortgage of \$600,000.
(i) Various customers owe Royson Co. a total of \$750,000 for goods supplied.
(j) Of the customers referred to in (i) above, approximately 4% will turn into bad debts.
(k) Royson Co. is being sued by one of its customers for \$500,000 in a product liability case. According to legal advice, there is a 40% probability that the customer will be successful, but the case has not yet gone to court.
(l) Royson Co. owes \$500 for utilities.

3. Would the following be carried out by personnel in financial accounting, management accounting, or neither?

    (a) Keeping records of employees' personal information.
    (b) Keeping records of where employees were working so that clients can be billed appropriately.
    (c) Keeping records of wages paid to employees.
    (d) Advising management on wage rates and bonus payments.
    (e) Monthly meetings to discuss budgeted and actual performance.
    (f) Preparation of operating budgets.
    (g) Preparation of annual financial statements.
    (h) Checking what inventory existed and matching that with inventory records.
    (i) Valuation of inventory.
    (j) Deciding whether the inventory is appropriate to production needs.
    (k) Advising senior management about the tax implications of their remuneration packages.

4. (a) Is the external audit related to the work of financial accounting or management accounting?
    (b) Who appoints the external auditor?
    (c) Who pays the external auditor?
    (d) What qualifications does an external auditor need?

5. Folsom Inc. prepared a budget at the start of the year, which anticipated a profit of $100,000. The actual results showed a profit of $250,000. When the actual results became known, the company decided to invest in some new production machinery.

Required
Of the actions stated above, identify which are scorekeeping, which are attention directing, and which are decision making.

6. Folsom Inc. prepared a budget at the start of the year, which anticipated a profit of $100,000. The actual results showed a profit of $250,000. You are given the budget and actual results below:

Folsom Inc.
Budget for the Year

Sales revenue		$750,000
Purchase of goods for resale		250,000
Gross profit		$500,000
Less expenses		
Rent	$200,000	
Wages	100,000	
Utilities	75,000	
Other	25,000	400,000
Budgeted profit		$100,000

Folsom Inc.
Actual Results for the Year

Sales revenue		$900,000
Purchase of goods for resale		300,000
Gross profit		$600,000
Less expenses		
Rent	$200,000	
Wages	50,000	
Utilities	75,000	
Other	25,000	350,000
Profit		$250,000

Required
Comment on the year's results. Should management's attention be drawn to any particular aspect of the company performance?