CHAPTER 1

FINANCIAL ACCOUNTING IN CONTEXT

Here are some of the things you will be able to do after reading this chapter:

- comfortably use terms like 'accounting', 'management accounting', 'financial accounting', 'financial reporting', 'financial statements', 'reporting periods', and 'International Financial Reporting Standards (IFRS)';
- contrast the key accounting functions of recording and reporting;
- explain the distinguishing objective of business and the basic forms of business;
- recognise the advantages of incorporating a business with limited liability, and describe the differences between types of companies, including between listed and unlisted companies;
- discuss the financing, investing, and operating activities of a business and the dividend decision, and describe how financial accounting achieves its objective to report the effects of these activities and decisions;
- list the financial statements using the names favoured by IFRS.

When you begin to explore a technical subject, it helps to know at the outset what that subject is all about. So in this chapter we will be answering the question, 'What is financial accounting?' We will zoom out and have a look at the broad landscape in which financial accounting is just one feature: the **accounting** discipline as a whole. As this book is primarily about the financial accounting done by business enterprises, we will also explore businesses: their various forms, their basic characteristics, and the means by which they create value. The chapter concludes with some basic but essential information about the purpose and practice of financial accounting for businesses.

1.1 THE ACCOUNTING LANDSCAPE

Accounting is the recording and reporting of financial information about an entity. The entity could be a business, a government institution, a club, a society, or even an individual or a family. The principles and practices of accounting are similar no matter what entity it is serving, although there are some small differences. We will not concern ourselves with these differences in this book, which focuses on accounting for businesses.

That is not the only way we will be reducing our field of view. As you have already learned, accounting consists of two processes: recording and reporting. *Recording* involves entering financial information into an accounting system, which is usually a software package. Before computerised systems became commonplace, recording was done in books called journals and ledgers, which is why the people employed to enter the information were, and still are, called bookkeepers. If you studied accounting at school level, you would have learned a lot about recording, or **bookkeeping**, because the modern economy still requires a lot of bookkeepers, and school curricula are designed to develop skills needed by large numbers of people. However, you will encounter very little about the recording function of accounting in this book, which is not designed for would-be bookkeepers, but rather for a wide range of business professionals who wish to understand the reporting generated by accountants.

However, our scope is even narrower than that, for there are two main types of *reporting*, each aligned with one of the two accounting subdisciplines: financial accounting and management accounting. Reports generated by a **management accounting** system are—you guessed it!—for management's purposes. They help the **directors** of companies and other executives understand the financial affairs of their businesses, and to make decisions based on this understanding. For example, management accountants might prepare reports to help a manager know the weekly volumes of **sales** per branch, or the total **cost** of each unit produced in a factory, or how much profit could be earned in a new market. In fact, if a business decision is impacted by financial considerations, then a management accountant should be able to design a report to reveal those considerations. This means that there are as many management accounting reports as there are decisions for managers to make. In designing each report, management accountants must apply their minds analytically to the particular needs of the moment, aided by some general principles taught in management accounting courses, but unconstrained by rules or regulations, because the report will only be for internal use, and may even be unique.

Financial accounting, also called **financial reporting**, is very different. It is intended to inform the decisions made by people external to the business, such as investors considering whether to buy shares in the company, or bankers determining whether to recall a loan. Because the users of financial accountants' reports do not know and understand the business as well as insiders, these reports are extremely comprehensive, and this means they need to be highly standardised. Each business prepares the same four or five reports, packed with dense information and supplementary notes, using the same set of tightly regulated guidelines as other businesses. These reports—the output of the financial reporting process—are called **financial statements**, and they are the main subject of this book.

FIGURE 1.1 The landscape of accounting, showing the focus area of this book

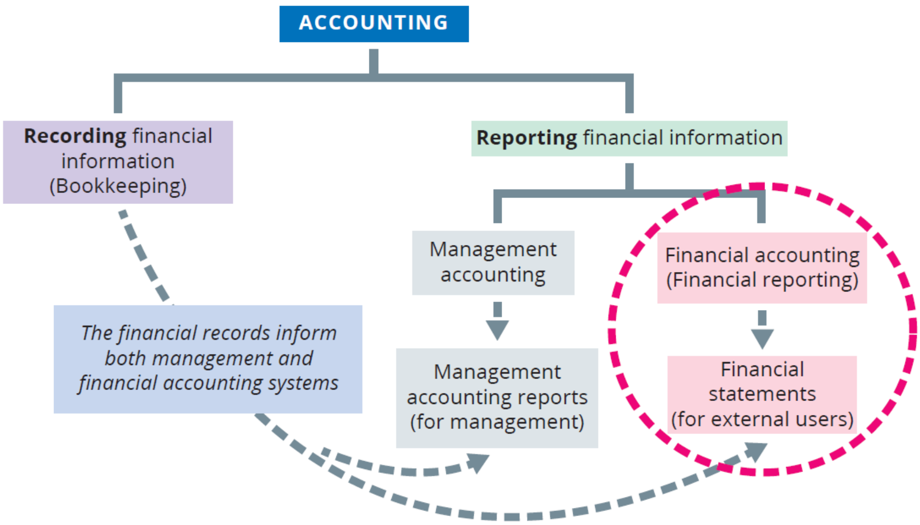


Figure 1.1 may help you consolidate your understanding of how financial statements fit into the landscape of accounting.

Section 1.4 will describe the four or five financial statements. People who aspire to become financial accountants must learn to prepare all of them for every type of business, which requires knowing every aspect of the recording process, and also how any possible business event should be represented in the financial statements. Moreover, in order to be able to perform a wide range of accounting functions, financial accounting students will also study management accounting, tax, and several other subjects. As you can imagine, acquiring this knowledge requires many years of training and experience.

This book is not for those accounting specialists who aspire to *prepare* financial statements. Instead, it is written for people who wish to *use* financial statements effectively in business. As we explained in the preface, financial statements are the scorecard, and accounting is the language of business. Anyone who occupies, or seeks to occupy, a key role in business—whether as an investor, director, manager, founder, entrepreneur, or frankly just an effective and impressive member of any business team—must understand the scorecard and be able to speak the language.

Every businessperson should be familiar with accounting, which is the language of business, and should be able to read financial statements, which are the scorecard.

1.2 CHARACTERISTICS OF BUSINESSES

As we've mentioned, the financial statements you will be learning to understand are those of businesses. Of course, everyone has some sense of what a business is, but it is important, before we start, to make sure that the essential features of businesses are clear.

Let us start with a simple question: what is it that makes a business different from other organisations? After all, there is a huge diversity of businesses, from the independent hairdresser down the road, hoping for fifty clients a week, to a company like Apple Inc, which has sold its products to well over half a billion people, and whose market extends to virtually every patch of the planet.[1] One could be forgiven for thinking that the hairdresser is more like the local sports club, and Apple is more like a powerful government, than they are like each other. Yet Apple and the hairdresser are grouped together as businesses, while clubs and governments are not. Why is this?

The answer is that businesses have owners who want the business to create value for them. Beyond this one commonality, there are many differences between businesses, quite apart from the type of products and services they sell or the size of their market. In this section, we will explore some of these differences.

A quick note: this book is written for readers in many different countries, which is possible because the financial reporting guidelines do not vary much between countries (or **jurisdictions**). However, the finer details of business law do vary considerably from one jurisdiction to another, and so by necessity we will be covering the characteristics of businesses in broad, generalised terms. At the end of this chapter, you will be encouraged to investigate the major aspects of business law in your country specifically.

1.2.1 Unincorporated businesses

The least complicated form of business is often called a **sole trader** or **sole proprietor**. As the name implies, a sole trader has just one owner. It is one example of an unincorporated business, which simply means the business has not been established by law to be a separate entity from the owner. In other words, legally speaking, it is the owner who owns the assets used by the business, and who owes the debts of the business. In law, the business assets and debts are treated no differently from the owner's house and the bank loan they used to buy that house. Indeed, even the term 'sole trader' has this same characteristic: it refers both to the business itself (as in 'that phone repair shop is a sole trader'), and also the owner of the business (as in 'Michelle is a sole trader').

One consequence of not being incorporated is that the tax authority will generally tax any **income** made by the business as if it were the owner's own income (that is, at the owner's individual tax rate). As individual tax rates are often—though not always—higher than the tax rate that applies to incorporated businesses, this is often a disadvantage of operating as a sole trader. However, a clear advantage of operating as a sole trader is simplicity, insofar as the owner does not have to comply with the extensive administrative requirements—the so-called 'red tape'—involved in starting and running a company. This advantage erodes as a business grows, so that over a certain size the benefits of incorporation justify having to deal with the red tape. Thus, sole traders tend to be small businesses.

The two most common forms of unincorporated businesses are sole traders and partnerships (though some partnerships may be incorporated, depending on the jurisdiction).

Not all small businesses are owned by only one person, of course. An unincorporated business with more than one owner is called a '**partnership**', and the individuals who own it are called 'partners'. A partnership agreement typically outlines several key features of the business, such as: the responsibilities of each partner; the way in which profits and **losses** will be allocated; and the way in which the partnership will be dissolved. Unincorporated partnerships are legally much like sole traders, except that ownership of the business assets and responsibility for the business debts are held jointly by the partners.

Because the business and owners are not legally distinct, the owners of unincorporated businesses need to be involved in any substantial transactions, such as taking loans, buying insurance, and acquiring productive capacity, which means that sole traders and partners are typically closely involved in managing their businesses.

It is worth briefly considering how the accounting works for unincorporated businesses. Whilst the businesses themselves are not *legally* separate from the owner, the business's *accounting* is kept apart from the financial affairs of the owners. Even in a tiny sole trader, decisions should be informed by a clear understanding of the financial position and performance of the business itself, and this requires a set of financial records and reports that ignores personal transactions such as the owner's spending on housing, food, and recreation. The need for separate accounting is even stronger in partnerships, where partners need to know precisely how the business is performing in order to know how the gains (or losses) should be divided. Also, some partners may not be as involved as others in the daily financial administration of the business, which means that stricter financial controls and record-keeping are desirable. This principle—that for accounting purposes businesses are treated as distinct from their owners, even if they are not in fact legally separate entities—is known as the **entity concept**.

1.2.2 Incorporation

In Latin, the word 'corpus' means 'body', and so '**incorporation**' means to give something a body, metaphorically speaking. Thus, to incorporate a business is to register it with the legal authorities as an entity separate from its owners.

Although commonplace, this is a bizarre idea, which needs some explanation. The law uses the term 'natural persons' to describe real, flesh-and-blood people, but it also recognises a separate, artificial category of legal person: a 'juristic' person. Juristic persons do not have all of the same legal rights and responsibilities as natural persons (eg they cannot marry, and since they cannot drive, they do not have to obey speed limits), but many laws apply equally to both types of legal person. So an incorporated entity can own assets, borrow money, sue other legal persons (or be sued by them), and be punished by the law in appropriate ways.

By establishing a business as a separate legal person entitled to own assets, owe debts, sue, and be sued, incorporation allows the business to transact in its own capacity.

Not all incorporated entities are businesses. For example, in most parts of the world, charities, universities, and clubs may be incorporated. Conversely, especially in developed countries, most businesses are incorporated. When a business incorporates, legal ownership of its assets and the legal obligation for its debts transfer to the new entity. Thus, sole traders or partners effectively sell their direct stakes in their businesses for an indirect stake: the right to benefit from the value generated by the business's operations.

Depending on the country, there may be a variety of incorporated business forms. For example, South Africa includes a form of business called a "close corporation", which is not technically a company, but which is a seperate legal entity from its owners. But in every jurisdiction, by far the most common form of incorporated business is the **company**. On incorporation as a company, a business's owners become **shareholders**, which is to say that they become owners (or holders) of shares that represent their stake in the business. These shares can be traded between existing shareholders, or sold by existing shareholders to new shareholders. The buying and selling of these shares are transactions between parties that are separate from the business, and so this trading does not affect the business as such. For example, if existing Shareholder A sells shares to new Shareholder B, then Shareholder B will pay a sum of money to Shareholder A and take ownership of these shares. The transaction affects Shareholders A and B financially, but not the business, which merely has a new owner.

Incorporation makes it easier for business owners to sell portions of their ownership, and makes it easier for accountants to record these transfers of ownership.

This characteristic of incorporated entities confers a major practical benefit: it is a mechanism by which small portions of the ownership stake in a business can be sold (or, say, be bestowed by a will), which is usually a lot more challenging for unincorporated businesses.

There is also a substantial accounting benefit. When any portion of the ownership in a sole trader or unincorporated partnership is sold or inherited, elaborate accounting is required to recognise the legal end of one business and the beginning of another. However, because incorporated businesses are legally distinct from their owners, none of this is necessary, since the accounting for the business can continue regardless of the change in ownership. This feature of incorporation is known as perpetual succession.

1.2.3 Limited liability

Because there is no legal distinction between unincorporated businesses and their owners, these owners are personally responsible, or liable, for the businesses' debts. In other words, if somehow it became impossible to pay the businesses' debts using the businesses' assets, the owners' personal possessions will be expropriated to pay off the debts.

Suppose that a sole trader puts in R1 000 to start a business, which is then used to pay the 20% deposit required to purchase R5 000 of high-end sunscreen. The business takes delivery of the sunscreen, expecting to be able to sell the sunscreen for R7 000, pay back the supplier the debt of R4 000, and end up with R3 000 in the bank. However, it turns out that there is a flaw in the business model: it is winter, and no one wants sunscreen. Instead, the best the sole trader can do is flog the sunscreen for R500, leaving only one business asset: a bank account containing R500. This is not nearly enough to pay back the supplier, who is still owed R4 000. The supplier can therefore make a claim against the sole trader's personal assets. Perhaps, for example, they will have to sell their car to pay the additional R3 500 owing to the supplier.

We thus say that unincorporated businesses have 'unlimited liability': there is no limit to the amount of money that owners stand to lose. When there is more than one owner, this is especially risky, because one partner may be held personally responsible for debts arising from poor business decisions made by other partners.

This introduces a major potential advantage of incorporation written into the law: **limited liability**. Typically, the shareholders of a company do not risk losing their personal possessions if the business goes bankrupt; instead, the most they can lose is the investment they have already made.

If the sunscreen business was incorporated as a company with limited liability, the supplier would not be able to make a legal claim against the shareholder's personal assets: they would receive only the R500 from the business's bank account. The owner—now called a shareholder of course—loses their initial R1 000 investment, but that is all.

If this seems too good to be true, it is worth knowing that in practice, banks and other major lenders are keenly aware of the dangers of giving credit to a client protected by limited liability, and will typically ask the shareholders or executives to personally secure business loans (that is, sign an agreement to allow their personal assets to be taken if the business cannot pay). Thus, especially in smaller businesses funded with bank loans, limited liability is unlikely to offer full protection for the owners. However, it certainly does protect them from being forced to pay *unsecured* debts, like the amount owed to the sunscreen supplier. And it fully protects the personal assets of investors who buy the shares of much bigger companies on a **stock exchange**: the most they can lose is what they pay for their shares.

Not all incorporated businesses have limited liability. For example, in some countries, professional practices like those of lawyers, doctors, or accountants are entitled to incorporate, but are nevertheless prevented from obtaining limited liability. In South Africa, these companies can be recognised by the letters 'Inc' after their names. Such companies's shareholders are denied limited liability in order to increase the level of accountability with which such professionals operate. There are even some notable businesses, for example Irish **subsidiaries** of Apple Inc, which have chosen to register as unlimited liability companies, in order to avoid the obligation to publicly disclose key financial information each year.[2] However, the shareholders of the vast majority of companies are protected by limited liability.

Table 1.1 summarises the chief differences between incorporated and unincorporated businesses, focusing on the benefits enjoyed by each. Note how, generally speaking, the

TABLE 1.1 Summary of the benefits enjoyed by unincorporated and incorporated businesses

	Unincorporated businesses (eg sole traders and partnerships)	Incorporated businesses (eg companies)
Less 'red tape'	Yes	No
Owners can avoid management responsibility	No	Yes
Easy transfer of portions of ownership	No	Yes (though may be restricted)
Perpetual succession	No	Yes
Limited liability	No	Yes (though not for all types)
Tax savings	Usually better for incorporated businesses, though this depends on business size, tax rates, and other features of tax legislation	

advantages of incorporation kick in as soon as a business grows beyond being very small.

1.2.4 Types of companies

Business law establishes a few different types of companies. For example, non-profit organisations like charities are often able to register as companies, even though they are not businesses, as they do not aim to make their shareholders wealthier. Thus, in South Africa, a non-profit organisation can register as a company, in which case they will add the letters 'NPC' behind their name. In the UK and Australia, charities are often incorporated as Companies Limited by Guarantee; in Germany, the equivalent type of company is a *gemeinnützige Gesellschaft mit beschränkter Haftung*, or gGmbH; and so on.

When it comes to limited liability companies that are for-profit, there is generally a distinction between **private companies** and **public companies**. The primary difference is that the shares of a private company, as the name suggests, may not be publicly traded, whereas a public company's shares are not subject to any trading restrictions. This, of course, limits the extent to which a private company can raise financing, but at the same time protects its shareholders from any undesirable changes in shareholding. For example, if the shareholders in a private company agree that, before any of them can sell their shares, they must first offer them to the other shareholders, they are then all protected from the risk of having to share their ownership of the business with someone they do not approve of.

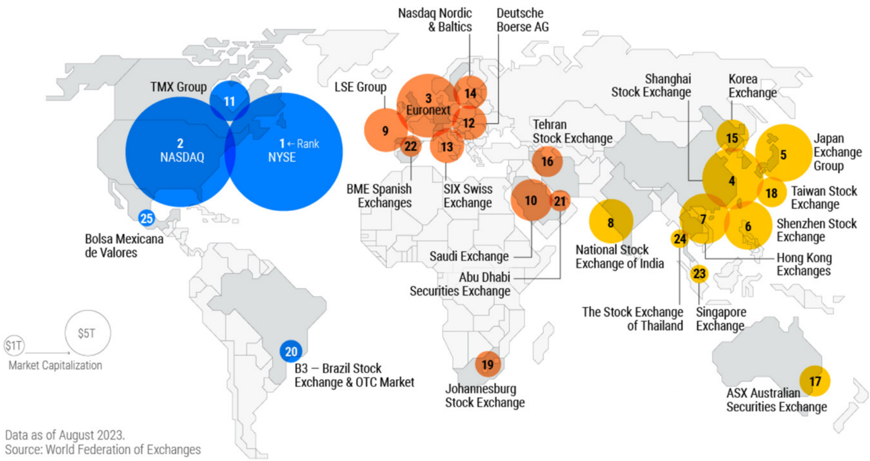
On the whole, private companies are smaller, and their shareholders often play a role in managing the business. The shareholders of public companies are generally not involved in the business operations; instead, they appoint a **board of directors** to manage the business on their behalf, and the board in turn selects a managing director (known by a variety of titles, including 'chief executive officer' or 'CEO') who takes overall responsibility for running the business. If the shareholders are unhappy with the way in which the company is being run, they can appoint a new board of directors who will (hopefully) run the company according to their wishes.

The official name of a company usually includes a designation at the end of its name to indicate what type of company it is. For example, in South Africa, '(Pty) Ltd' designates a private company, and 'Ltd' is used for public companies. You will also see 'PLC', 'LLC', 'SA', 'Inc', and several other such designations in other countries.

1.2.5 Listed companies

A public company may choose to **list** its shares on a stock exchange (that is, a market where shares are bought and sold) as a means to boost the marketability of its shares. Marketability may be important for many shareholders, as it allows them to sell their shares more easily when they require cash, or when they decide the company is no longer a good investment. If the shares are not listed on a stock exchange (usually we simply say that the shares are 'unlisted'), then the shareholders may have difficulty in finding a buyer for their shares when they wish to disinvest. Similarly, a prospective investor will find it much easier to acquire shares in a listed company than in an unlisted company.

FIGURE 1.2 The locations of the world's largest stock exchanges



Source: Neufeld, D. & Fortin, S. *Mapped: The Largest Stock Exchanges in the World.* The Visual Capitalist. 3 July 2024. Available at: https://www.visualcapitalist.com/largest-stock-exchanges-in-the-world.

Because of the restrictions on the sale of their shares, private companies cannot be listed. Not all public companies are listed: those which are not will typically have far fewer shareholders, who have each acquired relatively large investments directly from the company or from a previous shareholder.

1.2.6 Public interest entities

You may hear that a certain company is a '**public interest entity**', or '**PIE**' (yes, it is pronounced like the food product!). This is a term used in the business law of several jurisdictions to indicate a high level of public accountability and transparency demanded of that entity. In general, PIEs are defined to include all listed companies and other very large companies, and they are held to the strictest accounting requirements.

For example, virtually all companies are required to keep detailed accounting records and to produce annual financial statements. However, PIEs (or, in jurisdictions which do not use this term, listed companies) must do so in accordance with the rigorous and demanding standards set by the **International Accounting Standards Board (IASB)**, called '**International Financial Reporting Standards**' (or '**IFRS**'). Other companies are generally able to choose to report using less onerous guidelines. We shall discuss financial reporting requirements in detail in Chapter 3.

Public interest entities and similar companies are generally required to produce financial statements in accordance with IFRS.

The financial statements of PIEs and similar companies must also be subjected to an annual **audit**. This means that external auditors—a team of independent experts in financial reporting—must verify the validity, accuracy, and completeness of the company's financial statements each year, via a thorough investigation of the company's accounting system and records. Other companies may be permitted to undergo a less onerous review of their financial statements.

The financial statements we will be considering in this book are prepared according to IFRS and are audited, because they belong to listed, public companies, like Burberry, which by dint of being a listed, UK-based company is also a PIE.

Figure 1.3 illustrates the context of the various business forms that we have looked at in this chapter, showing the application of the terms we have been using.

FIGURE 1.3 Overview of the most common business forms

UNINCORPORATED BUSINESSES	INCORPORATED BUSINESSES	
Sole traders	Listed public companies	Public interest entities (PIEs)
	Unlisted public companies	May be PIEs, depending on the extent of their influence on the public interest
Unincorporated partnerships	Private companies	
	Other incorporated types of business	

1.3 CREATING BUSINESS VALUE

We have already established that businesses are distinct from other organisations because they aim to create value for their owners. This distinguishing objective applies equally to companies, partnerships, sole traders, and all other business forms. Any enterprise to whom it does not apply is, by definition, not a business.

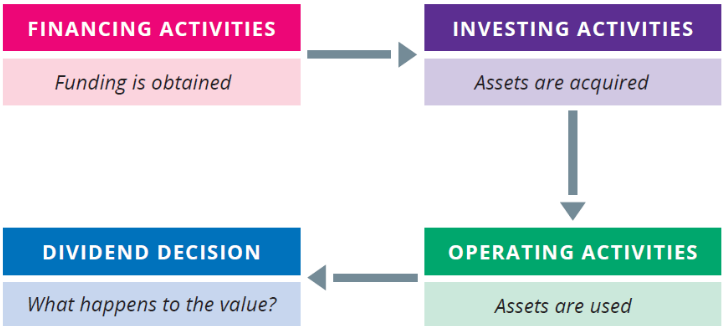
Many people believe that businesses also ought to achieve other objectives, for example taking care of employees, protecting the environment, and operating responsibly within the wider social context. These are noble and important goals, and businesses can certainly achieve them. The huge advances in human living standards, affluence, and well-being that have been achieved over the past few hundred years have come from many different sources: science, technology, political progress, and so on. But it is no exaggeration to say that much of this development has been driven forward by businesses. On the whole, agricultural production has been expanded, life-saving medicines have been developed, modern conveniences have been supplied, communication has been facilitated, and retirement savings have been grown, all by businesses. No matter what goods or services a business sells, it is essentially a **value creation** machine, and—in the best-case scenario—the value it creates can be spread far and wide.

In Chapter 14, we shall discuss forms of corporate reporting which explicitly report how well a business has created value for a wide variety of **stakeholders**. However, as you will see, the principles and practices underlying these reports are substantially different from those which you will learn about in the first thirteen chapters. This is because financial accounting—our main subject—is unashamedly designed to focus on the creation of value from a very specific point of view: those who have a financial stake in the business.

1.3.1 Introduction to the value creation cycle

It can be very difficult to create value in practice—just ask any business manager!—so let's begin with a simple illustration. There are many ways to depict the **value creation cycle**, but given our focus on the creation of value from the perspective of those who have contributed funding to the business, we shall use Figure 1.4.

FIGURE 1.4 Overview of the value creation cycle



Put simply, business managers must obtain funding, acquire assets with this funding, and then use the assets to generate additional value. They then from time to time make a decision about whether to distribute some of this value directly to the owners in the form of a **dividend**, which is usually in the form of cash, although other items of value are sometimes transferred. They may instead decide to keep the value in the business and use it as funding for further value creation.

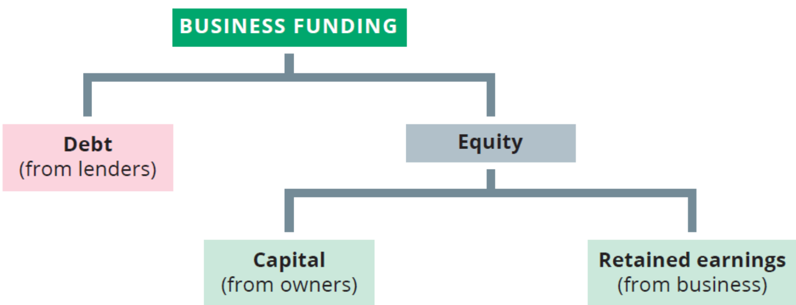
Over the next few sections, we shall build up your understanding of each phase of the value creation cycle, so that in section 1.3.6 we will be able to present a much more comprehensive picture of the process.

1.3.2 Financing activities

There are two main sources from which a business may be financed, which we call **debt** and **equity**. Equity is the funding that can be attributed to the owners, and it consists of two basic components. The first, called '**capital**', is what the owners contribute to the business when it starts, or later when it needs more funds to grow. The other component of equity is the value that the business has created but not yet paid out to the owners as a dividend. This value is often known as '**retained earnings**'. We will return to this concept in section 1.3.5 on the dividend decision.

Figure 1.5 summarises the sources of funding.

FIGURE 1.5 The basic sources of business funding



To the extent that a business is financed with debt, it is using funds borrowed from lenders. The simplest form of borrowed funds is a bank loan, but there are several other ways to obtain debt financing, including **bonds**, corporate **debentures**, and simply buying **inventory** or other goods on credit.

The **financing activities** of a business are determined by the *financing decisions* that the business's managers make when it starts, and from time to time as more funding is required. In particular, these decisions involve determining the optimal mix of equity and debt, as this mix has a direct and somewhat counterintuitive effect on the business's ability to create value for the owners, as Example 1.1 demonstrates.

Suppose that we have two people who each wish to start a similar business. Mr Cautious contributes R10 000 to the business, and his business does not borrow any money. Ms Risky also contributes R10 000 to her business, but this business borrows a further R10 000 from the bank at an interest rate of 8% pa. Each of their businesses uses the funds raised to invest in assets which earn a 10% return (before interest) each year, resulting in the following outcomes for the year.

EXAMPLE 1.1

	Mr Cautious R	Ms Risky R
Return before interest (R10 000 × 10%, R20 000 × 10%)	1 000	2 000
Interest (R10 000 × 8%)		– 800
Return after interest	1 000	1 200

It is clear that, although Mr Cautious and Ms Risky both contributed R10 000 to their respective businesses, Ms Risky's business made a return after interest of R1 200, compared to Mr Cautious's result of R1 000. Borrowing R10 000 from the bank has boosted the amount of value Ms Risky was able to create. This wonderful effect is known as **leverage** or **gearing**.

Leverage allows businesses to create more value for owners by borrowing, so long as the rate of return before interest is higher than the interest rate itself. In Ms Risky's case, she was able to borrow money from the bank at 8% and use it to produce a return of 10%, thus effectively making 2% for herself on the borrowed money (it is no coincidence that her additional R200 return is equal to 2% of her R10 000 borrowings).

On learning about the positive effect of debt, one may feel tempted to borrow as much as possible to lever up the returns to owners, but this would be treacherous. If interest rates were to rise to 25%, say, the results would change, as shown in Example 1.2:

EXAMPLE 1.2

	Mr Cautious R	Ms Risky R
Return before interest	1 000	2 000
Interest (R10 000 × 25%)		– 2 500
Return after interest	1 000	– 500

Assuming that business activity remains the same after the increase in interest rates, both businesses would still make a return before interest of 10%. And Mr Cautious would still make a return after interest of R1 000, but now Ms Risky would make a negative return—a loss—of R500. In fact, in reality this scenario is likely to be even worse for Ms Risky: when interest rates rise in an economy, customers tend to spend less (because more of their salary goes towards the higher interest payments on their mortgages), causing most businesses' sales to fall. Thus, value creation in Ms Risky's business would probably be squeezed by both a lower return before interest and also rising interest payments, resulting in an even greater loss than R500.

We can see from this example one of the great trade-offs in business, if not in life: on the whole, you cannot get greater returns without taking on more risk. When interest rates are low, Ms Risky is able to make returns superior to those of Mr Cautious, but these higher returns are more risky, as we see when interest rates rise.

A business is financed through a mix of debt and equity called the capital structure. Debt can leverage up returns to owners powerfully, but also increases the risk of a business making a loss.

In our example, who made the better financing decision? If interest rates remain low, Ms Risky's decision to borrow appears correct, but if interest rates rise, then the decision of the risk-averse Mr Cautious appears better, since he at least earns a positive return overall. Ultimately, there is no correct level of borrowings: it depends on the business and the economic conditions. If interest rates are low, and if the business can consistently use its assets to generate high rates of return, then additional borrowings are probably worth the risk; but when economic changes lead to higher interest rates, and/or when the business's assets are likely to be less productive, it would be well advised to borrow less.

So financing decisions are important, but not easy. A vast amount of research has been done over the years on the optimal **capital structure** (ie the mix of debt and equity) and, although some of the findings may be useful to those who have to make the financing decisions, the quick answer is that there is no simple rule for them to follow.

1.3.3 Investing activities

Once the business has raised funding, it must do something with this money. The resulting **investing activities** might include procuring an office building, constructing a factory, acquiring another business, investing in a brand, developing a new consultancy service, or indeed purchasing a million other things. You probably already know that the items a business acquires for use in the value creation process are called 'assets' by accountants. This book will have a great deal more to say about assets, and in time we'll give you a much more formal definition, but for now let's move on, confident that it is easy to appreciate the importance of the managers' investing decisions. After all, the business's assets are the only means by which it ultimately creates any value at all.

1.3.4 Operating activities

The assets acquired by the business's investing activities are now used in a wide-ranging multitude of **operating activities**: manufacturing, maintenance, software development, marketing, administration, and everything else that happens in a business each day to achieve the sale of its goods or services. For the creation of value, not only do these processes need to run efficiently and effectively, but key operating decisions need to be made well. These include, for example, decisions about the price at which goods or services are sold, the way in which costs are controlled, the extent to which advertising is used to promote goods and services, whether or not key functions are outsourced, and a myriad other decisions made on a day-to-day basis.

In overseeing a business's operating activities, managers need to pay close attention to three different indicators of value creation. Because of their importance, these items are each given great prominence in the financial statements. The first is **revenue**, the total amount for which a business's goods and/or services are sold. Of course, a business cannot create value unless it generates revenue. However, success in business is not actually about maximising revenue, because of a business's costs, known by accountants as '**expenses**'. For example, if a business had to spend R1.2 million in order to generate revenue of R1 million, then its expenses exceed its revenue, and the business would not be creating value, but instead destroying it. It would be better, say, to earn only R800 000 of revenue, if that could be achieved by spending only R500 000 on expenses. This is because value is only created to the extent that revenue exceeds expenses; that is, if **profit** is earned. Thus, profit is the second vital indicator of value creation.

The third is **cash flow**. The difference between profit and cash flow will be explained fully in Chapter 2. For now, it is enough for you to know that when accountants work out revenue, they include the full value of the sales that have been made on credit, even before the cash has been received. Similarly, they report the cost of using assets as an expense when the assets are actually used, not when they are paid for. For example, a machine costing R1 million that will be used for ten years will likely cause an expense of R100 000 for each of its ten years of use, even if it is paid for in full in the first year.

This means that it is perfectly possible for a business to be reporting profit and yet for these profits not to be producing net cash inflows. This may be remedied in the short term by obtaining more debt funding, but this comes at the cost of interest. And borrowing may not even be an option if, for example, the business has already reached its borrowing limit. Running out of cash is a major problem for a business because it means its debts cannot be settled, new products cannot be acquired, employees cannot be paid, and so on, threatening near-term sustainability. Indeed, many businesses have collapsed soon after reporting healthy profits because they were not generating the cash they needed to operate.

To create value, a business's operating activities must use its assets to generate revenue, from this revenue earn profit, and then convert the profit into net operating cash inflows.

On the other hand, if a business's operations generate sizeable net cash inflows, this money can be used to sustain the business in the short term and also to engage in more investing activities to expand the business's market and ultimately create more value. Although revenue and profits are two key indicators of financial performance, it is a business's ability to turn profits into net operating cash inflows which is the ultimate test of value creation.

1.3.5 The dividend decision

Value can either be kept in the business as retained earnings, or paid out as dividends.

Once the business has made financing decisions to obtain funding, investing decisions to acquire assets, and then through its operations has generated revenue, profit, and cash, its managers will be in a position to decide what it should do with the value that has been created. As we have already observed, this decision is a choice between paying out dividends to owners, or instead increasing the value of the owners' stake in the business by retaining the **earnings** and using them to finance further growth.

This brings us to a dilemma experienced by listed companies in particular. From the business's perspective, if there are lucrative opportunities to create more value using more assets, then it would be better if the business spent its earnings on acquiring these assets instead of paying the earnings out as a dividend. And in theory, rational investors should also prefer for value to be retained by a business. Unless they need the cash, they would have to spend time and energy deciding how to invest the dividends they receive. During that time, the money will sit in their bank accounts, where it will earn a relatively low return. If the business has good growth prospects, it would be better instead to quickly reinvest the dividends by using them to purchase more shares in the same business. However, this is inefficient: not only are taxes often **payable** on receipt of a dividend, but also stockbrokers and banks charge fees on these transactions. It would be better to skip the cycle of distribution and reinvestment and just leave the value in the business. After all, should investors need the money, or prefer to purchase a different investment, they could always 'monetise' their stake in the business by selling some of their shares.

However, in practice other factors influence the dividend decision. These are largely psychological in nature (in financial theory, such factors are called 'behavioural'), resulting from a deep-rooted cynicism about the trustworthiness of big corporations, whose investors generally have no involvement in day-to-day operations. Investing in a business is risky, and shareholders are continually looking for signals that there is a problem with their investment. You will see, as you work through this book, that a business's financial performance is difficult to understand: investors can never be sure that a business's success is sustainable.

The dividend decision has a signalling effect in financial markets: a deviation from expectations is understood to be an important indicator of the business's prospects.

Thus, when businesses do not pay a dividend, or when they cut the number of dividends that they pay, this is perceived by investors as a sign that there may be a problem in the business. Investors immediately fear either that the business has no cash or that something ominous is going to happen in the future. The dividend is thus seen as a powerful signalling mechanism, one which investors and consequently businesses take very seriously.

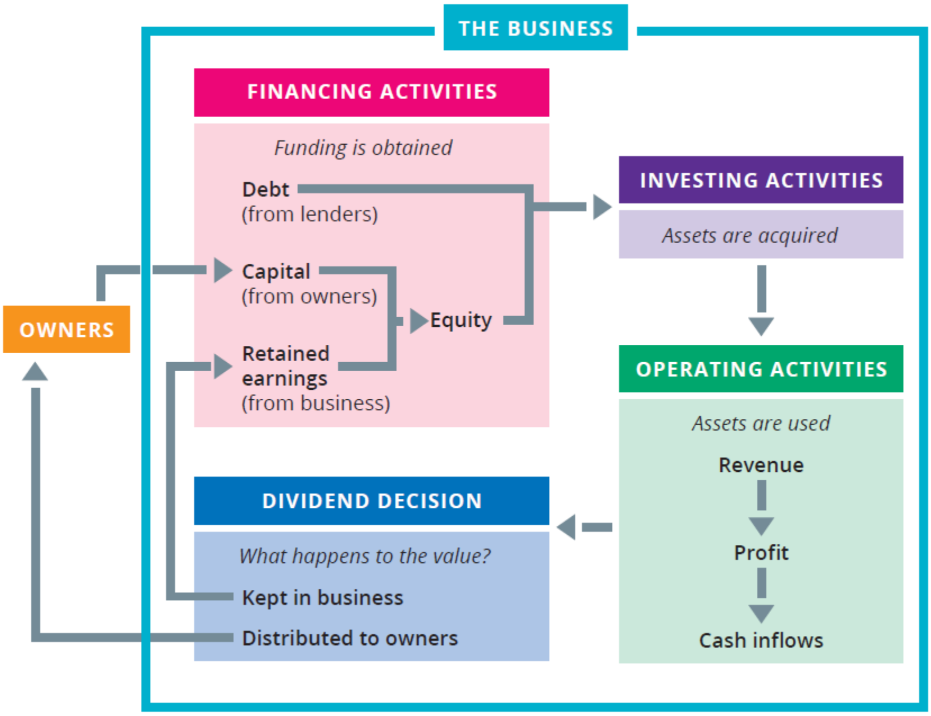
As with other business decisions, there is no simple rule for making dividend decisions: business managers have to balance the benefits of retaining earnings in the business against the signalling effects of a reduced or zero dividend.

1.3.6 Detailed illustration of the value creation cycle

Now that you have learned more about the value creation cycle, we can present a fuller picture as follows in Figure 1.6.

Bear in mind that paying a dividend is not the only way that a business can transfer value to its owners. By retaining some value, and putting it to work in the value creation cycle, businesses themselves become more valuable. This additional value raises the price for which the owners can sell their stakes in the business. This happens for any thriving business, but it is particularly noticeable in listed companies, whose success reveals itself

FIGURE 1.6 A detailed illustration of the value creation cycle



in higher published share prices over the long term, which in many cases in fact enrich their shareholders by substantially more than the dividends they pay.

This conception of how business value is created, from the perspective of someone with a financial stake in the business, is critical to your learning about business in general. It is also vitally important for your understanding of financial accounting, which is designed to report the business's financial position and performance in terms of this cycle. If you do not yet feel comfortable with any aspect of Figure 1.6, it would be advisable to revisit the relevant sections before moving on.

Financial statements comprise the statement of financial position, the statement of comprehensive income, the statement of cash flows, and the statement of changes in equity, accompanied by detailed notes.

1.4 FINANCIAL STATEMENTS

The financial statements officially consist of the **statement of financial position**, the **statement of comprehensive income**, the **statement of cash flows**, and the **statement of changes in equity**. Note, however, that this list suggests that there are four financial statements, but you should not expect always to see only four financial statements. The statement of comprehensive income is often split into two **separate financial statements** (the larger of which is often called the **income statement**, or **statement of profit or loss**), making a total of five. Indeed, there is yet one more component to a company's financial reporting, called the **notes to the financial statements**, sometimes more casually referred to as 'disclosures', which contain supporting information that usually covers far more pages than the financial statements themselves.

1.4.1 Twenty-first-century changes to the financial statements

If you learned some accounting in the late twentieth century, you would be forgiven for thinking that the financial statements are the **balance sheet**, income statement, and cash flow statement. Things have changed since then, with many resulting changes to the name, format, and contents of most companies' financial statements.

Table 1.2 is intended as a guide for those readers more familiar with earlier financial reporting requirements. In the first column, the financial statements that may be most familiar to such readers are listed, and the second column lists the financial statements that are currently required, indicating their relationship with the old financial statements.

TABLE 1.2 Summary of the twenty-first-century changes to financial statements

Earlier financial statement	Newer financial statement	Comments
Balance sheet	Statement of financial position	The new name is not compulsory. The new statement is not substantially different from the old statement. The chief contents of this statement are assets (see Chapter 6), liabilities (see Chapter 7), and equity (see Chapter 10).
Cash flow statement	Statement of cash flows	The new name is not compulsory. The format of the new statement is no different from the format of the old statement. The contents of this statement are cash inflows and outflows (see Chapter 5).
Income statement	Statement of comprehensive income (or statement of profit or loss and other comprehensive income)	The new name is not compulsory. The format has changed substantially, especially because of a new section reporting other comprehensive income. This statement can be presented in either a one-statement or two-statement format. The contents of this statement are items of income and expense (see Chapter 4).
	Statement of changes in equity	There was no twentieth-century equivalent of this statement, though much, if not all, of its content could be found in the *notes* to older financial statements. Particular attention is paid to this statement in Chapter 10.

1.4.2 Financial reporting periods

A set of financial statements is prepared for a particular period, known as the **reporting period**. In theory, this period could be any length of time—reporting the effects of the business events that occurred in a particular day, week, month, decade, and so on—but the standard financial reporting period is a year, known as a **financial year** or **fiscal year**.

That said, companies may have to prepare financial statements quarterly (every three months) or semi-annually (every six months), depending on whether they are public interest entities, whether they are listed, and the laws of the country in which they are based. These financial statements are called **interim financial statements**, but they typically attract less attention than annual financial statements, which are required of practically every company.

In most jurisdictions, the twelve months of a company's financial year do not have to align with the twelve months of the calendar: generally, companies are able to choose a year-end to suit them, which often is not 31 December. For example, H&M's year-end is 30 November. Some companies prefer their financial years to be composed of an exact number of weeks, usually because they measure performance during the year on a weekly basis. This is how, for example, Wm Morrison Supermarkets plc, which aims for a year-end near 31 January, had a fifty-three-week financial year ending on 4 February 2018, followed by a fifty-two-week year ending on 3 February 2019. Interestingly, Burberry recently adopted this policy, following its reporting period of a full year ended 31 March 2018 with a fifty-two-week period ended 30 March 2019.

When financial years do not end on 31 December, they are usually named according to the calendar year in which they do actually end. For example, even though the vast majority of the fifty-two weeks in Burberry's financial year that ended on 30 March 2019 were in the 2018 calendar year, it is nonetheless known as the '2019 financial year'. Even more trickily, quite often the words 'financial year' are dropped, and so when financial folks talk about '2019' at Burberry, they are talking about a period that ended only three months into the 2019 calendar year.

1.4.3 What the financial statements report

The objective of the financial statements is, in formal terms, 'to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other **creditors** in making decisions about providing resources to the entity'.[3]

In other words, the financial statements should enable these primary users of the financial statements—actual and potential providers of funding—to assess the business's financing, investing, and operating activities, and the quality of the dividend decision.

In particular, the outcomes of the financing and investing activities are reported on the statement of financial position, which shows the sources of funding, and to what use the funding has been put. The latter is shown by a list of the assets that the business has acquired (eg property, equipment, **financial instruments**, inventory, and so on). The sources of funding are shown as a list of the types of debt and equity that have been used to finance the business. The statement of financial position is often referred to as a 'snapshot' of the business: in other words, a view of the business at a distinct point in time, which is the end of the business's reporting period. This snapshot feature makes the statement of financial position unique: it is the only financial statement which is not in fact reporting for a period of time.

The statement of financial position shows the business's situation at a point in time, like a snapshot.

The statement of comprehensive income primarily reports the results of the business's operating activities; in other words, it shows how well the business has used its assets to create value, focusing on revenue, expenses, and profit. It also shows the interest costs of any debt arising from financing decisions. Whilst the statement of financial position is seen as a snapshot, the statement of comprehensive income is more like a movie, as it is a summary of events that influenced the business's performance during the reporting period.

The statement of cash flows also presents a summary of events that influenced the business's performance; but it does this by looking purely at the cash flows into and out of the business. These cash flows are carefully categorised according to whether they relate to the operating, investing, or financing activities of the business.

The statements of comprehensive income and of cash flows show financial performance over time, like a movie.

The statement of changes in equity explains how the amounts reported in each category of equity on the statement of financial position at the end of the reporting period changed since the beginning of the period. The effects of the dividend decision are also reported on this statement.

Whilst most of the information contained in the financial statements is historic, the insights they provide into the business should enable users to take a view of its ability to create value in the future. In particular, the ability to generate future cash flows is fundamental to any decisions that the users of the financial statements may wish to make, and therefore much of the information in the financial statements and accompanying notes is intended to help users understand the timing and certainty of these future cash flows. We will discuss this in much greater detail in Chapter 11 on financial analysis and Chapter 12 on business valuations.

CONCLUSION

Now that you understand the context of financial reporting, you are ready for a shallow dive into the mechanics of the accounting system. In Chapter 2, we shall explore the basic elements of recording a business's transactions, and in so doing, show how the system generates financial statements that achieve their objective and embody the characteristics we have described so far.

SUMMARY OF KEY POINTS

- Accounting consists of recording and reporting.
- Management accounting and financial accounting both make use of the recording function, but the reporting produced by these two subdisciplines is very different because the former is intended to inform the decisions of management, while the latter is intended to inform the decisions of existing and potential investors, lenders, and other creditors.
- The reports generated by financial accounting are called the financial statements. They consist of the statement of financial position, the statement of comprehensive income, the statement of cash flows, and the statement of changes in equity.
- In many respects, accounting is the language of business, and financial statements are the scorecard. This is why it is so important for anyone in business to understand them.
- Once a business has grown beyond being very small, there are many benefits of incorporating it, usually by registering it as a company. (See Table 1.1 for a list of the benefits of incorporation.)
- There are many business forms, including several different types of companies, the most influential of which are typically designated as 'public interest entities'. These must prepare their annual financial statements according to IFRS. (See Figure 1.3 for an overview of the most common business forms.)
- 'IFRS' stands for 'International Financial Reporting Standards' and consists of a rigorous and demanding set of international guidelines about how to prepare financial statements.
- Businesses are different from other organisations because they aim to create value for their owners, although they can—and often do—create value for other stakeholders too.
- The value creation cycle involves financing, investing, and operating activities, and ultimately a dividend decision. (See Figure 1.6 for a detailed illustration of the value creation cycle.)
- Businesses are financed by a capital structure, which is a combination of debt and equity. Equity usually consists of capital contributions from owners and also retained earnings.
- Through an effect known as 'leverage', financing a business with debt (as opposed to equity) can increase returns to owners, but also increases the risk of losses.
- In overseeing a business's operating activities, managers must pay close attention to three important figures: revenue, profit, and operating cash flows. To create value, a business must earn revenue, earn as much profit as possible from this revenue, and ensure that this profit produces as much net operating cash inflow as possible.
- Although in theory it is better for a successful listed company to retain earnings instead of paying out dividends, in practice this risks triggering a signal to financial markets that the company is in some kind of distress.
- The names and formats of the financial statements have changed since the beginning of the twenty-first century. (See Table 1.2 for a summary of these changes.)
- Reporting periods are usually a year long, but may be, for example, fifty-two weeks. A reporting period that ends in March 2019 is called the '2019 financial year'.
- The statement of financial position reports the business's situation on the **reporting date** in respect of its financing and investing activities.

- **The statement of comprehensive income shows the business's financial performance during the reporting period. It reports the effects of operating activities, focusing on revenue, expenses, and profit.**
- **The statement of cash flows also shows financial performance, but from a different perspective. It reports exclusively cash flows for the reporting period, categorised according to financing, investing, and operating activities.**
- **The statement of changes in equity reports movements in the categories of equity reported on the statement of financial position, including the effects of the dividend decision.**

CHAPTER QUESTIONS

The suggested solutions to the concept questions (marked 'CQ') can be found in Appendix III. Because of their wide-ranging and non-specific nature, it is not possible to provide suggested solutions to the investigative questions.

CONCEPT QUESTIONS

CQ 1.1 Briefly explain the difference between management accounting and financial accounting.

CQ 1.2 Identify three typical benefits of incorporating a business.

CQ 1.3 Explain what it means to say that a company is 'listed'.

CQ 1.4 Describe what it means to 'leverage' a business's capital structure. Explain the purpose of leverage, and also the circumstances under which it will achieve its purpose.

CQ 1.5 Identify the four main financial statements and briefly describe what each tells us about the business.

CQ 1.6 List the four phases in the value creation cycle viewed from the perspective of the providers of funding.

INVESTIGATION QUESTIONS

IQ 1.7 Investigate the different business forms in your country. Determine whether business law in your country establishes all of the forms mentioned in this chapter: sole trader, unincorporated partnership, incorporated partnership, private company, unlisted public company, and listed public company. What terms are used to describe these entities in your country and what designation appears at the end of the businesses' names in each case? Are there any other business forms available in your country?

IQ 1.8 Identify the prominent stock exchange in your country and obtain a list of the companies that are listed on this stock exchange. (They can usually be found on the stock exchange's website or in the financial press.) How many companies are listed on this stock exchange? List those companies with which you are familiar.

IQ 1.9 Identify a listed retail company based in your country and obtain its latest financial statements. (They can usually be found quickly via an internet search using the term 'financial statements' and the company's name.) Identify its financial year-end and locate each of the individual financial statements. Look through these statements for items that interest you and then find out more about those items in the notes to the financial statements.

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