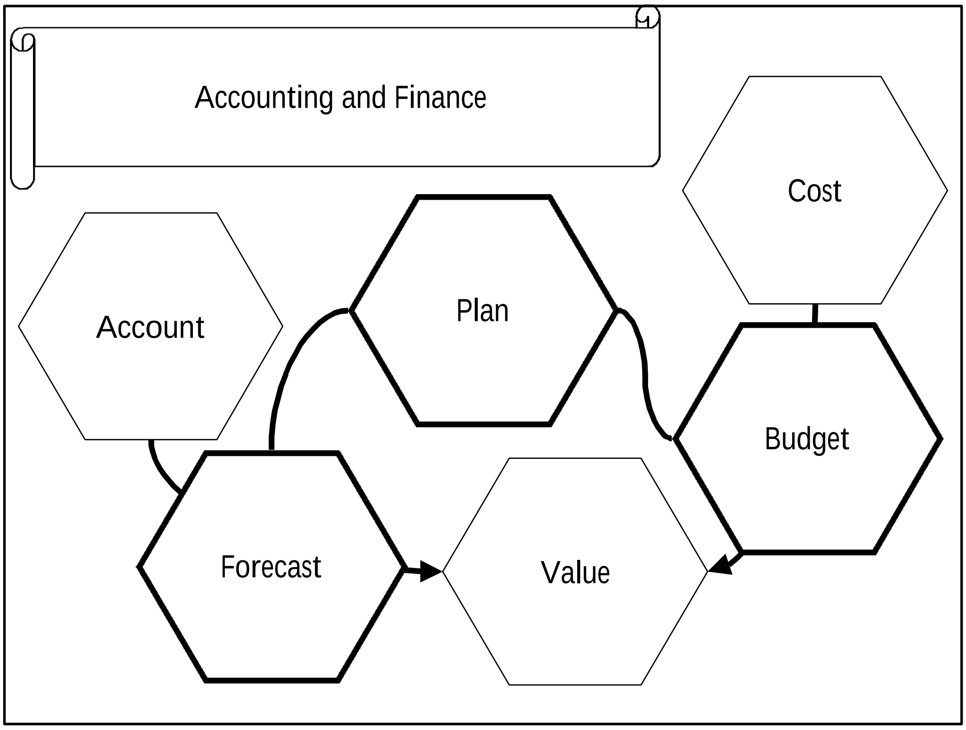


Overview

- Accounting is usually understood as a branch of Applied Economics
  - Making sense of the financial performance of the firm
- As recent events have shown (e.g. Enron), accounting and auditing have important Ethical implications.
  - Auditors represents the interests of outside stakeholders, and moderate the authority of the directors.

- Within business computing, accounting is studied as a typical example of a management information and control system.
- We may also recognize some of the social power and influence of the accounting profession within the business world.
  - We introduce the notion of "discursive practice" - a sociological concept that allows us to focus on the possible dominance of an accounting perspective over alternative perspectives.

Sociology of Accounting

- In sociology, “accounting” refers to the language that people and groups use to justify their actions to themselves and others. Accounts are often constructed to deny or reduce responsibility for illegal, anti-social or deviant behaviour.
- Accounts are often framed in the context of a relationship with “parent-child” characteristics.
  - The parent demands an account (where have you been, what have you been doing) from the child. Craig David’s song: “Can You Fill Me In?”
  - The policeman demands an account (what are you up to then) from a citizen.

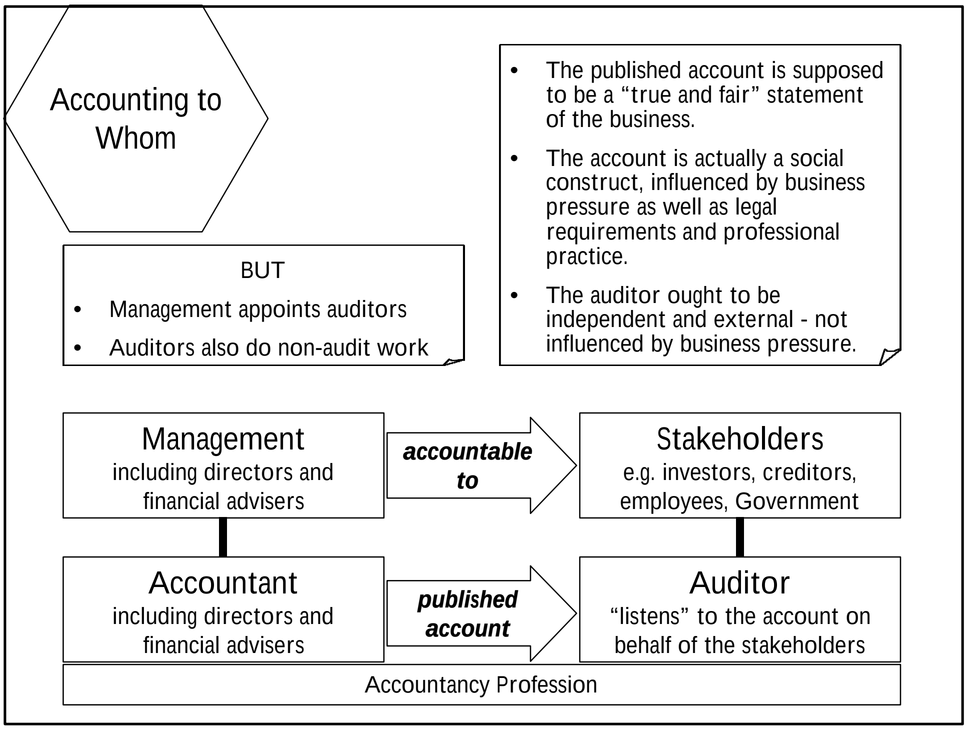
“statuses of the interactants”

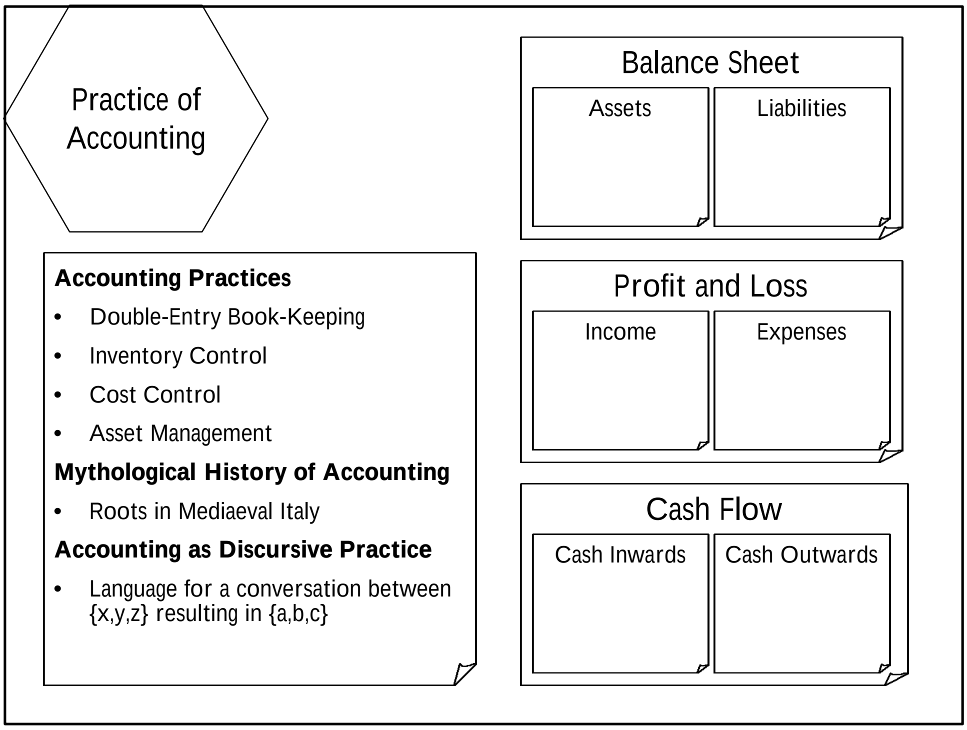
- An account is … “a linguistic device employed whenever an action is subjected to valuative enquiry. Such devices are a crucial element in the social order since they prevent conflicts from arising by verbally bridging the gap between action and expectation. Moreover, accounts are ‘situated’ according to the statuses of the interactants and are standardized within cultures so that certain accounts are terminologically stabilized and routinely expected when an activity falls outside the domain of expectations”. [Lyman & Scott]

Business of Accounting

- In business, accounting refers to the financial calculations that people and companies use to justify their actions to themselves and others - notably shareholders and other investors.
- Business accounting is a **Discursive Practice**
  - involving a special language as well as special techniques
  - conferring special power and influence over business affairs.

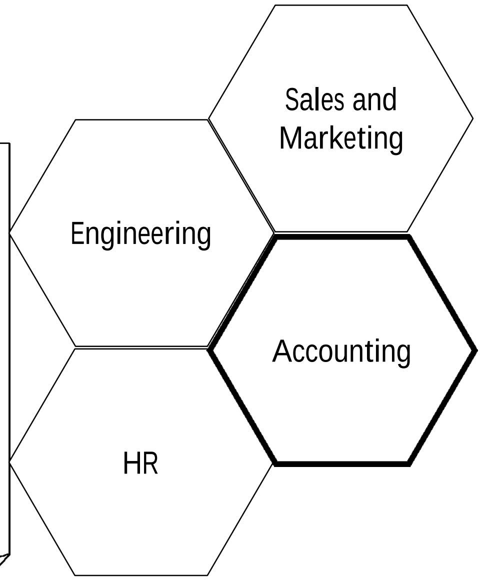
- Financial or historical accounts are calculated from historical records of financial or financially significant transactions. Companies are required to publish a summary of their financial accounts - in the UK, these summaries are known as the statutory accounts.
- Management accounts are calculated from future projections of financial or financially significant transactions. They are used to support management decisions and to express management intentions and policies.
- Sometimes management accounts and plans are published to investors and/or creditors, to support a bid for further capital or to approve an acquisition.


Accounting to Whom
BUT
• Management appoints auditors
• Auditors also do non-audit work
• The published account is supposed to be a “true and fair” statement of the business.
• The account is actually a social construct, influenced by business pressure as well as legal requirements and professional practice.
• The auditor ought to be independent and external - not influenced by business pressure.
Management including directors and financial advisers
accountable to
Stakeholders e.g. investors, creditors, employees, Government
Accountant including directors and financial advisers
published account
Auditor “listens” to the account on behalf of the stakeholders
Accountancy Profession


Practice of Accounting
Accounting Practices
• Double-Entry Book-Keeping
• Inventory Control
• Cost Control
• Asset Management
Mythological History of Accounting
• Roots in Mediaeval Italy
Accounting as Discursive Practice
• Language for a conversation between {x,y,z} resulting in {a,b,c}
Balance Sheet
Assets
Liabilities
Profit and Loss
Income
Expenses
Cash Flow
Cash Inwards
Cash Outwards

Accounting as Projection

- Different management perspectives can be reduced or “projected” into an accounting perspective.
- Accounting therefore seems to offer a common (universal) language or currency.
- As a common language, accounting seems especially relevant to highly diversified companies, where there may be many different fields of engineering and styles of marketing.
- Accounting appears to be a clear and simple representation of complex reality.



Content of Accounts

- The value of a business is founded on the assets it possesses
- Only some of the assets it possesses are listed in the accounts
- For example a company may expend large amounts of money on training to improve the skills of its workforce but this investment is not listed as an asset

Intangibles

- Assets known to affect company performance, and therefore the value of a company, but not listed in the accounts are known as intangibles
- Government calculations across Europe indicate that more than half (by value) of the significant assets held by companies are intangible
- Over time the significance of the accounts in other domains such as the legal liabilities of directors has led to the accounts becoming progressively less meaningful

Accounting for Value

- Shareholder Value -- what is the company worth?
- Asset Value -- what are the assets worth?
  - In context
  - Out of context - book value or breakup value
- Profit -- how much value does the company generate?
- Liquidity / Cashflow -- survival value
  - Put simply, a business fails (bankruptcy) when it runs out of cash. This can sometimes happen to highly profitably companies with substantial assets.
  - Example: a small independent record company with a surprise hit record. May go bust, because it cannot handle the negative cashflow.

- In the long term, the different accounts should be consistent.
  - Balance Sheet
  - P & L
  - CashFlow
- In the short term, they may tell very different stories.

Balance Sheet: Assets and Liabilities

Management Goals

- Increase assets and/or increase effective utilization of assets
- Decrease liabilities and/or increase effective control/containment of liabilities

Typical Assets

- Financial - Cash & Investments
- Property - Buildings & Land
- Equipment & Systems
- Contracts - Future Business - Inventory, Work in Progress
- Customer Relationships
- Partnerships, Alliances & Channels
- People, Capability
- Product , Brand, “Goodwill”
- Information & Knowledge, Intellectual Property
- Business Opportunities

Typical Liabilities

- Contract Obligations - Future Costs
- Expenses & Overheads
- Regulations
- Bad Publicity
- Business Threats

A poorly managed asset can become a liability. (Example: legacy computer system) →

← Effective management of a liability can become an asset.

The Value of Assets

Financial Accounting View

– Value is constructed by the rules of auditing.

- Asset must be separable and uniquely identifiable.
- The asset must be in control of the firm, and the firm owns any benefits accruing from the asset.
- There must be a market where its value can be determined.

Finance Theory View

– Value is derived from a prediction of future cash flows.

- Value of the whole firm is decomposed into the assumed value of separate assets.

Intangible Assets

- It's sometimes difficult enough to measure the value of tangible assets - such as buildings and equipment.
- It's even more difficult to get a "true and fair" estimate of the value of intangible assets.
  – Brand
  – Knowledge
  – People
- It's one thing to assert that "Our People are Our Greatest Asset". It's quite another to persuade the accountants to put the human capital onto the balance sheet.

- For some businesses, practically all the assets are intangible.
  – Designer label company - Brand
  – Drug company - Knowledge
  – Football Club - Players
  – Dot.Com startup - Customers
- In such cases, the accountants may be persuaded to "capitalize" the value of these assets.
- This has important management implications - because any actions to develop or enhance these assets can now be clearly linked to shareholder value.

Which is the True Value of a Company?

Balance Sheet Value

- Companies are valued at fixed intervals - for example, year end. Large companies publish accounts quarterly or even monthly.
- The value of the company is the surplus of assets over liabilities.
- This surplus "belongs" to the shareholders. The surplus is thus regarded as the liability of the company to its shareholders.
- In the published accounts, the total assets of a company exactly balances the total liabilities (including the shareholder surplus).

Stock Market Value

- The market capitalization of the company is calculated from the stock market price.
- The stock market value can be quite different to the balance sheet value.
- Whereas the balance sheet is only published monthly or quarterly, stock market prices can fluctuate every day.
- The stock market price is therefore nearly always more up-to-date than the latest published accounts.
- *But is it more accurate?*

The Value of Projects

Cost-Benefit Analysis

- Benefits and costs are modelled as future cash flows.
- Cash flows are compared at a fixed baseline (e.g. Net Present Value NPV)
- Risks may be modelled in three ways
  - as probability-weighted future cash flows
  - as hedging costs / insurance premium
  - as premium on the cost of capital ("beta")

Cost-Benefit Analysis

- Result is extremely sensitive to the scoping of the system
  - Which/whose costs, benefits and risks are counted?
  - Over what time horizon?

Budgets

- A budget is a declared expectation of future financial activity.
  - Usually focused on expenditure
- Budgets arise from a budgeting process, which may be
  - Top-down, bottom-up or both
  - Imposed or negotiated
- Question: Do budgets (and sales quotas) need to add up?
  - For example, must the travel budget for the whole company equal the sum of the travel budgets for each department?

<u>Koch International (KI)</u>

- KI has no budgets or budget systems.
- KI CEO Charles Koch believes that budgeting
  - is not a value-adding activity.
  - assumes availability of critical information.
  - Is inconsistent with delegating decision-making authority
- KI expects employees to constantly make decisions to maximize the value of the firm.

Capital

Capital and Labour

- Although some goods and raw materials are supplied by Nature, most economic value comes directly or indirectly from human work, past or present.
- Work done by machines, animals and land may be regarded by economists as derived from the past human work of inventing, making and programming the machines, taming the animals and preparing the land.
- The stored-up results of past human work (physical and mental) is known as Capital.

Capital-Intensive and Labour-Intensive

- Present work may involve a combination of Labour (i.e. present work) and Capital (i.e. past work).
- Industrial processes are known as 'capital-intensive' if they require more capital than labour, and 'labour-intensive' if they require more labour than capital.
- For many processes, there is a range of possible methods, with different ratios of capital to labour.

ROI is King

- ROI (Return on Investment) is a measure of the productivity of capital.
- The higher the perceived risk, the higher the return that must be promised to persuade people to invest.
- The higher the promised return, the higher the implicit risk.
  - There is no free lunch.

- Companies are expected to use the available funds productively.
- Directors often like to retain profits in the company, to enable the company to grow (e.g. by investing in new products, or by acquisition).
- However, if they cannot deliver a respectable ROI, it will be better to return excess funds to the shareholders (e.g. as dividend).

Earnings

Why Earnings?

- EBITA - earnings before interest & tax - measures operating profit
- Headline Earnings - separates "platform" from trading activity on platform
- P/E - value of the shares expressed as a multiple of the value of earnings - a key indicator of shareholder value
  - The P/E ratio is quoted next to the share price and dividend yield in the city pages of many newspapers.
  - If the P/E is high, it means that investors are happy to buy shares at a relatively high price because they expect earnings to increase.

Problems

- Historic earnings exclude "extraordinary" items.
  - But what counts as "ordinary"?
  - Many companies reckoned costs incurred after Sept 11 as "extraordinary".
- Use of financial derivatives blurs boundary between operating profit and financial engineering.
- Forward earnings is based on forecast cash flows.
  - Whose forecast?

Accountancy Perspective

- strengths and weaknesses
- power

- What phenomena are easily visible from an accountancy perspective?
- What phenomena are not easily visible from an accountancy perspective.
- What kinds of truth is the accountancy perspective designed to uncover?
- What kinds of illusion or misconception might the accountancy perspective be susceptible to?

- It is sometimes said that American businesses are run by lawyers, British businesses by accountants, and German businesses by engineers.
- To the extent that this might be true, what consequences would you expect it to have?

Sample Exam Question

- Accountants are often regarded as "mere bean-counters", and yet many accountants become successful business executives.
- Explain this apparent paradox, with reference to accountancy as a discursive practice.

- *A satisfactory answer will explain that accountancy is not just a set of techniques and activities (book-keeping) but establishes a dominant language for business. Accountants are seen as the masters of this dominant language, and this confers power and success. Success is largely measured by accountancy.*
- *An above-average answer will acknowledge this power, and will go on to question the validity and completeness of this language, with clear indication of the possible gaps and distortions in this language. It will distinguish between "accountancy" as a discursive practice, and the career paths of trained accountants.*
- *An excellent answer might discuss the nature of success for a business executive, and the degree to which a trained accountant can and must go beyond accountancy practice to achieve success – even in terms of accountancy. It might show how rivals for top management positions (such as engineers) are also caught within their own discursive practices.*

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