



Introduction to the context of accounting

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Introduction

Through a series of activities and practical examples, this course provides a broad overview of the field of accounting, including: its origins and objectives, the nature of accounting information and accounting information systems, and accountancy's role in helping organisations meet their objectives.

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Learning Outcomes

After studying this course, you should be able to:

- describe accounting's primary objective
- explain what is meant by inputs to and outputs from the accounting information system
- explain the relationship between data, data processing, data summarisation and information
- explain the difference between data and information
- describe the five main characteristics of 'good' information.

1 What is accounting about?

Let's start with a question – we shall call questions 'Activities'. For many of these activities you will need a pen and paper, or you can use the course Forum, to note down your own ideas. Once you have completed the Activity you should return to the text, read the comments that follow the activity, and then think again about your answer. Change it, if you like. Once you are happy that you have understood the comments and that your own answer is alright, you should continue to read the text. OK? Well, here's the question:

Activity 1

What do you think is the main objective of accounting?

Answer

You may have found the question quite difficult. Maybe you didn't? You may have said accounting's main objective is any one (or more) of the following:

- to let people know if they are making a profit or a loss
- to let people know what their business is worth
- to let people know what a transaction was worth to them
- to let people know how much cash they have
- to let people know how wealthy they are
- to let people know how much they are owed
- to let people know how much they owe to someone else
- to enable people to keep a financial check on the things they do.

The list could go on and on. You could have used 'organisation' rather than 'people' and you could have used terms like 'surplus' and 'deficit' instead of 'profit' and 'loss'.

If you thought the main objective of accounting is any of these, you did well. They are all similar. However, the primary objective is a bit more complicated, it is to provide information for decision-making. The information is usually thought to be financial, but it need not be – it could be, for example, the number of sheep owned by a farmer, or the number of cars belonging to a car dealer, or the number of footballers under contract for a football club. Now let's consider what gave rise to accounting.



Accountants and accounting are not modern phenomena. They have been around since ancient times!

Accounting goes back many hundreds, even thousands of years. It began because people needed to record business transactions and to know if they were being financially successful in their businesses.

For many years, accounting was based on common sense – businesses recorded the data they considered necessary in order to obtain the information they required.

Let's see what information you might get from the records of accounting data you might keep.

Activity 2

(Remember, you should *never* look at the answer that follows before attempting an activity.)

Imagine a business recorded what it had sold, to whom, the date it was sold, the price it was sold at, and the date it received payment from the customer, along with similar data concerning the purchases made by the business.

What information do you think could be produced from this data? Take five minutes to write down your answer.

Answer

This data would enable the business to know how much it had sold and how much it had purchased, how much cash it had received and paid, how much was owing to it and how much was owed by it, and whether it was making a profit or a loss over a particular time period.

Sometimes, even these basic pieces of data were not recorded. Rather, the **invoices** (each of which shows the details of a transaction) and **receipts** (each of which confirms that a payment has been made) were kept and then given to an accountant to calculate the profit or loss of the business up to some point in time. The accountant would be someone who had learnt how to convert the financial transaction data (i.e. the data recorded on invoices and receipts, etc.) into accounting information. Quite often, it would be the owner of the business who performed all the accounting tasks. Otherwise, an employee would be given the job of maintaining the accounting records.

About 500 years ago, an Italian monk called Pacioli wrote down the basic rules for recording accounting data. These rules still form the basis of accounting.



Portrait of Luca Pacioli (c.1445–c.1514) Mathematician and Friend of Leonardo da Vinci, 1495 by Jacopo de'Barbari (1440/50–c.1515) Museo e Gallerie Nazianale di Capodimonte, Naples, Italy/Bridgeman Art Gallery

As businesses grew in size, so it became less common for the owner to personally maintain the accounting records and more usual for someone to be employed as an accounts clerk. Then, as companies began to dominate the business environment, managers became separated from owners – the owners of companies (shareholders) often have no involvement in the day-to-day running of the business. This led to a need for some monitoring of the managers. Auditing of the financial records by accountants became the norm and this, effectively, established the accounting profession.

Accounting has expanded greatly from its intuitive beginnings. It is now heavily regulated and controlled and there are well-established procedures for virtually all the traditional accounting tasks. The environment within which accounting exists is known as the

accounting information system (often abbreviated to 'accounting system'). Let's look at what an accounting information system is.

2 Accounting information systems

A **system** can be defined as a group of elements that are formed and interact to achieve goals or objectives. You spend all your life with systems – your home, your work, your family, the school you attended. An organisation is a system in which a number of people work together to achieve particular objectives.

Within each system there are smaller systems. The one everyone knows is the solar system. Within it, each of the planets is, itself, a system. Taking Earth, each country is a system, and so on. Another one you will recognise is you – you yourself are a system, full of subsystems such as your respiratory system and your nervous system. Within a business, there are sub-systems called departments which, themselves, can be broken down into smaller systems right down to individual employees.

All systems are themselves located within an environment – even the solar system, which has the universe as its environment. Input enters a system from something located in its environment. (The space shuttle entering the earth's atmosphere from outer space is an example of an input to the earth from its environment.) A system processes its input and then sends its output to something located in its environment. A business receives inputs to its system in the form, for example, of raw materials from suppliers, payments from customers, etc. It then converts the inputs into goods and services and sends its outputs (goods and services) into its environment (to its customers). It records these activities in its accounting information system.

Figure 1 shows examples of the data inputs and information outputs from an accounting information system.

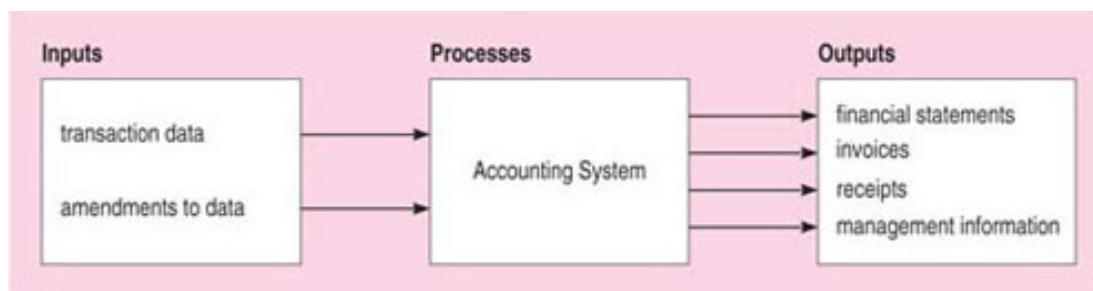


Figure 1 A simple accounting information system

Businesses continue to exist because managers take decisions about what they should do. In order to take a decision, a manager needs information. The information is provided to the manager from an information system. It is an item of output from the information system. The decision taken by the manager is input back into the information system. Changes are then made to information held within the information system, and then output from the information system to the recipient(s).

For example, a manager who is in charge of ordering raw materials will be told by the information system how much raw material is held by the organisation and how much will be needed. The manager then decides how much raw material to order and who to order it from. That decision is entered into the information system by the manager, the order is

sent to the supplier by the information system and the information system is updated to show that an order has been placed.

Business organisations have a number of systems, all of which must work together in an effective and efficient way. There are systems for purchasing, production, marketing, human relations, etc. The accounting system is just one of the systems within an organisation. They also have an information system. The information system receives data from its environment, processes it, and then sends the converted data into its environment in the form of information.

The accounting information system is part of the organisation's information system. Whereas the information system will process a mixture of quantitative (i.e. numerical) and qualitative (i.e. non-numerical) data, the accounting information system focuses almost entirely on processing quantitative data. The accounting system is just one of the systems within an organisation, all of which must work together in an effective and efficient way.

Activity 3

Think of an organisation you know and spend one minute listing examples of the *input* to its accounting information system.

Answer

Input to the accounting information system means any entry of data made to it. That data recorded can refer to both things going into and out of the organisation.

You might have thought of things like details of goods purchased for resale (e.g. price, quantity, date received); goods purchased to be used in the organisation (e.g. machinery and computer equipment); details of cash received from customers (e.g. the amount received, date received); details of cash paid for wages, purchases, rent, rates, telephones, electricity, and so on. The actual list is very much longer. Just about anything that can be quantified coming into an organisation or going out of it will be recorded as input to the accounting system.

Activity 4

Think again of the same organisation you know and spend one minute listing examples of the *output* from its accounting information system.

Answer

You might have thought of things like reports showing the total cost of everything sold and the total revenue from their sale; reports showing the profit made on a sale and/or for all sales over a period of time; payslips, totals of the amount spent on wages, or of the cost of all the equipment belonging to the organisation, and so on. It can also include data or information sent from the accounting system to another of the organisation's information systems.

As with inputs to the accounting information system, the actual list of outputs is very long indeed. Some of the output is organised in a commonly agreed format so that anyone looking at the output will understand it. Other output is presented in a way that suits an individual or group of people who will use the information to take decisions of one type or another.

3 What is an accountant?

To return to basics, let's take a few minutes to think about the role of an accountant, and the basic abilities and skills he/she needs to have.

Activity 5

Use your word processor to write a short answer to each of these questions. You should spend at least two minutes on each question:

- What do you think an accountant does?
- What makes an accountant different from a lawyer, a doctor, an engineer, or an IT specialist?
- What abilities and skills do you think a 'good' accountant has?
- What abilities and skills do you think make a 'great' accountant?
- What do you think the accountant of 2010 will be doing every day?

Did you manage to write down answers to them all? Did you try? Well done if you did. Even if you wrote something that you later discover was wrong, it's useful to save these answers as a record of your early ideas about accountants and what they do.

Your views will evolve as you learn more about accounting. Let's begin by looking at the questions from a different perspective.

Activity 6

Consider your answers to the questions in Activity 5 and then **use the course Forum** to write 100 words describing why you are studying this course. Then write another 100 words describing what job you want to be doing in 2010. Finally, write 100 words on whether or not accounting is useful for decision making. In each case, try to ensure you write *precisely 100* words.

Answer

You were asked to write precisely 100 words because accountants have to summarise things a lot. Usually it is data that they have to group together and summarise so as to produce information. However, they also have to produce reports that, ideally, should be clear, brief, and focused. One way to learn how to do this is to set a word limit on something you have been asked to write and then making sure you write exactly that number of words.

Did you find it easy to write precisely 100 words for each of these answers? Did you succeed in doing so? Whatever you did, you now should know why you are working through this course, what you want to be doing in 2010, and whether you think accounting as you know it is or is not useful for decision making. I hope you decided that the answer to that question was 'yes'.

You have also just experienced one of the features of accounting – summarising. Part of the processing that occurs within the accounting information system is the summarising of data (input) into information (output).

Now, let's consider the relationship between data and information.

4 Data v. information

4.1 What's the difference?

The distinction between **data** and **information** is very important in accounting. New accounting students often ask, 'what is data?' 'How does it differ from information?' 'Are they the same thing?'

Activity 7

What answers do you have to these three questions?

- 1 What is data?
- 2 How does it differ from information?
- 3 Are they the same thing?

Answer

Data is the accountant's raw material that is converted into information. Data means nothing until it is processed. What good is it to know that a book cost a bookshop £10? That only becomes information when it is combined with something else that enables you to assess it within a relevant context, such as how much the book would have cost had the bookshop bought it from a different supplier.

Information is the accountant's product.

Activity 8

What other data do you think could be used in order to convert the data about the cost of the book into information?

Answer

You may have suggested any of the following:

- the selling price of the book
- the amount the bookshop could have purchased the book for elsewhere
- the time it took to receive the book from the publisher after the bookshop ordered it
- the condition of the book when it arrived in the bookshop.

These are all good answers, and there are probably many others. In each case, they provide the means of assessing something:

- what profit will be made if the book is sold
- whether the bookshop paid a 'good' price for the book

- how long in advance the bookshop should order the book if it wants it to be available for customers on a particular date
- whether the supplier packages books appropriately.

By assessing it, a decision can be made. The data has been converted into information. Information is data processed for a purpose. In each and every case, once you have information, you can take a decision. You can't take meaningful decisions with data. First, you must convert the data into information, you must have a purpose in using the information, and the decision maker must exercise judgement in how to use the information in taking a decision. This can be expressed as:

Decision = Purpose + Information + Judgement

Accountants specialise in converting data into information. In other words, they specialise in taking data and making it useful for decision making. Much of the data accountants process is financial – pounds and pence – and some is non-financial but quantitative – e.g. the number of pairs of shoes available for sale in a shoe shop. Traditionally accountants do not deal with data that cannot be expressed in numbers.

4.2 Qualitative v. quantitative data

Accountants do not, traditionally, deal with qualitative data, such as whether a customer was happy or sad, or whether it looked like it would rain when a customer bought an umbrella.

Activity 9

Why do you think accountants do not normally deal with qualitative data? Take a minute to write down your answer.

Answer

Qualitative data is not objective. It cannot be reliably verified. Quantitative data can often be verified – you can see the evidence on paper that it is correct. For example, if it was recorded in the information system that a certain customer said they liked the flavour of the ice cream in an ice cream shop, you'd find it very difficult to prove that that customer actually said that. On the other hand, the cost of raw materials entered in the accounting records can be checked against the data on the invoices received from the suppliers. Accountants like things to be clear and unambiguous, for there to be no doubt, for the amounts they present to be clearly verifiable.

Accountants believe that dealing with qualitative data is someone else's task, so they leave it to engineers, marketing staff and others to make what they can of it. There is a school of thought that believes this to be very short-sighted of the accountants, and that by doing so they run the risk of losing out in the long-run to members of other professions who extend their expertise to encompass the processing of both qualitative and quantitative data.

Activity 10

What do you think? Should accountants restrict themselves to processing financial and other quantitative data? Why?/Why not?

Answer

The rational answer to this question is 'no', accountants need to be more flexible, more willing to embrace new sources of data that can enable them to provide ever-better information. However, before they rush off into these new areas, they must first master the basics of accounting, which is what you are in the process of doing.

Now let's consider what makes information 'good'.

5 The characteristics of 'good' information

Have you ever seen a set of published accounts for a company? If you haven't or, even if you have, take a look at some now. (They are often called the **annual report**.)

Internet activities are intended to show you the large range of information available at your fingertips. Some of it is useful, most of it is not. Accountants are increasingly having to deal with growing quantities of information and many are having to search for relevant information as part of their jobs. These Internet activities are designed to develop your skills of searching for information, identifying relevant and useful information and filtering out the rest. These are key skills for accountants and ones that will become increasingly more important over the next few years. You may find the Internet activities quite long, perhaps boring, perhaps tedious. If you do, remember that you are learning how to do something that is really only learnt through practice. Do your best to do them and spend the recommended time on the exercise. If you can't, return to it later and, over the course of reading this course, do your best to spend the suggested time on each of these electronic activities. It will be worth the pain of getting used to it!

Internet Activity 1

Go to Carol <http://www.carol.co.uk>. You will need to register to use this website. **Spend at least 30 minutes** looking at some of the annual reports of the companies it contains. In particular, try to find one that includes something called a 'balance sheet'. Do you think what you've been looking at is 'good' information? Why?/Why not? Take five minutes to write down your thoughts.

Answer

It would be 'good' if you found it useful. Did you? Probably not. It didn't meet any need you had other than to fulfil the request I made that you look for it.

To be 'good' from an accounting perspective, information must be *useful*. That is, it must serve a purpose. **Information must be useful to someone or it is not worth producing it.** What other characteristics do you think information needs to have before it can be considered 'good'?

Let's consider an example. Imagine that you decided you wanted to extend your knowledge of accounting beyond this course, and decided to buy a copy of *Business Accounting 1* by Frank Wood and Alan Sangster. You want the book in the next week, but unfortunately, your local bookshop has none in stock. Your bookshop manager tells you that they could order one, but that it would take three weeks before the bookshop would have it for you. When you explain that you want it urgently, the manager gives you the

phone number of another bookshop five miles away, together with the correct area code. You phone the other bookshop. It has a copy in stock and you are able to go there and purchase it that day.

Activity 11

Was the telephone number 'good' information? Why?/Why not?

Answer

You probably noticed that a number of things tell you that it was 'good':

- You received the phone number quickly and when you needed it. In other words, the information was *timely*.
- It was directly useful in the context of your problem – that is, it was *relevant*.
- It was *complete* – you were given the entire telephone number that you needed in order to get through to the the bookshop.
- It was *accurate* – the number was correct.

These are some of the more important aspects of information that make it 'good'.

Now, let's consider something else. Without organisations – whether they are profit-seeking businesses, charities, universities, clubs, churches, or any other type of organisation you can think of – accounting would not have much of a role to play. Why do organisations such as profit-seeking businesses exist?

6 Accounting and the objectives of the firm

6.1 Variety of business objectives

Most people would agree that the primary objective of a business is to survive and, in order to survive, its revenue must be greater than its expenditure.

Activity 12

What other objectives do you think a business may have? Take a minute to write down at least four.

Answer

Here are some possible objectives for a business you may have considered:

- to ensure that profit is maximised
- to achieve a given proportion of market share
- to achieve and maintain a high level of quality in the goods and services it offers
- to ensure customers are satisfied
- to ensure full employment of employees

- to protect the welfare of employees (through, for example, a sound company pension scheme)
- to ensure that employees are well-trained
- to protect the environment.

Some businesses will include some of these in their objectives, others will include more of them, others less. It is up to the management of individual businesses to decide what their objectives are, and many similar businesses will have very different objectives. In the end, people working in a business need to know what its objectives are if they are to take the correct decisions. If they don't, decisions will be taken on the basis of the individual beliefs of the decision takers and the businesses will suffer as employees pursue different objectives.

An example would be where the person responsible for selling assumes that the business wishes to maximise market. In order to do so, selling prices are set very low. Another employee assumes the business wishes to minimise costs. In order to minimise costs, the volume of goods kept in store for sale is put to a minimum. When higher than expected orders come in for goods as a result of sales prices having been cut to boost demand, there are not enough available so the business needs to put employees onto overtime with its higher wage costs, resulting in reduced profits. If the primary objective of the business was to maximise profits, these two employees have prevented it being achieved because they made the wrong assumptions concerning the objectives of the business. That was an example of how objectives can conflict. Let's look at that in more detail.

6.2 Conflicting objectives

You have just seen how an objective to maximise market share may not be compatible with an objective to maximise profits. Businesses may have multiple objectives, many of which conflict. Think, for example, how difficult it would be for an oil refinery to both maximise profits and minimise the effect upon the environment of its production activities. Similarly, maintaining high product quality while minimising costs would be extremely difficult.

Imagine if a business was struggling. Its costs were rising, its revenue was falling, and it was being threatened with closure. It had two objectives, to minimise costs while maintaining a high quality product. It could survive if it were to reduce the quality of its products, but it would have to alter its quality objective. It might get away with it in the short term, but its customers would be bound to notice fairly soon. If they do, the reputation of the business would suffer. Demand for its products would fall and it could end up in an even worse position than it is in at present.

Activity 13

What would you do if you were in charge of the business? Spend a minute writing down your thoughts.

Answer

You could try improving the after-sales service, to ensure that anyone who had a substandard product would be able to get a good one or a refund very easily. That might be quite expensive. You could try increasing demand by spending more on

promotion, but that may take some time to make an impact, by which time the market may have become aware of the drop in product quality. It really is a very difficult situation that can possibly only be dealt with by the business completely revising its objectives. To do so, it needs good information from its accountants.

To summarise, people working in a business need to know what its objectives are if they are to take the correct decisions. If they don't, decisions will be taken on the basis of the individual beliefs of the decision takers and the business will suffer as everyone pursues different objectives.

Thus, everyone in the business needs to know what the objectives are, and accountants need to provide the decision takers with the information they need in order to (a) pursue their objectives (b) monitor performance in relation to the objectives, and (c) amend the objectives when needed.

Accountants provide information so that decisions can be taken that are compatible with the objectives of the organisation.

Conclusion

You should now have a clearer idea of the context in which accounting is set. You should also be aware that accounting is the recording and processing of data into information, of the characteristics of 'good' information, and of the relationship between accounting and organisational objectives.

Now, you should complete the following self-assessed question.

Follow-up activity:

Visit each of the following online search engines: alltheweb, metacrawler and Yahoo; and in each search for the word 'accounting'. Now spend at least 45 minutes comparing the results by looking at some of the sites for each list, trying to find some useful looking sites returned by each of the search engines. Which of the search engines do think returns the most useful results?

Answer

The three sites can all provide you with links to useful information, but they all do so in different ways. The first, alltheweb, does so by accessing a vast database of URLs – look at how many more links its search produced than the other two. This has the disadvantage that you will find that a large proportion of the sites found are useless to you, so you are paying for easy access to a large database with increased time spent filtering out rubbish.

The second site, metacrawler, uses a very different approach. When you ask it to perform a search it then searches a set of other search engines and provides you with what it believes to be the most helpful links from each of them. Generally, the results should be of a higher immediate quality than those from alltheweb (as you won't need to do nearly as much weeding out of rubbish). However, it doesn't produce nearly such a large list of links.

Yahoo presents you with a very different form of result. You can see the way in which it is organised in hierarchies. This allows you to narrow down a search by going deeper

and deeper into a branch of the database. It has the advantage that once you find the right branch, any information found there will likely be of some use. It has the disadvantage that compared to the search engines like alltheweb, metacrawler, webcrawler, lycos, and altavista it has a very small database.

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