Introduction

Accounting: a subject widely important yet not widely understood

Your choice to read this book is probably determined by a perception that accounting is important, coupled with a sense that your own knowledge of accounting, at least at present, is insufficient for your needs.

In this introductory chapter, we will explore these motivations – in effect, why you are reading this book. This will be important in setting the scene for the rest of the book. The focus will be on you, on why an understanding of accounting is important for you, and on how best you can get your mind around the subject.

We will first explore *why* knowledge of accounting is important. This will help in motivating your study and in contextualising and making sense of the content of this book. We will then explore why accounting is typically perceived to be a difficult and impenetrable subject. This concerns a more subtle motivation for you, namely that you have probably chosen an introductory book because anything else might feel daunting. Such feelings are typical, but actually may not be well placed. Understanding why people typically find accounting difficult, or perhaps more accurately why they perceive it to be difficult, will help greatly in making it simpler and in giving you confidence in your learning.

Before continuing reading, it will be helpful to pause, and for you to ask yourself why you think that accounting is important. Why do you want to learn about it? What do you expect to be able to understand or do, having read this book, that you cannot currently understand or do? Why do you feel that your current knowledge is insufficient for your needs? Are there specific issues that you have in mind, or do you simply feel a general sense that your understanding is not what you would like it to be?

These questions are important. If you have a clear objective in mind in reading this book, and if that objective is reasonable and achievable, then you are in good shape. It will be straightforward to judge whether the book has the content that you need, and whether your expectations are likely to be met. It is more likely, however, that the purpose of learning accounting is not entirely clear. You may believe the accepted wisdom, held among peers and others, that accounting is important, yet it might not be clear why this is so. In what ways, for example, does accounting actually help in understanding business performance and making better decisions? It is important, as we will see, to try to explore these issues more fully. By so doing, we will establish a more powerful foundation for learning.

Why is accounting important?

There is a very simple reason why accounting is important. As a society, we care about wealth, including whether wealth is increasing or decreasing, and whether it is distributed equitably. In order to keep track of wealth, we need a measurement system. Accounting *is* this system.

If we want to know the profit or loss made by an organisation, we refer to its accounts; we are seeking to understand *financial performance*, which is reported in an income statement (otherwise known as a profit and loss account). If we want to know the wealth of an organisation, we also refer to its accounts; our concern here is with *financial position*, which is reported in a balance sheet. Now, there is a lot more to be said about accounting than this, of course, but in essence the importance of accounting is simply that it measures financial activity. It is the measurement system with which we evaluate financial performance and financial position.

This simple conclusion is likely to have several implications for you, and for the value to you in reading this book. These can be summarised as follows.

Financial decision making Accounting data provide the input to a whole range of decisions, for example the pricing and costing of products and services, the acquisition or divestment of businesses, the evaluation of business plans, and the issue of loans or shares. In order for you to be able to make good use of accounting information in the context of these decisions, it is important for you to understand whether and how that information can be relied upon – i.e. to understand the strengths and weaknesses of accounting as a measurement system. Information that is not understood is apt to be used incorrectly, leading to decisions with adverse economic consequences.

Performance measurement It is almost certainly the case that the evaluation of your own job performance relies, in one way or another, upon accounting information. You may have responsibility for the profit or loss of a business operation, or for a cost centre, or for the management of assets. Your performance may be measured in financial terms, for example, revenue, expenses, return on capital, or cash flow, and you may be rewarded by means of a financial metric, for example as a percentage of profit or by stock options linked to your company's share price. In all of these cases, it will help you personally to understand how the numbers are put together to evaluate your performance. This is particularly important because, for reasons that we will explore in this book, accounting information is inherently subjective. There is no 'right answer' for the amount of profit that an organisation makes. Rather, there is a range of numbers, any one of which could reasonably and justifiably be called profit. This being the case, and the number that is determined being of great importance to you personally, it matters that profit is not taken as given but that you understand and are engaged in the process by which it is determined.

'Language of business' Accounting terminology is ubiquitous. Management meetings make full and frequent use of the accounting lexicon, referring, for example, to revenue, cash flow, depreciation, capitalising, expensing, provisions, assets, profit, margins, liquidity, return on capital and so on. As with any language, some people can understand what is being said and others cannot. For the latter group, the conversation is awkward and uncomfortable. This is particularly the case because the terms being used are, in some sense, fundamental to the organisation: it is unavoidable, for example, that profit and return on capital are centres of attention. Accounting is therefore not just important but also divisive, in the sense that those 'in the know' are in a position of power, and probably also of career progression, while those unable to speak the language are at an obvious disadvantage. The motivation to learn accounting often comes from this source, in effect from a feeling of insecurity and exclusion. If, through this book, you can get your mind around the role of accounting in economic decision making, and in the assessment of your performance, then confidence in management meetings will follow. And when you get there, you will have transitioned from being silenced by a foreign language to enjoying being able to speak that language.

Why is accounting perceived to be a difficult subject?

Accounting is commonly perceived to be difficult to understand. The reality, however, is that accounting is not rocket science. For example, you do not need to be good at maths to be an accountant, any more than you need to be good at maths to manage your own bank account. Neither do you need some special capacity for understanding, any more than you need special capacity to comprehend how your bank account fits into the overall picture of your personal finances. In short, you probably perceive accounting to be more difficult than it really is.

This is not, of course, to say that accounting is very simple and easily learned. And neither is it to deny that there are challenges in applying accounting knowledge to the real-world complexities of any given organisation, which is often not straightforward, even to the most expert of accountants. It *is* the case, however, that accounting is commonly perceived to be more difficult than it really is. It will help with your confidence in learning accounting to identify and discuss the reasons for this, as follows.

Financial statements are not particularly customer-oriented In most sectors of the economy, there is a very direct relationship between customers and suppliers. Moreover, competitive forces typically dictate that suppliers owe their economic survival to meeting customer needs, and to doing so with increasing effectiveness over time. Accounting is not quite like that. There exist suppliers of accounting information, namely companies, working with their auditors, and there exist customers also, in the sense that investors and other stakeholders are active users of accounting information. But the process of continuous improvement to meet customer needs is, for the most part, conspicuous by its absence. If you find it difficult to read the accounts in a company's annual report, you are not alone. You may have concluded, correctly, that the accounts are not designed with ease of reading primarily in mind. It is perhaps best to view a set of accounts as the minimum of information that meets regulatory requirements. Companies report what they are required to report, and auditors make sure that regulations are met. Neither the company nor the auditor need ever meet you, the customer, to discuss what information you might require, and in what form; the information is simply not designed in that way. You should not, therefore, be unduly hard upon yourself if you find the accounts difficult to read.

Accountants are preparers, not users If you train as an accountant, you learn how to create a set of accounts from a mass of individual transactions and events. You learn about accounting standards, tax laws, auditing standards and other relevant regulation and guidance. In short, you become expert in preparing accounts. Once the accounts

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have been signed off, however, your job is done. Accordingly, you actually learn surprisingly little about what somebody is supposed to do with a set of accounts once it has been prepared. This has two problems. First, it reinforces the lack of customer orientation described above. Second, while non-accountants reasonably assume that accountants know all there is to know about accounting, this turns out to be something of a mistake: accountants are preparers not users, they are taught to build a car but not to drive one. Moreover, the mistake is typically made by accountants themselves. They, too, assume that because they are qualified as accountants, they must be experts in accounting. They can therefore represent themselves as driving instructors. Certainly, they have no incentive to represent themselves otherwise. Most accounting textbooks also reflect this preparer-oriented shortcoming, for example choosing to focus on how to apply accounting standards to produce accounts, rather than on the inherent usefulness of the information that is generated. In general, however, you should not assume that others, including those with accounting expertise, are at much of an advantage to you when it comes to using financial statements. Your reasons to be confident are greater than you probably realise.

Accounts need context To borrow from John Donne: no set of accounts 'is an island, entire of itself'. There is very limited value in attempting to interpret accounting information without understanding its context. The good news for you is that, for sets of accounts in which you have an interest, for example those of your employer, you may already have the contextual information that you need, meaning that you start at an advantage. So, for example, the issue of how best to measure revenue is a common problem for technology companies. The best solution cannot be reached through an understanding of accounting alone, because it also requires knowledge of the underlying technology and of the company's business model, because these are the things that the accounting is attempting to measure. Likewise, accounting for inventory or for amounts receivable from customers is fairly simple if, but only if, you already have an understanding of the organisation's operations and customers. In short, you should see an understanding of accounting as a natural extension of the knowledge that you already have, and you should seek to understand accounting by means of contextualising it. If, instead, you view accounting as a technical subject, to be studied in isolation, then you put yourself at a disadvantage, because you assume that there is more to the subject than there really is.

This discussion highlights reasons why accounting has the appearance of being difficult. As mentioned earlier, however, this is not to say that accounting is very simple and easily learned. It is also worth exploring these real challenges in learning accounting. Understanding these will help your capacity to learn. These challenges may be grouped under five headings, as follows.

A unique way of thinking As this book will explain, there is a specific and unique way of thinking that is central to the way that accounting works. This is the so-called ‘double-entry’ method, which is at the heart of the recording of accounting information and the construction and presentation of financial statements. Getting your mind around the double-entry method is fundamental to an understanding of accounting, but the method may not be intuitive, and it is likely to differ from anything else you will have learned. Once you have grasped the essence of the method, you will see that a great strength of the double-entry accounting model is its inherent simplicity, yet you may need to be patient, as it can take some time and effort to reach the point where this simplicity becomes apparent. This sets accounting apart from many other subjects. Typically, a subject is simple when taken at an introductory level and it becomes increasingly complicated and difficult to understand as the levels are taken higher. Accounting is, in some sense, the opposite. It has a high entry barrier, meaning that a basic understanding of the essentials of the subject can be difficult to achieve, yet once this point is reached, the implicit and enduring simplicity of the double-entry accounting model starts to work in your favour. The good news, therefore, is that this book provides you with a more comprehensive foundation than you might have expected, because you can go a long way having grasped the fundamentals.

All data are connected Accounting is a measurement system, and each part of that system is in some way related to each other part. This increases the challenge in building your knowledge of the subject because understanding one part of the system requires, to some degree, understanding the other parts also. For example, the method of accounting for an item of machinery requires a simultaneous understanding of how assets are valued, how cash flows are recorded and how profit is measured. At some point, everything will come together, and a subject that may have seemed incredibly complex all of a sudden becomes greatly simplified. So, it will become instinctive and obvious why accounting for the above item of machinery is not just a question of asset valuation, but also of cash flow and profit. But it will take some time and effort to be able to make these connections.

Accounting is subjective A subject is no doubt easier to understand if there is always a right answer, and if it is always possible to know when that answer has been achieved. Accounting is not quite like that. Assets can be valued in different ways, and a choice between different, equally reasonable assumptions will lead to different determinations of profit. It is important, therefore, to approach the study of accounting with a willingness to accept ambiguity, and to seek to understand the reasons why the ambiguity arises.

Accounting is incomplete We cannot measure everything, and so the accounts cannot be a complete record of financial performance and financial position. For example, a pharmaceutical company may make a breakthrough discovery, but at the time that this discovery is made, it is not possible to estimate with any reliability how much the discovery will prove to be worth. In other words, while the company undoubtedly has an asset, we are unable to measure that asset's value. It follows that, although it is natural to think of total assets on a company's balance sheet as being a complete measure of wealth, this is not quite accurate because an asset that cannot be valued also cannot be reported on a balance sheet. In order to understand accounting, we must therefore appreciate the limitations of what we are able to measure.

Accounts provide high-level summaries If you look at the financial statements of a public company, you will not actually find that many numbers. It might be the case, for example, that a single number called revenue aggregates thousands of units of sales of hundreds of different products, each made at different periods of time across multiple markets. Likewise, thousands of transactions, ranging from the employment of people, to the purchase of services, to the consumption of goods, might all be added together into a single number called expenses. It is inevitable that accounting information must be highly aggregated in this way, because it is summarising considerable underlying volume and complexity. It is equally inevitable, therefore, that the majority of an organisation's accounting information is, in effect, unobservable. As a user of accounts, you are looking at a model of reality, built upon a series of assumptions, rather than looking directly at the reality itself, and this abstraction can make it more difficult to know what is going on. If, instead of relying upon high-level summaries, you choose to dig down into the details of the accounting information, then the opposite problem arises, namely that you can become overwhelmed by the sheer volume of data, and by the linkages among each of the components of the overall data set.

These are all good reasons why accounting information can be difficult to understand. In some cases, the issue is simply one of getting your mind around how the double-entry accounting model works, for which this book will help greatly. In some other cases, the problem is more fundamental, for example, when it is inherently difficult to measure financial performance or financial position. In these cases accounting information is inherently insufficient or subjective, and this book will help you to identify when these problems arise. This will also help you to recognise where there are challenges in accounting that are beyond the capacity of even the experts to deal with. In these cases, this book will enable you to take part in a debate around accounting issues, without fear that others have the answer and you do not.

The approach in this book

This Introduction has set the scene for this book, and it remains only to describe to you briefly the style of the book, the way in which it is structured, and the ground that will be covered.

The style of the book, as you will have already detected, is intuitive and informal. It is intuitive in the sense that a spirit of enquiry runs throughout the book. For example, we will not simply describe what an income statement is, but additionally we will explore why we have an income statement in the first place, what purpose it is intended to serve, and what strengths and limitations it has in achieving this purpose. The aim is that you will really come to understand what accounting is all about, which will give you a lasting foundation in the subject. But this will be achieved without getting too heavy or serious, because the style will be informal and designed to engage you. You should find that you are constantly being encouraged to think, and trying to ensure that you are mastering what you are reading. This is achieved in two ways. First, you will be posed questions at various stages in the book, and you will also be asked periodically to stop and reflect. You should take these opportunities as they arise. If you can give thought to a question before subsequently reading the answer, your engagement with the subject and your depth of learning are likely to be significantly enhanced. Second, you will have the opportunity to test your knowledge by means of worked examples throughout the book. Practising what you are learning in this way will help greatly, not least in identifying and filling gaps in your knowledge. It is important to remember that, in accounting, information is connected in various ways, and by working through these connections yourself, by way of numerical examples, you will deepen your understanding.

In terms of coverage, this book will not attempt to touch upon all aspects of accounting, nor will it get drawn into too much detail. The aim is to focus on the fundamentals. We will cover the most important components of any set of financial statements, such as revenue, gross margin, operating profit and so on. This focus on a small number of important items will achieve two things. First, it will prevent complexity from compromising clarity. Second, it will provide vital insight into the fundamental purpose, design, strengths and limitations of the financial statements.

This focus on a small number of key variables does not constrain the scope of the book. Indeed, the book will give you a wide-ranging overview, covering the use of accounting information by managers within organisations, the external communication of accounting information through an organisation's report and accounts, and the use made by investors and others of an organisation's published accounts. The focus on key variables will actually make it easier to maintain this wide scope, because we will be concerned with building a general picture, without risk of being sidetracked into details.

While a focus on key variables will be maintained throughout, you will nevertheless find yourself covering a considerable financial vocabulary as you progress through the book. To help you keep on top of this, and as a basis for consolidating and applying your learning, a full glossary of terms is provided at the back of the book.

It remains simply to outline for you the structure and content of the book. There is a basic distinction made between the foundations of accounting, which are covered in Part I of the book, and the applications of accounting, which are covered in Part II.

Part I

Introduction to Part I

Part I of the book will introduce you to the way that accounting works. We will review the purpose of financial statements, the process by which financial transactions and events are recorded in the accounting system, and the ways in which accounting information is presented. By the end of Part I, you will have a comprehensive overview of the foundations of accounting, as follows.

Chapter 1: A guided tour of the financial statements Chapter 1 will give you an overview of each of the financial statements, so that you can develop a high-level, introductory feel for how these financial statements can be read and interpreted.

Chapter 2: The need for financial information The primary financial statements are the balance sheet, income statement (profit and loss account), and cash flow statement. Chapter 2 will build on Chapter 1 by exploring in some depth the need for these statements, how they are related to one another, and what information each of them provides.

Chapter 3: Keeping track of economic activity Chapter 3 will take you through the nuts and bolts of accounting. Understanding where the numbers come from, and how they are fitted together, will greatly increase your insight into the subject of accounting.

Chapter 4: Summary of the foundations of accounting
To conclude and consolidate Part I of the book, Chapter 4 will test your understanding by means of an extended worked example, through which you will build a set of financial statements from a list of underlying transactions and events.

Part II of the book will cover several applications of accounting, such as how the financial statements can help in understanding how an organisation has grown, how effective its financial performance has been, what inherent risks it has in its financial structure, and how accounting can contribute to financial forecasts, budgets and corporate valuation. These applications of accounting will be introduced in a little more depth after the end of Part I.